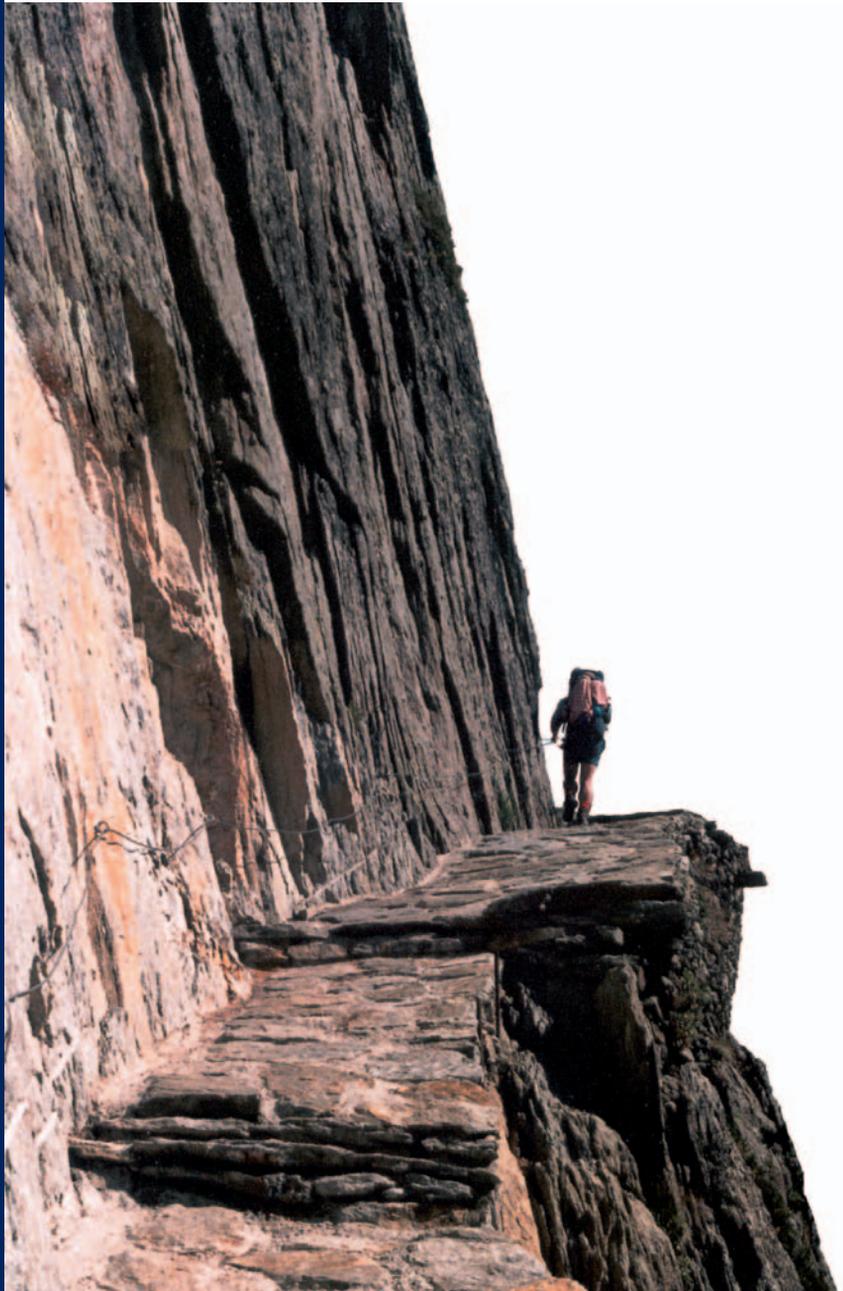


ALFRED M.H. SLAGER

# Banking Across Borders



# **Banking across Borders**

**Grensoverschrijdend bankieren**

Proefschrift

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aan de Erasmus Universiteit Rotterdam  
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# **Introduction**



# 1 Introduction

This study assesses the international expansion strategies of a sample of large banks between 1980 and 2000. Why and how were such strategies formed, did these strategies positively influence profitability, and did shareholders gain by them? A bank plays a pivotal role in the economy. As a mediator between the savers and investors it facilitates economic growth, and as creator of money it is vital for financial stability. The pivotal role broadens when the banks extend banking activities beyond the national border. Dozens of the largest banks in the world have been struggling toward a new organizational model where terms as home market seem to become a by-product in a broader strategic vision.

Swiss bank UBS, the fifth largest bank in the world measured by assets in 2000, has more than 80% of its assets outside Switzerland. Netherlands based bank ABN Amro owns a retail branch network in Brazil, 9,500 km from Amsterdam which constituted 15% of total profits in 2000. Successes in international banking are few, failures have been common. One of the more spectacular failures was the acquisition of American Crocker bank by British Midland bank in 1981, costing the bank one billion dollars over the next five years and forcing its strategy to retreat on the English retail banking market. Midland was acquired by Hong Kong based bank HSBC in 1992, a bank who subsequently showed that internationalization can be a profitable activity.

Internationalization of banks is not a new phenomenon. In 1913 there were approximately 2,600 branches of foreign banks worldwide. The dominating factor at that time was colonization, over 80% of those branches belonged to British banks. The share of foreign banks accounted for one third of banking assets in Latin America and over one half in countries like South Africa, Turkey or China (Goldsmith, 1969). The financial empire of J.P. Morgan started out as a partnership financing American civil war loans from England (Chernow, 1998). International banking has in some respects not changed that much. Over time, innovations in financial instruments, telecommunication, information technology, organization innovation and the growing sophistication of customers have meant a dramatic transformation in the conduct of banking business and client relationships in international banking.

What sets the current internationalization of banks apart, and why does it merit a study? The major reason is that the sheer size of international involvement of banks has

increased dramatically (cf. De Nicoló et al., 2003). Foreign assets of the thirty largest banks as a percentage of total assets have changed from 35% in 1980 to over 41% in 2000. The absolute size of foreign assets of the thirty largest banks has risen eightfold from 650 billion US dollar in 1990 to 5,177 billion US dollar in 2000. The increasing importance of foreign activities has affected profitability and stability of internationalizing banks in their home country; it can also have serious effects - positive as well as negative - on the host economies. The vehemence with which banks have pursued internationalization strategies also warrants an investigation.

The dissolution of the British Empire meant that British banks represented the "old" internationalization of banking. American banks on the other hand have been on the rise since the Second World War. American financial aid, exports of American firms and the export of American ideology such as freeing of competition or creation of uniform markets were feeding ground for internationalization activities of American banks, usually using London as a springboard for activities in Europe and reversing the decline of London as a financial center as a side effect. From the 1960s onwards income in Western economies rose and banks developed more financial products to cater households and businesses as increasing scale of firms raised transaction volumes in corporate finance. American banks formed an apparent threat, seeking out the more profitable activities in investment banking in Europe, being equipped with better staff, more financial resources and more experience.

The creation of off shore markets to circumvent (American) regulation and the political potential of seizure of capital belonging to communist states induced the first series of international activities, later propelled by the inflation of capital markets when oil producing countries forced serious wealth transfers. European banks either tried to work together in consortium banks to participate in these activities (which in the beginning was a cost saving and knowledge rewarding construction) or set up foreign activities themselves. Redistribution of the surpluses of oil producing countries found their way to emerging markets, with American banks leading the way. The growing volume of loans masked growing economic imbalances, brought to light from 1981 onwards when Latin American countries defaulted in their loans. Internationalization of banks became a worldwide event. Institutions like the IMF aided governments with restructuring loans, dealing with severed banks and capital markets in distress. Governments of the lender banks, especially the United States, faced potential crisis at home when the losses in emerging markets were transferred by the large banks to their home country.

A consequence of this restructuring period was that in the 1980s capital strength and adequate supervision of internationally operating banks were major issues for bank regulators. A major coordination initiative took place in the Basle Accord of 1988, creating more transparency and uniformity among regulatory policies for internationally active banks. Among others, the Basle Accord became one of the drivers for the Japanese banks to retreat from the international arena. Japanese banks increased international activities sharply from the early 1980s fuelled by strong domestic economic growth, a fast pace of deregulation, and large flows of foreign direct investment by Japanese industrial firms. The Japanese stock market decline from 1989 showed that (international) banking strategies

had not been based on sound banking practices, affecting bank capital and loan quality at the same time. Japanese banks found ways to stave off restructuring of their bad loans for almost a decade, contributing substantially to the prolongation of economic recession, and steadily retreating their importance in international banking.

A general trend fuelling international activities was the ongoing process of disintermediation from mid-1960: large firms found it more profitable to arrange loans directly with institutional investors, thereby bypassing the role of banks as financial intermediaries. Additionally, stricter monetary policies introduced from the late 1970s onwards eventually led to a steady decrease of interest rates consequently lowering income from the core business of banks. These trends forced banks to reconsider their strategic business portfolios. Non-interest income, especially the high margins of fees and commissions in investment banking, became a promising route. The liberalization of British securities markets in 1984 was followed by an unprecedented wave of acquisitions by host banks. By the end of the 1990s British owned investment banks or securities houses in London were few in number; London as an important financial center had become a manifest of internationalization activities of banks.

Internationalization of banks was also a response to further regional integration and deregulation (cf. Group of Ten, 2001). In Europe especially, banks were aware that the competition for larger clients extended over the geographic borders, but the competition for retail clients remained a domestic issue. By the mid-1980s European integration created momentum in Europe, redefining markets for banking activities on a multinational scale. Mergers and acquisitions became an important strategic tool for banks. They generally took place in two phases: domestic consolidation and then, international expansion; the creation of higher domestic concentration in order to more effectively compete internationally. Opportunity was provided by the capital markets (lower interest rates and higher stock market prices) and the regulators, privatizing banks or not opposing the takeovers.

The close of the decade shows the financial might of just a handful of banks: the top 25 banks in 1980 had total assets of 1,858 billion US dollar, equal to 30% of GDP. In 2000 this had risen to 64% of GDP, a combined total of 12,781 billion US dollar. Of this amount, 41% are assets outside the home country. In fact, foreign banks practically control the banking sectors in many Eastern European countries; for some observers the "single global banking space is almost a reality" (Mullineux and Murinde, 2003, p. 3). The foreign owned assets of the largest banks exhibit uneven geographic patterns, "regions and/or countries of the developed world currently represent the most interconnected cluster of national banking systems" (de Nicoló et al., 2003, p. 18).

### **1.1. Research debates**

The subject of internationalization of banks as a research subject combines two separate research debates: on international business and on financial intermediation. The overlap of these debates concerns the internationalization of banking.

The theory of banking is based on the concept of *financial intermediation*. Theories of financial intermediation in general assess the allocation of capital in an economy, where the bank intermediates between savers and borrowers, transforming wealth into loans and monitoring the loan process. Bank intermediation should theoretically lower transaction costs for both parties and is basically welfare enhancing. Debates in financial intermediation have centered on a number of themes: the construction and evaluation of new financial instruments<sup>1</sup>, the roles actors play in financial intermediation, the role of risk, and the relationship between financial intermediation and economy.

The field of interest has gradually shifted from explaining the existence of financial intermediaries (why do we need financial intermediaries) to describing their behavior, embedding financial intermediaries in the general capital structure theories. The main question has been: if the allocation process of markets is efficient, why is there a need for financial intermediation? Two converging routes have been taken on this subject. If the allocation process of markets is less than perfect, what value could a financial intermediary offer under these conditions? On the other hand, what does a bank actually do, and is this a function which can be solely done by a financial intermediary: what is the uniqueness?

The introduction of information asymmetries and agency costs to model financial intermediation behavior has been a major step forward, notably by Jensen and Meckling (1976): how are incentives for behavior allocated among borrowers and lenders, and what happens if they change? Leland and Pyle (1977) argued that information asymmetries lead to the existence of financial intermediation. Diamond (1984) showed that financial intermediaries, when aiming to reduce monitoring costs to resolve incentive problems between borrowers and lenders, reduce these costs through diversification. Boyd and Prescott (1986) extended the role of financial intermediation and deduced that financial intermediaries arise when agents' private information is to be allocated efficiently.

At an aggregated level the relationship between financial intermediation and the economy is another research subject; more specifically the design of a financial system where financial intermediaries operate, and its effects on financial stability and the economy. Compared to *International business*, theories of financial intermediation have a methodological advantage because there is a natural boundary of what its research encompasses: financial intermediation and the financial system and markets in which it exists.

*International business*, the internationalization of firms, has a far broader scope as its research field. Toyne and Nigh (1998) identify two paradigms that have dominated and guided much of the international business inquiry for at least the last 40 years: the extension paradigm and cross-border management paradigm. The extension paradigm, reflecting the outward pattern of US firms, presents international business as the extension of a firm's activities across national borders. Adjustment and adaptation of the activities is studied because environmental differences are found to exist between the firm's home and its host countries. The firm is the unit of analysis, and research questions are those asked in

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<sup>1</sup> A large part of studies in financial intermediation tend to focus on the valuation and assessment of financial instruments. This will not be discussed here.

a nation-bound setting for disciplines like production, finance and marketing. This form of international business research is traditional in the sense that the questions, knowledge and methodological framework are also applied in existing research to study nation bound firm behavior.

The cross-border management paradigm focuses attention on the problems that arise from the movement of goods and capital across national boundaries and the monitoring, coordinating, and integrating of operations and activities existing in more than one country. This model presents international business as distinct from nation bound business because the managerial environment is more diverse (governmental entry barriers, foreign exchange risk, international taxation, logistics). For both the extension and cross-border paradigm, a firm level approach prevails. Another issue guiding the international business literature is the theoretical conceptualization of that particular research field. International business research draws on the extension of existing research fields necessitating the need for a unified framework to guide international business research to ask systematically questions and relate findings (Sullivan, 1998, p. 877).

Another debate centers on the location patterns of business behavior. Location patterns have emerged as a serious research topic since the 1950s, stemming from economic geography. This represents a blend of deterministic theories (Vernon), common business sense and reasoning from regulatory constraints. Are patterns to some extent deterministic or are there no common elements to be found between different firms? Are the changes in patterns, i.e. organizational commitment and involvement, different? Location patterns bear particular relevance to internationalization strategies, with the emergence of financial centers.

This study will be embedded in financial intermediation theories and international business theories. The research subject of this study is banks; they are the subject of financial intermediation theories and will be analyzed here within a framework of international business theories. A drawback might be that the study is susceptible to eclecticism, grazing over a multitude of theories with the possible temptation to select one or more to support reported findings to fit into or modify the theoretical framework. Two broad research fields are combined, with the possibility that neither of them is done justice. To counter this, a framework is constructed which outlines the premises and boundaries to investigate the internationalization activities and strategies of banks.

## **1.2. Research question and contribution of this study**

The main questions to be answered are: how has internationalization of the largest banks evolved, and to which degree has the internationalization of banking contributed to the financial performance of the banks and to shareholders value. The focus of the study is on the internationalization of banking between 1980 and 2000, and addresses two main issues:

- The *patterns* of internationalization strategy of banks and
- The *effectiveness* of internationalization strategy of banks.

The approach adopted consists of three distinct steps; first a framework is created to systematically analyze internationalization strategies of banks (*Concepts*). Second, differences and commonalities in the internationalization strategies are described and analyzed (*Patterns*). What have been the banks' realized internationalization strategies: did banks pursue the strategies independently, and what did the strategies have in common? Third, the study examines the *Effectiveness* of the realized strategies. How has internationalization contributed to the profit and loss development of banks, and have shareholders gained by it? Finally some implications for the near future are presented. For example, will the current asset seeking strategies of large international reach a natural limit, what future strategies might benefit shareholders most, and are internationally active banks catalysts to change financial systems?

What does this study contribute to the existing research on this field and where can it be positioned?

- It first of all builds on research of Canals (1993) on European banking strategies, updating it with developments over the last ten years, and extending the comparative analysis with banks in the United States and Japan.
- Second, it aims at a systematic description and analysis of internationalization strategies. Authors like Canals (1993, 1997), Walter (1988), Smith and Walter (1990, 1997) have published extensively on banking strategies. This study adds a broad and comprehensive analysis to this line of research.
- Third, the study contributes to the research field by extending the time period of analysis to 20 years, quantifying the extent of internationalization by measuring the degree of internationalization with the Trans Nationality Index (TNI) and addressing the question of effectiveness of the banks' strategies.

### **1.3. Research method**

The scope of this study is broad. The advantage is that an integral view of internationalization is pursued, leaving ample room to observe and analyze other interesting events and/or episodes which otherwise would have been left out of the analysis. The broad scope is also the limitation of this study. Investigating a large number of banks in different countries over a longer period prohibits a rigorous single econometrical approach, due to lack of data.

The purpose of the research design is to investigate and to measure the relationships between the measures representing internationalization strategy, financial key figures for domestic and foreign bank activities, and economic variables. The research design was to take a sample of the five largest banks of the United States, United Kingdom, Netherlands, France, Germany, Spain, Japan and Switzerland, assembling this list for 5 year periods between 1980 and 2000. Banks were initially selected for the benchmark year 1995, and this list of banks has been expanded prior to 1995 to include mergers, acquisitions and

relocation of banks. Published information in annual reports, newspapers, databases and other accessible sources have been collected and entered in a database, based on the theoretical framework developed. Subsequently, analyses of internationalization strategies have been constructed per bank as separate case studies.

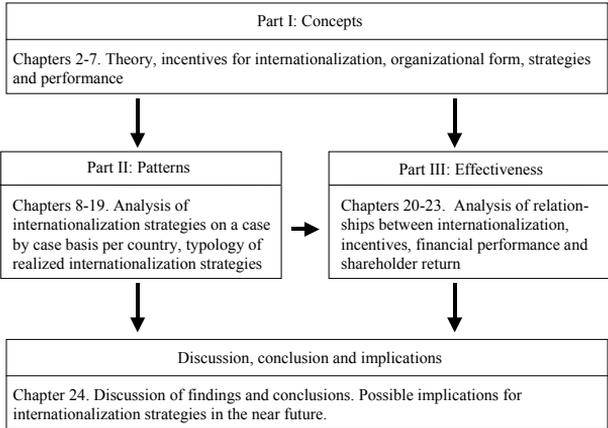
Internationalization of banks started well before 1980; this year was however chosen as the starting point of analysis for two reasons. First, 1980 is a natural demarcation point in the internationalization strategies of banks. The emerging market loans crises that erupted a year later started a decade of reorientation on the role of international activities of banks. The reorientation also has substantially influenced internationalization activities of banks in the 1990s. Second, 1980 as a starting year has also been chosen for data availability reasons. In 1980, the largest American and British banks were at the height of their internationalization (and disclosed financial geographical information) while the majority of banks in the sample were starting to increase their international banking activities (and therefore began to disclosure more financial geographical information).

The case study information was combined with quantitative information on internationalization. Income statement and balance sheet information have been dissected if possible into home and host information. The analysis proceeds with the addition of shareholder value, testing its relationships with internationalization strategy and financial statements. Relationships are tested on basis of hypotheses developed in Chapter 7, as conclusion of the theoretical framework.

**1.4. Outline study**

The study is organized in 24 chapters and three parts. The outline of the study is summarized in Figure 1.1.

Figure 1.1. *Outline of the study*



Part I, *Concepts*, explores the theoretical foundations of internationalization strategies of banks. Chapter 2 is a prelude to international financial intermediation and presents an overview of financial intermediation. What are the characteristics of banks? Functions, activities and products of financial intermediation are reviewed. The role financial intermediation plays within the economy is considered, leading to a stylized description of different financial systems. The transformation from financial intermediation to international financial intermediation is the subject of Chapter 3. Incentives mentioned and investigated in literature are summarized and discussed. An attempt is made to cluster the incentives. The transition from incentives to actions is considered in Chapter 4 (organizational form), Chapter 5 (formulation of international strategies) and Chapter 6 (resulting performance).

Chapter 4 considers the implementation of internationalization strategy, such as focus and organizational form. Which clients and what sort of services can the bank target in which country. Which organizational form can a bank choose in the host country to achieve its goals. By now a number of ingredients for formulating and implementing a strategy have been reviewed. In Chapter 5, the question is which strategic goals can be formulated in general for banks? Literature review shows that such a summation has not been developed for banks specifically, so existing typologies for strategic goals are adapted for the internationalization of banks. Financial performance related to internationalization of banks is the subject of Chapter 6. What relationships have been investigated between performance and international banking activities, market structures or country characteristics? The concluding chapter in this part is Chapter 7. The complete framework to analyze internationalization strategies of banks is presented, and will be empirically investigated in Part II (patterns of internationalization strategies) and Part III (effectiveness of internationalization strategies).

Part II, *Patterns*, is a case study oriented approach to internationalization strategies, focusing on strategic similarity issues (cf. Molyneux, 2003). What were these internationalization strategies and how have they evolved? Have they something in common, and is this commonality related to country of origin, period considered, other identifiable factors? As an introduction, developments affecting all banks to some extent between 1980 and 2000 are reviewed in Chapter 8. The sample is considered in more detail in chapter 9. Representativeness is considered: by selecting the largest banks, do they have different characteristics compared to a larger sample? Finally, major developments in income and balance sheet are considered.

Subsequently the internationalization of banks is presented, adopting the Trans Nationality Index (TNI) as a commonly used measure to represent the degree of internationalization of banks. The development of TNI is discussed for different dimensions, comparing countries and time periods. Also, relationships between TNI and other financial measures are investigated, as is internationalization in the home region (Chapter 10). Chapters 11 through 18 consider the internationalization strategies of the largest banks in the Netherlands, Germany, France, Switzerland, United Kingdom, Spain, United States and Japan. In each chapter, a brief overview of country specific incentives

related to the internationalization of banks or the entry of foreign banks is presented. How has the banking industry in general evolved, to which influences has it been susceptible, and how has this helped to shape internationalization strategies? Which role has government played, for instance through regulation? Next, has foreign presence been a significant factor? The chapter then presents a description of internationalization strategies of the banks in the sample, concluding with a comparative analysis.

Part II concludes with an integral analysis of the internationalization strategies of the banks discussed in earlier chapters. Can commonalities in internationalization strategies be observed and if so, on a country basis or for different periods. Possible implications of these results are discussed (Chapter 19).

Part III, *Effectiveness*, examines the relationships between the banks' internationalization and incentives, strategies, performance and shareholder return. This part investigates the hypotheses formulated at the end on part I. Basically, the following questions are asked:

- What relationships exist between the level of TNI (Trans Nationality Index) and incentives to internationalize (Chapter 20)?
- Have international activities delivered a better performance than home country activities, and what relationships exist between performance measures of banks and TNI (Chapter 21)?
- What relationships exist between strategic typology, performance measures and TNI (Chapter 22)?
- Is the TNI, strategy or its performance related to shareholder return? Are incentives related to shareholder return (Chapter 23)?

The findings of Part II and Part III are reviewed in chapter 24 and discussed; implications are considered for internationalization activities of banks for the near future.



# **Part 1**

## **Concepts**



# Introduction to Part 1

Part I reviews the theoretical foundations for internationalization strategies of banks, and integrates them in a framework. This framework is then applied in Part II and Part III to analyze differences, commonalities and effectiveness of internationalization strategies of banks.

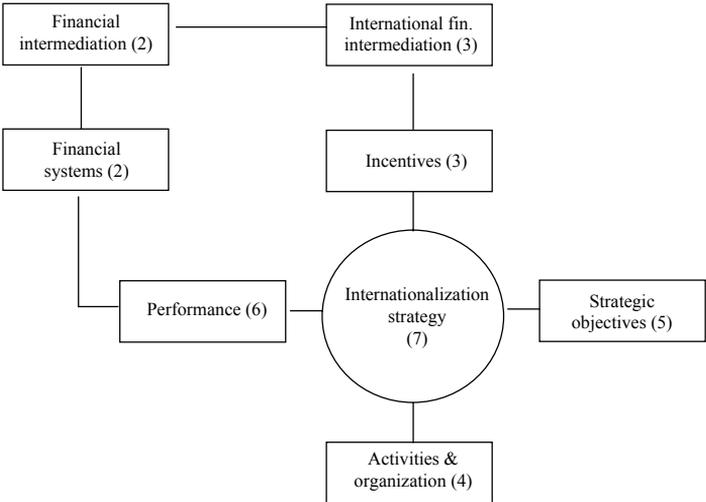
A definition of strategy is the organization's determination of the basic long term goals and objectives, the adoption of courses of action, and the allocation of resources to achieve the goals. An internationalization strategy of a bank then implies 1) an incentive to form long term goals resulting in 2) organizational objectives and 3) an activity outside the home country, or in the home country in relation to activities in a foreign country or region. This leads to the following research questions:

- What are the specific characteristics of banks? An exhaustive literature has been built up on the subject of financial intermediation, the theoretical framework for a bank. Functions, activities and products of financial intermediation are reviewed in chapter 2. Also the role financial intermediation plays within the economy is considered, leading to a stylized description of different financial systems.
- What sets international financial intermediation apart from financial intermediation, and why pursue international financial intermediation? Chapter 3 reviews incentives for banks to internationalize. Can these incentives be clustered and can something be said about their relative importance as a driver to internationalize?
- The implementation of international financial intermediation as a worthwhile activity leads to practical issues such as focus and organizational form. Which clients should the bank target in what country. Not less important, what sort of services should be provided. Do any of these questions have a relationship with the clients of the bank in the home country? Also which organizational form should a bank choose in the host country to achieve its goal, i.e. what organizational form suits which purpose best? These issues are covered in chapter 4.

- In chapter 5, the question is which strategic goals can be formulated in general for banks. Literature review shows that such a summation has not been developed for banks specifically, so existing typologies for strategic goals are adapted to include the internationalization of banks.
- Research on the performance of banks, and performance of internationalization activities of banks are reviewed in chapter 6. What relationships have been found between performance and international banking activities, market structures or country characteristics?
- Chapter 7 summarizes part I, and presents a framework to analyze internationalization strategies of banks, and formulate stylized hypotheses within the framework. These hypotheses are empirically investigated in Part III.

The following figure represents the discussion of Part I. The numbers between brackets in the figure correspond with the chapters.

*Design of discussion in Part I: Concepts*



## 2 Financial Intermediation

What are the specific characteristics of banks? This is the research subject of financial intermediation, the theoretical foundation for banks. Financial intermediation exists because risks and costs related to financial intermediation functions are expected to be lower when organized by a bank. A brief review of the literature is presented. Functions, activities and products of financial intermediation are considered. Finally the role financial intermediation plays within the economy is considered, leading to a stylized description of different financial systems, each with distinct consequences for the role of the financial intermediary.

A financial intermediary can be characterized from three different angles. The first angle is its function: what is its contribution to the economy. Financial intermediation theories have evolved around this theme: why do banks exist, what kind of potential externalities do they create, and how do economic systems cope with this? Once a function is defined, an activity is the next step to denote the work or duties to be organized for this function. Activities thus embody the implementation of a function in an organization. The third angle to consider is the actual production of these activities. Several product groups can be classified as a result of one or more activities. One element all banking products have in common is that they are a service, whose characteristics will be reviewed.

The roles banks play within an economy have to be explored more thoroughly as this might have some bearing on future discussions: do banks in different financial systems have specific internationalization characteristics in common? The role of banks depends heavily on the design of the financial system within an economy. Three stylized variants of financial systems are considered: bank oriented, market oriented and institution directed. Their characteristics are reviewed. Do financial systems change and what can be said about their dynamic evolution?

### 2.1. Financial intermediation

Theories of financial intermediation are in general based on the allocation of capital in an economy. The field of interest has gradually shifted from explaining the existence of

financial intermediaries to describing their behavior. Part of this role is related to embedding financial intermediaries in the general capital structure theories. With capital structure and financing, the seminal work of Miller and Modigliani in the 1950s which stated that capital structure does not matter (a fact disputed by actual observation) set off a stream of research mitigating the extreme consequences of this theory.<sup>1</sup> Within investments, the efficient market hypotheses and the Capital Asset Pricing Model developed in the 1970s led to the conclusion that active investment policies should be rendered useless within efficient markets. This took more than twenty years to repute, and discussion is still going on.

The development of financial intermediation theories, prodding along the same path, seems to have evolved along a similar path. The main question has been: if the allocation process of markets is efficient, why is there a need for financial intermediation? Two converging routes have been taken on this subject. If the allocation process of markets is less than perfect, what value does a financial intermediary offer in such a circumstance? On the other hand, what does a bank actually do, and is this a function which can be solely done by a financial intermediary (what is the uniqueness).

Literature on the subject has been steadily growing since the 1970s with the introduction of information asymmetries and agency costs, notably by Jensen and Meckling (1976). Informational asymmetries lead to the existence of financial intermediation (Leland and Pyle, 1977). When aiming to reduce monitoring costs to resolve incentive problems between borrowers and lenders, Diamond (1984) showed that financial intermediaries reduce these costs through diversification. Boyd and Prescott (1986) extended the role of financial intermediation and deduced that financial intermediaries arise when agents' private information is to be allocated efficiently. Developments in real markets have set their mark on financial intermediation theories too. Allen and Santemero (1998) viewed the new markets for derivatives as mainly markets for financial intermediaries. A new role arose for financial intermediaries which is difficult to reconcile with aforementioned "traditional" financial intermediation theories, they concluded that risk had to be more strongly incorporated into financial intermediation theories.

Kroes (1996, p. 7) found that "there is no need for financial intermediaries in a perfect capital market, so that the existence of financial intermediation can be explained as the optimal response to capital imperfections". There has to be a technology in the credit market to (partially) overcome one or more of these imperfections, and this technology must display some economies of scale or scope leading to the concentration of these activities in a limited number of agents, i.e. financial intermediaries. On a macro-economic scale, Bryant viewed financial intermediation as "the complex process through which the

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<sup>1</sup> With the capital structure discussion started by Modigliani and Miller, the main argument to be repudiated has been the irrelevance of capital structure (2001, pp. 75-76). A large part of financial intermediation theories seem to have the same problem: how to repudiate the irrelevance of financial intermediaries. This argument has been forwarded by Fama (1980). See for a review of capital structure theories Harris and Raviv (1991) or Prasad et al. (2001).

differing needs of the ultimate savers and ultimate investors are reconciled" (Bryant, 1987, p. 6). Freixas and Rochet (1997, p. 15) narrowed financial intermediation down to the "specialization of an economic agent in the activities of buying and selling (at the same time) financial contracts and securities".

A financial intermediary therefore exists because the risks and costs of organizing financial intermediation activities through a company are expected to be lower than if these activities are organized and carried out through open markets (Canals, 1997, p. 115). This argument raises two questions: what are these risks and costs and how can they be lowered, and just how important are these risks and costs?

One way of analyzing market imperfections and the resulting type of financial intermediation is done by emphasizing the relationship between balance sheet items of a financial intermediary (De Bondt, 1998, p. 274; Kroes, 1996, p. 6). Combining assets and liabilities, risk reduction can first of all be achieved through the insurance principle which is essentially a combination of the law of large numbers and modern portfolio theory. Because of the low correlation between withdrawals by depositors (liabilities) and loans (assets), the financial intermediary could be modeled as a portfolio manager in accordance with the modern portfolio theory. The law of large numbers also has its impact on the second element of risk reduction, liquidity insurance. Provided that random changes of cash needs are not perfectly correlated between households, the total cash reserve needed by the financial intermediary will rise proportionally less than the need of the individual household. The financial intermediary can take advantage of this liquidity insurance by providing enough ready available cash to provide those random needs, and using the excess wealth to extend loans. Thus liquidity insurance is also one of the funding elements of asset transformation.

A financial intermediary must have technology and economies of scale and scope resulting in a cost advantage to overcome market imperfections, notably through the potential reduction in transaction costs and asymmetric information. Scholtens (1991, pp. 18-21) divides costs into contract costs, exchange costs and information costs. Administration, (re)negotiation and bonding costs are all associated with contract costs. Exchange costs are related to the purchase of goods and services. Providing checking accounts to do payments not only lowers risks but also the costs. Transformation costs refer to costs of generating information necessary for financial transactions: searching, administering, monitoring, screening and verifying (Scholtens, 1998, p. 274).

Cost advantage to overcome market imperfections, through the reduction of transaction costs, has not been enough to solely base the existence of financial intermediation on, especially if one takes into account that most aforementioned measures of cost must have fallen dramatically over the last decades through deregulation and advances in information technology. As a response the subject of informational asymmetry as a cause of monitoring costs has grown in importance. Informational asymmetry exists because firm managers are assumed to possess private information about the characteristics of their firm's expected results that investors do not have (Scholtens, 1991, p. 306). Asymmetric information about the prospects of the firm can lead to different

objectives that were not agreed upon when drawing up the financial contract. The costs associated with realigning these different objectives can be partially mitigated by the firm itself (signaling) and by the financial intermediary. Financial intermediation can therefore be modeled as a natural response to the existence of asymmetric information.

With asymmetric information, financial intermediaries are viewed as information sharing coalitions and delegated monitors who act on the depositor's behalf (Saunders, 1994, p. 54). Once wealth is redistributed households should monitor further activities of the firm, at least to ensure loan redemption. Any household would have to devote a considerable amount of time and money to collect sufficient information to assess what the firm is undertaking. The household would be better off if it could delegate the resulting monitoring and transaction costs. The financial intermediary is the logical choice to delegate this to since it has more information about the firm than households and it has the possibility to apply experiences with other firms to good use with credit rating. The financial intermediary becomes 'an expert in the production of information so that it can sort out superior good credit risk from bad ones' (Scholtens, 1998, p. 275).

Authors reviewing the theories of financial intermediation usually note that the theoretical framework is not yet coherent and still under construction. A topic of increasing importance, as a reflection of the day-to-day activities of financial intermediaries, is the changing role of financial risk. Allen and Santemero (1998, p. 1462) suggest that the theoretical role of financial intermediaries as reducing costs and asymmetric information is too strong. In their view financial intermediaries are "facilitators of risk transfer and deal with the increasingly complex maze of financial instruments and markets". Since the 1970s there has been a steady flow of new derivative related financial instruments all designed to transfer or (re)distribute risk (Allen and Santemero, 1998, pp. 1467-1474).

The financial intermediary can eliminate or avoid risk by business practice such as underwriting standards, due diligence procedures and portfolio diversification. Risk can also be directly transferred to market participants by creating offsetting transactions. Most important is the risk inherent to the activity of a financial intermediary resulting from transforming short-term liquid assets into long term illiquid liabilities.

Scholtens and Van Wensveen (2000, pp. 1247-1248; 2003) agree with Allen and Santemero's central role of risk management for a financial intermediary but argue that risk management traditionally always has been the central theme of financial intermediation, while Alan and Santemoro attribute the increasing role of risk management to the growing importance of new financial instruments. Risk transfer and management is best viewed as an entrepreneurial activity; to place this in a proper context Scholtens and Van Wensveen suggest that financial intermediation theories should be amended: "It should [...] assume a more dynamic concept in which new markets are developed for new products, where financial institutions do not act as 'agents' who intermediate between savers and investors and thus alleviate 'market imperfections' like asymmetric information and participation costs, but are independent market parties that create financial products and whose value added to their clients is the transformation of financial risk, term, scale, location, and liquidity" (Scholtens and Van Wensveen 2000, p. 1249).

### 2.1.1. Functions of financial intermediation

An attempt to define the business of a financial intermediary encompasses the problem of timeliness: the activities of a financial intermediary have changed or are changing so rapidly that it is also preferable to define functions which seem to be more stable, opposed to a focus on the institutions relating to a financial intermediary. Merton and Bodie (1995) have advocated such an approach, identifying six different functions. On the other hand, Greenbaum considered this approach as a variation on an old theme.<sup>2</sup> The basic functions of financial intermediation are summarized in Table 2.1.<sup>3</sup>

In the presence of transaction costs, it is generally more efficient to exchange goods and services for money rather than for other goods and services, like in barter operations (Freixas and Rochet, 1997). *Payment systems* can be viewed as networks that facilitate the transfer of funds between the bank accounts of households and firms. The facilitation takes place through clearing, the processing of payment instructions, whereas settlement refers to the actual transfer of funds (Perold, 1995, p. 33). The safety and efficiency is a fundamental concern for governments and central banks.

Table 2.1. *Functional classification of financial intermediation*<sup>4</sup>

- 
1. Offering access, and provide payment system
  2. Brokerage
  3. Transformation of assets
  4. Managing risk
  5. Process and provide information
- 

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<sup>2</sup> Greenbaum has a different classification than Merton and Bodie (and by inference Freixas and Rochet). He argues that the functions described by Merton et al. all come down to a variation of brokerage or asset transformation. Furthermore, this classification serves the author's purposes and is suggestive as well. According to him, there is no disconvergence between the "old definition" (like the one Saunders gives) and Crane's. Brokerage and asset transformation absorb all of the above mentioned functions. Institutional design should simply be viewed as a channel of distribution for one or more of the functions. Freixas and Rochet expand on the asset transformation function while not explicitly mentioning brokerage. One could argue whether the 'processing of information' function should be considered an asset transformation function. Also, access to a payment system as a function is introduced. To single this one out surely has some merits, especially since negative externalities are closely related to this function.

<sup>3</sup> The table lists the more commonly mentioned functions. Different functions have been defined for financial intermediaries and banks. The basic functions for financial intermediation, brokerage and asset transformation, are forwarded by Saunders (1994, p. 54) and Greenbaum (1996). Freixas and Rochet (1997, p. 2) name four different functions, 1) i.e. access to payment system, 2) asset transformation, 3) risk management, 4) processing information and monitoring. Merton and Bodie (1995) recognize seven different functions for the financial system: 1) access to payments system, 2) pooling and distributing resources, 3) transfer economic resources, 4) risk management, 5) provide information, deal with incentive problem. The comparison of functions between the authors is of course a subjective one, where finesses posed by the authors may have been ignored. Saunders and Greenbaum use brokerage and asset transformation to encompass all functions.

<sup>4</sup> The ordinal listing of the functions cannot necessarily be translated into a hierarchy of these functions. Most authors abstain from such a presentation, although a development of the relative rise (and fall) of each function in itself over time might be construed.

The *brokerage function* is perhaps the narrowest definition one can give to financial intermediation: the specialization of an economic agent in the activities of buying and selling (at the same time) financial contracts and securities (Freixas and Rochet, 1997). Full service brokerage firms carry out research and make recommendations to their clients. They purchase and sell on commission fees. These activities decrease monitoring and transactions costs. More specialized firms only perform the purchase and sell activities.

*Asset transformation* by a bank is also a crucial function. Due to differing needs of buyers and sellers the characteristics of the contracts or securities issued by firms are in general not compatible with the needs of the investors. The consequences of these differing needs are resolved with asset transformation: the financial intermediary issues financial claims which are more appealing to saving households than the claims directly issued by firms (Saunders, 1994). Banks typically must hold these contracts in their balance sheets until they expire: the contracts are non-marketable.

Any asset transformation can be unbundled into a combination of one or more of the following types of transformation: convenience of denomination, quality transformation and maturity transformation. The bank can change the unit size (denomination) of the financial claim in a way that is most convenient for its clients. There is an incentive to venture into quality transformation when banks have better information about the loans than the outsiders. Issuing a claim in its own name then offers a return/risk profile which closer approximates that of the perceived profile than outright securitization. Maturity transformation has the most far-reaching consequences. The maturity transformation relates to the difference in holding period preference between firms and households. A household has compelling reasons not to offer its total amount of excess savings to firms. For example, it can have a precautionary motive to hold more money than required for current transactions because of unforeseeable events (Felderer and Homburg, 1987, p. 86). Furthermore time preferences can differ. The inter-period transfer of wealth (pensions, life insurance) is a strong motive to do so.

Most of the functions of a bank incur some kind of *risk* which the bank has to manage. On an operation level credit risk occurs when loans are or become more risky: the probability of default increases. In general, when loans are more risky, the necessary contracts should be more exhaustive since issues like risk aversion and moral hazard play an important role. Higher monitoring and bonding costs are the result. Besides credit risk the territory of risk can be broadened to interest, liquidity and balance sheet too. The interest rate risk is due to the difference in maturity. Mismanagement of interest rate risk can have severe repercussions for the soundness of a bank (cf. Darroch, 1994, p. 10). Liquidity risk takes place when a bank faces an unexpected number of withdrawals. When this happens liquidity insurance is de facto declared void. A recent phenomenon is off balance risk: instruments that do not correspond to a genuine asset or liability for the bank but are expected to generate a random cash flow.

The final function relates strongly to the monitoring function on behalf of the information sharing coalitions: *processing and providing information* as the delegated

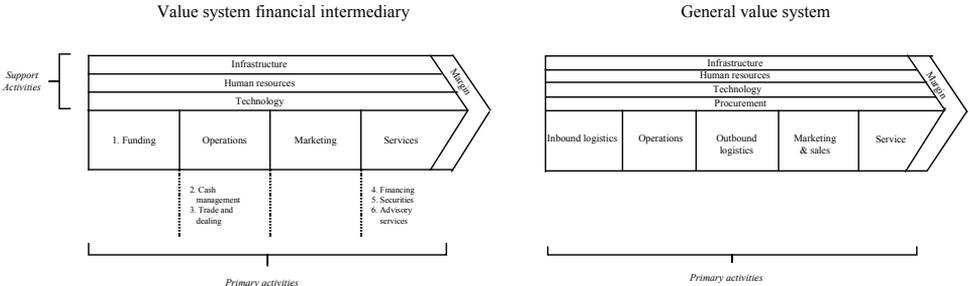
monitor for depositors. This entails the management of some of the problems resulting from imperfect information. A bank has also other motives to process and provide information. Recently the emphasis is gradually shifting to fee based income from interest-based income. The basis for fee-based income is the (re)packaging of information. Processing and providing information then becomes a firm intrinsic goal, instead on behalf of stakeholders.

2.1.2. Activities of financial intermediation

Activities embody the implementation of functions. Porter considers every firm to be ‘a collection of activities that are performed to design, produce, market, deliver, and support its product’ (1985, p. 36). In his conceptual framework all these activities resemble a value chain consisting of value activities and the resulting margin. This value chain is a tool to understand the behavior of costs and the existing and potential sources of differentiation. It is a prerequisite to disaggregate the value activities of the firm.

Activities are divided into primary activities and support activities. Primary activities involve activities needed to create the product or service, to transfer this to the buyer and to deliver after sale service. On the other hand, support activities support the primary activities by providing technology, human resources and infrastructure. Infrastructure does not refer to physical presence but consists of general management, planning, finance etc. A number of distinctive activities can be established, adapting the identification of activities by Walter (1988, pp. 16-19) which seem to adhere nicely to the boundaries Porter applies to define activities. Figure 2.1 shows the value system for a financial intermediary (adapted from Canals, 1993)<sup>5</sup>, compared to a general value system (Porter, 1985, p. 37):

Figure 2.1. Value system of a financial intermediary and a general value system



<sup>5</sup> This figure is based on the value chain by Canals (1993, p. 199). However Canals considers operations as a support activity. This has been changed to a primary activity due to the importance it has in asset transformation and its propensity to generate products and services, such as cash management.

The first primary activity in the value chain for a financial intermediary, *funding*, is synonymous to deposit taking. The bank is entrusted with temporary superfluous savings in exchange for interest payments. These interest payments entail funding costs for the bank. Deposits and current accounts have been the main fuel for the asset transformation function of the bank. Other possibilities are the issuance of commercial paper and medium term notes.

Traditionally *cash management* has been a synonym for the upholding of the payments system: the clearing of accounts between different banks when payments take place. Technological innovations have enabled banks to create new cash management activities - such as cash pooling<sup>6</sup> - which enhance the efficiency of a firm's treasury. Other cash management services include the servicing of debit and credit cards for individual clients.

*Trade and dealing*, the third primary activity in the value chain, is done by a bank on its own behalf. This is also a necessity since banks are active in asset transformation which causes a mismatch risk in maturity of assets and liabilities. Trading has to be undertaken to keep this risk within acceptable limits. On the other hand, if a bank strives to achieve above-average returns, then it can engage in proprietary trading as an intended source of risk.<sup>7</sup> Here, the bank acts on expectations with regard to changes in its own maturity structure, and expectations of market developments.

Another traditional activity (*financing*) is lending to individual households, firms and governments. Applicants have to be screened when applying for a loan, and have to be monitored when the loan is granted. In the 1970s, government budget deficits increased sharply, and international lending became a major international activity, further expanding to multinational institutions (Smith and Walter, 1997, p. 21). Financing also has taken on other shapes, due to changing demands and financial innovation. Traditional lending has been augmented with innovations such as revolving credit agreements. Riskier forms of asset activities include lease financing and project financing. These are "specialized forms of lending that have limited recourse to ultimate borrowers [...], or sometimes none at all" (Smith and Walter, 1997, p. 51).

A bank can also deal in *securities*. First of all, a bank can act as a broker: buying and selling of any tradable financial instrument at the same time on behalf of clients. This requires a well-developed secondary market for securities and high investments in trading technology. Second, a bank can underwrite and distribute new securities. This activity requires collaboration between banks, a high degree of distribution power in the own organization, and the commitment to take substantial underwriting risk, ultimately risking becoming shareholder in the issuing company itself when the underwriting fails.

The term *advisory services* as the sixth primary activity in the value chain embraces a broad range of services, which all have in common that they require a high degree of

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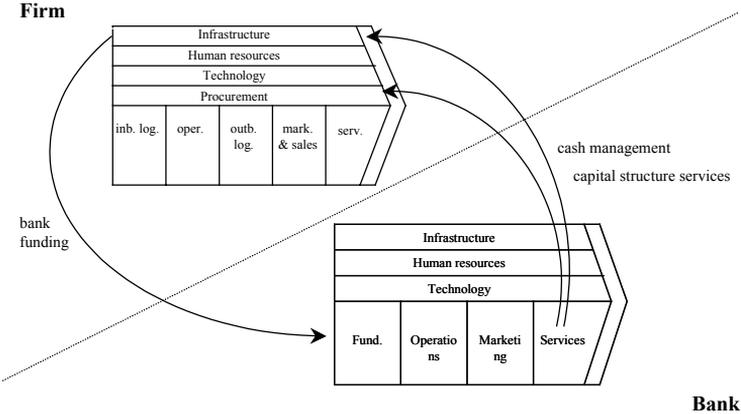
<sup>6</sup> With cash pooling, a firm agrees with the bank only to pay interest over the aggregate balance of all (foreign currency) payment accounts. Since credit interest usually is higher than debit interest, potential savings for the firm can occur.

<sup>7</sup> Based on the premise that risk and return are positively correlated, as stated by theories such as the CAPM.

proprietary expertise, and that the services offered basically combine at least one or more of the above mentioned activities. Three distinctive areas can be distinguished. First of all, a bank can give advice to corporations and institutions. This can include mergers and acquisitions, private placements and other specialized financial advisory services. These activities are usually termed investment-banking activities. Second, a bank can manage assets on behalf of clients, individuals as well as institutions like pension-funds. They also manage in house mutual funds, which are created to serve individual clients in their investment preferences. Finally, there is a range of personal banking activities. This includes the offering of cash management services such as issuance of checks and credit cards, brokerage activities (stockbrokerage and investment advice), the offering of mutual funds and the individual catering of the wealthy clients.

In Figure 2.1, the value systems for a bank and a firm are shown. An important difference between these value systems is that "outbound logistics" is a separate primary function for a firm, but not for a bank. Functions defined as outbound logistics, such as the collection and distribution of information, are integrally part of the service the bank provides. Also, the storage function is not relevant for the bank as service provider. Procurement as a function is left out too for a bank. Funding and procurement basically take on the same meaning within a bank and are treated as a primary activity.

Figure 2.2. Relationship between firm and bank



The interrelationship between the value system of a bank and firm is straightforward (Figure 2.2).<sup>8</sup> Generally, the primary functions of a bank should translate in one or more support activities for a firm. Infrastructure to includes a number of activities, i.e. finance, supporting the entire chain and not individual activities (Porter,

<sup>8</sup> The relationship between bank and firm can be close in other ways; Pastré (1981), surveying relationships between American firms and their banks in France, found that the majority of American firms based their internationalisation strategy on their traditional banking relationships in the United States.

1985, p. 43). This makes sense for treasury activities for example. One could consider the determination of capital structure more of a procurement function. Management has to decide how much capital it needs and the mix of stakeholders, which serves management best. These issues determine the procurement of financial services from a bank, such as the servicing of primary securities, the issuing of bank loans or even obtaining equity stakes within the firm. There is also reciprocity since the firm can put its ample cash balances on deposit, fuelling funding as one of the primary functions of a bank.

Finally one should also consider the relationships between banks. Banks can provide funding to each other, take deposits, or arbitrage with its own activities such as foreign exchange or securities. Differences in risk management operations, asset liability mismatches or plain arbitraging opportunities can be exploited through these routes.

2.1.3. Products

As any banking consumer can attest to, the choice between banking products seems sheer endless. Walter (1988, pp. 20-21) breaks down financial services that appear in the market, independent of its financial complexity, into at least one primary category (Table 2.2).

Table 2.2. *Product classification of financial services*

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1.	Credit Products
2.	Financial Engineering Products
3.	Risk Management Products
4.	Market Access Products
5.	Arbitrage and Positioning

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Credit products may decrease in importance over the last decade, but are still the main source of income for many organizations. Financial engineering revolves around "the design and delivery of technology-intensive financial services" (Walter, 1988, p. 21). The main emphasis is on the packaging of the product, which in his view is perhaps the ultimate form of product differentiation. Risk management can assume two forms. The banking organization provides the technology and the proprietary knowledge to shift the risk to/from a client from/to another party other than the bank itself. Or the bank takes on all or part of the potential exposure. This exposure is then managed through "arbitrage and positioning".

Market access products are services which benefit from the internal networks banks have to transfer information, funds, or securities from one client or geographic area to others. Here technology plays an important role too. Although Walter lists it as a product group, "arbitrage and positioning" is an internal process and closely aligned to the trade and dealing activity in the value chain. The most important characteristic is that a product can be sold to a client. This product group provides the supply of the above mentioned product groups.

#### 2.1.4. Spatial aspects of financial products and services

The activities and products share one common element: they are services, and banks are essentially service providers. A general characterization of what services are will be given, and some comments will be made how this applies to banking activities. Five distinguishing elements have been identified to differentiate services from (physical) products (Kotler, 1988, pp. 477-481): intangibility, inseparability, perishability, variability and ownership.

Services are foremost intangible. They cannot be experienced and evaluated in any way before they are consumed. The consumer may have difficulties of knowing what the bank is really offering, which is caused by asymmetrical information between the buyer and seller (Arvidsson, 1997). The bank partially can mitigate this by offering proxies (its reputation, marketing image, or the building it resides in). Banks carefully covet these proxies. A survey showed that banks "rely above all on their reputation to attract new customers".<sup>9</sup> Inseparability refers to the fact that consumption and production are closely connected. Perishability is closely connected to inseparability. Once a service is produced, it cannot be stored and must be consumed in some way. Also the producer can be part of the service. Another distinguishing feature is that services are less standardized. Banking services encompass a complete range from fully standardized to fully customized. An example of a standardized product is an investment in a mutual fund that is managed and offered by a bank. On the other end of the scale a customized service encompasses a stock portfolio which the bank manages and advises for the client.

Finally, the non-transferal of ownership is partially applicable for the characteristics of bank services. Brokerage clearly implies the transferal of ownership. The buying and selling of securities are in this respect no different from any other commodity. When on the other hand specialized financial advice is given to a client, he cannot apply it in any other situation without amendments (Arvidsson, 1997, p. 77). The inseparability characteristic has geographical consequences. As mentioned before, inseparability refers to the fact that consumption and production are closely connected. The close connection differs and Boddewyn et al. distinguish three levels of separability (Buckley and Ghauri, 1999, p. 150): service commodity, physical presence and mix.

Service commodities are services distinct from their production process, are tradable and thus exportable. The actual place of consumption can differ from the place of production. For example, brokerage services and cash management services might fit this profile. On the other end of the scale production cannot be separated from consumption. Physical presence is needed. This is the case with personal financial advice, or the financing of small and medium sized firms. Local knowledge is pre-eminent. In between exists a continuum of services, which is a mix of distinct service commodities, and location bound service elements. Some location substitution is possible. Underwriting activities or special financing projects fall into this category.

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<sup>9</sup> A new Swiss Role (1999, February 20). *The Economist*, p. 85.

Table 2.3. *Banking activities, location and production*

Activities	Includes	Match between location and production of banking activity		
		Service commodity: production $\neq$ location	Physical presence: production = location	Mix
1. Funding	Deposit taking			•
	Sale of bank securities			•
2. Cash management	Payments mechanism	•		
	Cash management	•		
	Consumer services			•
	Trade services			•
3. Trade and dealing	Proprietary trading, dealing	•		
	Risk management	•		
4. Financing	Lending			•
	Special financing activities			•
	Insurance related activities			•
5. Securities	Underwriting			•
	Distribution			•
	Brokerage	•		
6. Advisory services	Corporate financial advice			•
	Asset management services			•
	Personal banking services			•

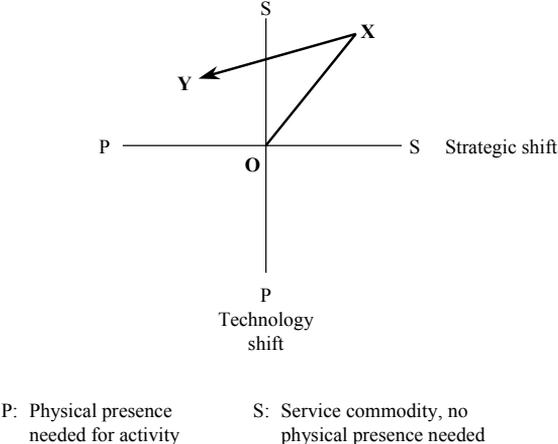
Note: dot in the right columns classifies an activity as a service commodity, requiring physical presence, or a combination of the latter two. Source: adapted from Smith and Walter, 1997

The classification of banking activities can be enriched with these three levels of separability. Based on the description of activities and product groups, a location-production distinction can be added (Table 2.3). Several banking activities can be classified as service commodities, such as trading and dealing, brokerage and risk management. On the other hand, a limited number of activities need a physical presence, such as advisory services. The remaining half of the activities constitute a mix between location bound service and commodity service. For example, when a firm takes out a loan the deposits can easily be acquired from different locations (service commodity) but the monitoring of the firm has to be done locally (location bound).

Separability characteristics are not static: the technology applied to financial services and possible strategic shifts can enforce change. Whereas a number of bank activities could be denoted as ones requiring physical presence ten years ago, technology has changed this to a service commodity. Combining such bank activities in one place should generate economies of scale. In Figure 2.3 such a shift could be represented by the line OX. Separability characteristics also play a role when management changes course. A

shift from funding and financing to get more involved in advisory services would imply stronger emphasis on the physical distribution network the bank has built up. This move is graphically displayed by line XY.

Figure 2.3. Shifts in strategy and technology



**2.2. The role of financial intermediation and financial systems**

After the brief review of financial intermediation, the role of a financial intermediary in economic society is now discussed. The design of financial systems is intertwined with the role financial intermediaries play. Although many variations exist, three basic designs of financial systems can be distinguished and will be discussed.

The role of financial intermediaries has been scrutinized, especially if compared with the role of other activities in economic society. Why is that? Financial intermediation is inherent to the design of economic society and this special role carries some burdens for a bank. At the very least, it created debates about the design and performance of different financial systems in which financial intermediaries operate and the relationship between financial intermediaries and government. To analyze the role of financial intermediaries in economic society, a framework of economic society by Heilbroner and Milberg is presented and then applied to the role of financial intermediaries. This will position the role of financial intermediaries and provide a starting-point for the discussion of financial systems in 2.4.

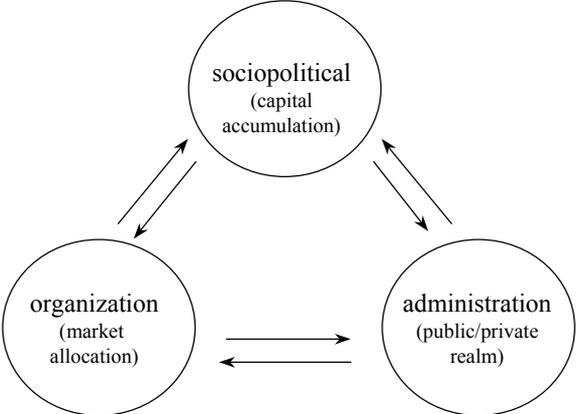
Heilbroner and Milberg (1995, p. 106) consider capitalism to be a "complex system of social and political relations that collectively determine the dynamics of economic institutions". Although this system is one with considerable variations, Heilbroner and Milberg identify three characteristics which are common to all: socio-political (capital accumulation), organizational (market allocation) and administrative (public/private realm) characteristics.

Capital accumulation as a socio-political goal is the means to acquire power and prestige within society. Capital is not a means in itself, the accumulation of it is. To this purpose a "continuous search for innovation but also self-protection [of acquired capital]" takes place. The drive for capital accumulation is a socio-political, not an economic goal. Economics is concerned with allocation and choices.

The second characteristic, market allocation, has to do with the "coordination of production and the regulation of distribution" for the sales and purchases of objects by the abstract notion known as the market. It not only allocates capital for investments but at the same time oversees consumption decisions of its members. Markets are an economic, organizational concept rather than socio-political. The existence and proper functioning of markets is a necessary prerequisite for capital accumulation. Market allocation alone does not suffice to construct a capitalist system.

Third, a capitalist system divides its space into a public and private one. The role in the public space is reserved for government, who can be an economic regulator, an economic administrator, or an economic player (Zysman, 1983, p. 75). As regulator, it sets boundaries and influences behavior of agents hoping that a certain set of desirable outcomes will occur. As an administrator, government embodies the values and goals of the (dominant) agents in society executing operations like a law system and defense based on a specific task or assignment. As a player, it can pursue specific outcomes on a case by case basis, discriminating between firms and applying administrative rules and regulation to accomplish particular objectives. For example, selective control over technology transfer and investments can be used to shape industrial policy.

Figure 2.4. *Characteristics of capitalist society*



The public space consists of mainly political activities. The private space on the other hand refers to mainly economic activities. Agents in the private sector can conduct

their affairs as they wish as long as they are within the boundaries set by the public sector or acceptable to the scrutiny of the other agents, whichever weighs heaviest.

What is the role of financial intermediaries within this capitalist system? Merton and Bodie (1995, p. 12) advocated a functional approach to research financial intermediation and argued that the primary function of any financial system is to facilitate the allocation and deployment of economic resources. Thus the main goal of financial intermediaries and its institutions should be the allocation and reallocation of wealth. The functions of a financial intermediary, i.e. asset transformation, brokerage, processing and providing information, risk management and the maintenance of a payment system are all functions discussed earlier which are instrumental to realizing such a goal. An adequate functioning of the (re)allocation furthers the effectiveness of the price system, arguably the most important transmission mechanism of allocation.<sup>10</sup> Furthermore financial intermediaries have additional distinguishing features compared to other agents in the economy.

The allocation mechanism itself is mainly based on the transfer of capital into money and vice versa. Money, central in this (re)transformation process, becomes a store of wealth, generally increasing or decreasing with the perceived effectiveness of the market allocation. There is a difference between capital and wealth; the importance of wealth as a natural or manmade object lies in the power or prestige the owner can derive from it. Capital is also a symbol of wealth and prestige but, unlike wealth, cannot be passive: the owner uses it to acquire objects to create saleable commodities continuing the transformation circuit.<sup>11</sup> Financial intermediation is a circulation service: it is totally fundamental to the operation of every aspect of the economic system. Each element in the production chain depends upon the necessary levels of capital to keep the chain in operation (Dicken, 1998, p. 399).

As a result, the financial intermediary implicitly gets bestowed with the responsibility to uphold both the efficiency of the market allocation and the value of money. A complication with far-reaching consequences lies in a second distinguishing feature. Financial intermediaries, as a private actor in the capitalist system, have goals of their own to accumulate capital. The organization of means to achieve this end may not coincide with the organization needed to achieve efficient market allocation. Realignment between organization goals of a financial intermediary and societal responsibilities for efficiency of allocation and the value of money is the basis of regulation.

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<sup>10</sup> Heilbroner and Milberg cite a study by Frey, where a overwhelming majority of economists consider this the most important part of a well functioning economic system. (Heilbroner & Milberg, 1995, p. 92)

<sup>11</sup> Restated, Marx's famous M-C-M' circuit is instrumental in this process. "M" symbolizes money, "-" a transformation process and "C" capital; the apostrophe indicates a changed state, usually larger than the previous one. See for a thorough expose Heilbroner (1985).

### 2.3. The role of regulation in a financial system

Banks must conduct their affairs within the boundaries set by the institutions within the public sector. These boundaries between private and public realm are molded into a regulatory framework; regulation in banking industry has had a long history. Traditionally government has taken a special interest in banking for two reasons, externalities and competition policy. As mentioned earlier, a financial intermediary is situated for a unique role. On the one hand the financial intermediary serves a public goal maintaining the mechanism for allocation of wealth, stabilizing the financial system and the economy. On the other hand does a financial intermediary act as a private agent using the allocation process to pursue its own goals.

These two roles do collide at times and can result in externalities (Ferguson, 1988, p. 106): social costs and benefits of economic society that do not coincide with private costs and benefits of the financial intermediary. Externalities are created if the financial intermediary fails to take account of the effects of its own activities upon others. If the banking system is not performing well, the financial disruption is likely to be more serious than it would be with other sectors in the financial system, because banks have more interconnections than other industries (Goodhart, 1998). Saunders illustrates this for a city where the only bank in town defaults and businesses find it difficult to get financing elsewhere.<sup>12</sup> Customers suffer the loss of their entrusted savings leading to a serious protraction of the economic prospects of the community. In order to prevent, or at least mitigate these undesirable consequences, government tries to prevent this through regulation: government actions to control decisions of a financial intermediary to prevent decision-making that would take inadequate account of public interest (De Bondt, 1998, p. 282).

The regulatory framework defines which functions can be performed by banks and other institutions and specifies the constraints to which they are subjected to provide a certain degree of protection to savers and investors (Rybczynski, 1997, p. 10). Goodhart (1998, p. 4) identified the following motives for regulation:

- *To protect the customer against monopolistic exploitation.* With free competition as a yardstick for economic policy, regulation aims to prevent financial intermediaries from accumulating excessive market-share and power. Concentration of competition is therefore discouraged.
- *To protect smaller retail banking customers (who are less informed).* The failure of an individual financial institution may have adverse effects on systemic stability and cause losses to individual investors. Because of this, regulators are bound to have a concern with the financial health of individual institutions.
- *To ensure systemic stability.* Systematic regulation is necessary when the failure of a financial institution can create negative externalities. Banks in particular are subject to

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<sup>12</sup> See for example Kindleberger (1978), who discusses the process leading to negative externalities in the financial community.

runs<sup>13</sup> which have a contagion effect; "failure (losses) in one bank will (rightly or wrongly) cause outsiders to revise their view of the value of other banks' assets" (Goodhart, 1998, p. 9), driving down the value of marketable assets of a bank.

Smith and Walter discuss the state of regulation by the end of 1993, summarizing *what* should be regulated, and *how* should regulation be enforced. Three areas should be regulated (Smith and Walter, 1997, pp. 328-332):

- *Industry and structure.* Competition should be encouraged, consistent with providing for capital adequacy and soundness of market participants.
- *Protection of retail investors.* Minimum disclosure standards are required for new issues and companies whose securities are traded publicly. Efforts have been underway in the European Union since 1990s to standardize these disclosure. A worldwide convergence has proven difficult, due to the strict attitude of the SEC in the United States, enforcing most regulatory requirements there, to change its accounting standards. Foreign companies and banks that are reporting, or publicly traded, companies face different levels of disclosure.
- *Protection against securities fraud.* In the United States the Foreign Bank Supervision Enhancement Act was passed in 1991 as a direct reaction to the fraud scandals, the Banca Nazionale Del Lavoro and the Bank of Credit and Commerce International.

The principles for enforcement of regulation were shaped in the 1980s, when regulators sought to create frameworks for increasing competition while creating a (more) stable financial system (Smith and Walter, 1997, pp. 328-332):

- *Regulation should be as light as possible, but not too light.* Too much regulation can have adverse effects on diversification possibilities and the profitability of banks, decreasing the attractiveness of financial centers. On the other hand, it should be enforceable. Off shore centers and tax havens have been accused of having too light regulation, allowing credulous banks to be chartered (cf. the BCCI failure in 1991).
- *Minimum solvency standards for the securities industry, consistent with those for banks.* The insolvency of large investments poses similar systemic risks to the financial system as for a bank. Although most of such firms face regulatory requirement from the local regulator, an overarching regulatory framework such as the Basle Accord for banks has not been created.
- *A level playing field should be established for banks and investment banks.* The separation of activities has been a major distinction between regulatory systems.

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<sup>13</sup> Financial crises are also contra productive for the other goals of regulation. Also, if the crisis is large enough the government ultimately becomes lender of last resort and has to pay the bill. One of the findings of a cross country study of bank failure losses by the World Bank was that governments in generally have not dared to pass the bank losses to depositors: 'deposit insurance demands sound preventive bank supervision' (Sheng, 1996, p. 3).

Whereas European banks moved in the 1980s to a universal bank system, allowing a wide range of (bank and non-bank) activities under one bank, which theoretically enhances profitability possibilities. American regulators have been slowly adapting adjusting their framework to the European model, as have the Japanese. These differences have not only resulted in different strategies (universal vs. specialized banks) but also have had major impact on activities of foreign banks in the United States.

- *Market surveillance and enforcement powers are necessary.* Regulatory bodies need to monitor market behavior of participants and enforce regulation if possible. Diversification of activities of market participants could exploit regulatory competition between (domestic) regulators, created potential externalities and forcing the centralization of regulatory powers in a few institutions. In the United States, the SEC and Federal Reserve have emerged as the most important regulators. Other countries have established similar bodies centralizing financial regulation activities such as the Financial Services Authority in the United Kingdom and in Japan.
- *Retail services need the most regulation.* The range of financial products has increased over the years, many of which are sold to retail clients. Regulators need to ensure that financial services providers do not take advantage of unsophisticated clients.

It is generally argued that regulatory arrangements have had a profound impact on the development of the banking sector. Extensive regulation can lead to a moral hazard dilemma, which increases the sector's susceptibility to recurring crises signaling new rounds of regulation (Walter, 1988, p. 4). Governments have an added incentive to prevent this form of externality since the banks can act as an extension of the monetary policy of the government.

Competition policy has also been a major concern for governments, resulting in regulation. To minimize the chance of undesirable market behavior regulatory authorities can intervene in the market structure in several ways such as price regulation or interest rate ceilings. It can also explicitly prohibit strategic activities by banks, such as the acquisition or financial participation in other banks. Extreme intervention takes place when the government decides to become (sole) shareholder of one or more banks.

Prevention of negative externalities by public authorities pays off if compliance cost and other costs of regulation do not exceed the social benefits. These other costs (excess burden) are costs imposed on society as a whole through regulatory curbing of potential efficiency of the market by creating entry barriers or reduction in competition. Definition and measurement of these excess burdens is difficult, but comparisons of status quo before and after regulation indicate they could be substantial.

#### **2.4. Financial systems**

A financial intermediary plays an instrumental role in the (re)allocation of wealth and operates on the verge of the public-private realm and societal goals. A financial system is

merely the grouping of relevant functions, activities and organizations influencing the financial intermediation process. Any design of a financial system is by inference thus a reflection of the socio-political goals set in this society, the influence sphere of public and private functions, and the process and efficiency market allocation. Several main designs have evolved over the years: *Market oriented*, *Bank oriented*, and *Government/institution directed*.<sup>14</sup> Table 2.4 presents an ideal-type classification of financial systems describing the main characteristics and resulting consequences.

### *Market oriented system*

There are relatively few market oriented systems around to observe; paradigms of market oriented financial systems are usually modeled after the financial systems in the United States or Great Britain (Demirgüç-Kunt, 2001; Canals, 1997). A market oriented system has the following stylized characteristics. Market participants are economic agents who aim to realize the maximization of their own (financial) goals, with as little interference and restrictions as possible. The allocation process has to be above all efficient as possible through the price mechanism, implying that securities markets hold the center stage in a market oriented system.<sup>15</sup>

There exists a complete separation between investors acting on capital markets and non-financial companies. Internalization of relationships between ultimate borrowers and financial intermediaries - the sharing of private information - is therefore not preferred; companies obtain their financing by fixed and variable yield securities issues through the capital markets. The financial intermediary provides mainly short term financing, unable to build up a long term relationship with the firm and therefore does not permanently hold equity stakes in firms.

The financial intermediary uses the price mechanism as the main allocative drive by securitizing loans from its balance sheet into assets with certain risk-return combinations, releasing the financial intermediary from credit risks.<sup>16</sup> Securitization also implies that the

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<sup>14</sup> Similar designs of financial systems were forwarded by Zysman (Zysman, 1983, p. 69-75): capital-market based system, credit-based system, and credit based system where markets are dominated by government-administered prices. Here, capital-market based system and credit-based system resemble the here used terminology of market-oriented and bank-oriented to a large extent. The definition of institution directed system is broader Zysman's credit-based system with government administered prices. Not only direct government intervention in the allocation and price setting process are considered, but also the (informal) coalitions around government which goals can align with that of the government. Naturally other designs have been presented. See for example Dicken (1998, p. 89) where a typology by Johnson is presented based on the dichotomies of market vs. plan (price mechanism prevails as an allocation mechanism vs. allocative intervention) and ideological vs. rational (goal in itself vs. the regulation of parameters). A closer examination shows that a mapping can be made.

<sup>15</sup> With a market oriented financial system, agency problems may arise between management and shareholders because large corporations may have a large number of shareholders with few concentrations of equity stakes. This problem is addressed through the realization of a market for corporate control enforcing mergers and acquisitions, performance based managerial compensation, and monitoring by outsiders (Berger, 2000, p. 47).

<sup>16</sup> Risks and return from assets get unbundled as far as possible offering the customer the possibility to diversify efficiently. At some point the unbundling stops resulting in some residual risk. The financial intermediary may be left with residual risk that cannot be "unbundled", finding no counter parties to absorb or offset this potential risk. This problem surfaces with with financial crises, when extreme illiquidity appears.

financial intermediary has to find additional sources of income to achieve superior returns for shareholders; it is an entrepreneurial provider of financial services, aiming for product innovation and new markets (Scholtens and Van Wensveen, 2003). The government plays no part in the allocative process, except through setting boundaries in the allocation process itself. Firms, banks and governments operate from different realms and often meet as autonomous bargaining partners (Zysman, 1983, p. 70).

Table 2.4. *Characteristics, consequences and performance of financial systems*

		Bank oriented	Market oriented	Government/ institution directed
Characteristics	Interference in allocation process	High	Low	Very high
	Public/private realm	Neutral	Based on efficiency	Based on equality or other societal goals
	Goals	Long term capital Accumulation	Short term capital Accumulation	Long term capital accumulation, specific institutional goals
Consequences	Lender to companies	+	0	+
	Shareholder of companies	+	0	+
	Strategic shareholder	0	-	++
	Delegated manager of companies	0	-	++
Performance	Effectiveness of price system	0	+	-
	Stability of financial system	0	-	0

Note: (0) just as important (-) less important (+) more important than with the other financial systems.

Source: adapted from Canals, 1997, pp. 42-56

### *Bank oriented system*

A bank oriented system bears a closer resemblance to the theoretical underpinnings of a financial intermediary. These activities are centered around banking relationships. Banks play a leading role in mobilizing savings, allocating capital, monitoring investment decisions of corporate managers and in providing risk management services (Demirgüç-Kunt and Levine, 2001, p. 2). A banking relationship evolves when lenders and borrowers share information with the financial intermediary not available to other parties. This

sharing of information enables lenders to provide finance to the borrower during times of financial difficulty. In exchange there is a tacit agreement that the lender stays with the financial intermediary and pays diverging rates during normal periods (De Bondt, 1998, p. 279). In other words, economic agents appear to be less risk seeking than in market oriented systems.

A consequence of the banking relationship is that the preferred financing method of firms is (long term) debt, especially bank loans which require less need of publishing private information.<sup>17</sup> This is contrary to the market oriented system, where firms consider debt as a temporary solution and therefore plays a minor role in the balance sheet structure. The resulting relationship between financial intermediaries and firms in a bank oriented financial system is therefore long term and the financial intermediary as actor in the allocation process assumes a stronger role. Corporate governance is addressed by the consolidation of ownership of firms in financial institutions rather than the stock market. The financial intermediary can take equity stakes, in some cases overtaking management. This reduces the incentive in monitoring management (Berger, 2000, p. 47). By inference the price mechanism as core principle of allocation is not shared by all market participants. This also implies that unbundling of assets into different risk-return products has not a high priority enforcing the "backwardness" of the price mechanism and financial innovation.

Government also assumes a stronger role, even possibly taking equity stakes herself to promote other societal goals such as the equal access to capital, or a more equal distribution of wealth. But government does not have the means to influence the allocation process in the financial systems. Banks can serve as policy allies for government, on terms negotiated between government and banks (Zysman, 1983, p. 72).

#### *Government/institution directed system*

Classifying financial systems in either bank oriented or market oriented is an approach taken by for example Canals (1997) who considered this dichotomy to be leading, viewing all exceptions as being special cases. The government/institution directed system can be viewed as a special variant of the bank oriented system (Zysman, 1983). Most characteristics of an institution directed system overlap with the discussion of bank oriented. However, where in a bank-based financial system coalitions exist on a

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<sup>17</sup> In other words, banking relationships change the 'standard' pecking order of financing, as forwarded by Myers and Mayluf (Brealey & Myers, 1988, pp. 433-434), explaining the inverse relationship between profitability and debt ratios set up the following framework. To start, firms prefer internal finance. If external finance is required firms issue the safest security first. That is, they start with bank debt, next public debt, further down the line hybrid finance instruments like convertibles and perhaps equity as a last resort. This pecking order theory is based - among other things - upon the assumption of preference for internal funds and an aversion to issuing equity. Emotionally, internal funds relieve the manager of contact with outside investors and the transparency effects of the securities market. Rationally, issuing costs can make a difference. Internal funds are costless, whereas issuing equity demands a fee.

A firm can use a widening range of (new) financial instruments to actively steer future cash flows, invalidating the pecking order to some extent. Nonetheless a more cautious risk seeking attitude with firms and an inclination to share information with a financial intermediary could explain a number of differences between market oriented and bank oriented systems.

fragmented scale, there are situations where coalitions of agents evolve on a larger scale. These coalitions can pursue other goals than initially envisaged by the individual financial intermediary or firm. Basically three types of coalitions can emerge in a government/institution directed financial system: *Government* coalitions (between government and financial intermediaries)<sup>18</sup>, *Industrial* coalitions (between industrial firms and financial intermediaries), and *Economic complex* coalition (between government, industrial firms and financial intermediaries).

The allocation process is actively controlled and steered, more explicit than with bank oriented systems.<sup>19</sup> This can be done by the government holding large decisive equity stakes in financial intermediaries, or fully controlling some of the key players. Regulatory frameworks are shaped in such a way that encourages national financial intermediaries to expand and prevent foreign financial intermediaries to enter the market. Regulation can also be very steering in its execution. The borderline between private and public realm becomes difficult to establish, "not simply because of political arrangements, but because of the very structure of the financial markets" (Zysman, 1983, p. 72).

The most outstanding representative of a financial system with an industrial led coalition is Japan. The Japanese financial system distinguished itself by development of specialized institutions to provide finance for specific purposes and a high degree of regulation by the financial authorities (Canals, 1997, p. 181, 191). A special category is banks with which Japanese companies have close business relationships. Besides the usual financial services, share swapping and the presence on the company's board of directors can take place (Canals, 1997, p. 186). Thus direct equity stakes, such as in the German financial system, are replaced by subtle cross holdings. A company's main bank is usually one of its major shareholders clustering business groups or "keiretsu" around a main bank.

The financial intermediary becomes an instrument to group companies furthering their common goal. The institutional goals can be twofold. As distribution activities unfold along the lines of the keiretsu, it has proven to be an effective barring of foreign competition (Van Wolferen, 1989, p. 515). More important, the institutional arrangement has provided firms with a continuous supply of funds which have served the expansion of activities after the Second World War (Canals, 1997, p. 195; Van Wolferen, 1989, p. 503). The allocation process by the financial intermediary - reconciling ultimate borrowers and savers - is partly replaced by an allocation process which is not price driven, but based on other institutional goals.

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<sup>18</sup> Government is the highest hierarchical power in a democratic nation state due to its legislative power and monopoly over "violence". Over time it has been confronted by the loss of its rights of direct access to surpluses of economic society. It however usually has retained the right to tax (the power to destroy economic activity) and it can set the boundaries and reach of the public realm. Governments not content with this limitation can instill a special role on economic society, trying to lead economic society in desired directions. In some cases necessary for the common good: 'the public realm also assumes a command function to force modernization upon the [...] economic sphere' (Heilbroner, 1985, p. 88). In this case the government has a strong vision of where economic society should go. Perhaps more important, less benevolent arguments like status, prestige and power also play a role.

<sup>19</sup> Hence the difference in names: bank *oriented* and market *oriented* versus institution *directed*.

## 2.5. Classification and dynamics of financial systems

Reviewing the different financial systems raises some questions. First of all is it possible to classify countries into the different systems. Second, what can be said about the dynamics of financial systems: (how) do they evolve? Demirgüç-Kunt and Levine (2001) developed distinctive measures between bank-based and market-based financial systems, constructing a composite index of financial structure based on several measures of banking sector development relative to stock market development. Countries with a ratio above mean are classified as bank oriented, below the mean they are classified as market oriented. Table 2.5 shows the financial systems for the countries in the sample.

Table 2.5. *Countries with bank oriented or market oriented financial systems*

Bank oriented		Market oriented	
Strong	Moderate	Moderate	Strong
Spain	France Germany Japan	Netherlands United Kingdom	United States Switzerland

Classification is based on the rank of a constructed index covering 1990 to 1995. The higher the rank the more market oriented versus bank oriented characteristics weigh. "Moderate" and "strong" values are based on below and above the means of the bank oriented and market oriented sub groups. Source: Demirgüç-Kunt and Levine , 2001, table 12

The dichotomy between bank oriented and market oriented does not allow for the incorporation of an institution directed financial system, this has to be done tentatively. Literature suggests that this might be applied to Japan and France, this is presented in Table 2.6. A special case is Germany, where it could be argued that the financial system is a bank oriented one with the exception of Landesbanken. The relationships between these banks and their shareholders show characteristics of a Government/institution led financial system.

Demirgüç-Kunt and Levine (2001) examined financial systems for a broad set of countries over several decades. Classifying financial systems as underdeveloped, market-based or bank based, they found that:

- Banks and securities markets are larger, more active and more efficient in richer countries. Financial systems are on average more developed in richer countries.
- In high-income countries, stock markets become more active and efficient relative to banks. There is some tendency for financial systems to become more market oriented as they become richer.
- Legal and regulatory measures matter: countries with a Common Law tradition, strong protection of shareholder rights, good accounting regulations, low levels of corruption and no explicit insurance tend to be more market oriented. The opposite is true for French Civil Law tradition, where countries with poor protections of shareholder and

creditor rights, high levels of corruption, poor accounting standards, restrictive regulation, and high inflation tend to have underdeveloped financial systems (Demirgüç-Kunt and Levine, 2001, p. 83).

Table 2.6. *Financial systems in the 1990s*

	Market oriented	Bank oriented	Government/institution directed
High	United States	Germany	Japan (Germany)
Degree of regulation ↑			France
↓	Switzerland Netherlands United Kingdom	Spain	
Low			

Note: degree of regulation for the United States, United Kingdom, Japan, Spain, France taken from Canals, 1997, p. 36. German banks are classified twice; overall they are part of a bank oriented financial system, with the exception of for example state owned Landes-banken who could be classified as part of a Government/institution directed financial system

Indicators of financial development are positively correlated with economic growth (Goldsmith, 1969; Demirgüç-Kunt and Levine, 1996). Economic growth however is not different for market-oriented or bank-oriented financial systems: "countries do not grow faster, financially dependent industries do not expand at higher rates, [...] firm's access to external finance is not easier, and firms do not grow faster in either market- or bank-based financial systems" (Beck et al., 2001, p. 233). Fase (2001), and Fase and Abma (2003) examined the causality of the relationship between economic growth and financial development, measured by aggregate financial assets in a country. For 9 emerging South-East Asian economies for a period covering more than 25 years, Fase and Abma found that financial development mattered for economic growth and that growth in financial development led to economic growth. This indicates that in emerging countries financial reforms might improve economic growth (Fase and Abma, 2003, p. 21). However once a country reaches a mature stage of economic development the causality may change, at least in the investigated case of the Netherlands where between 1950 and 1999 economic growth influenced financial development (Fase, 2001).

Financial systems do change over time (Demirgüç-Kunt and Levine, 2001), and a question is what the role of banks has been in this process. For example, market oriented financial systems like the United States and United Kingdom, started out as bank oriented systems and over time transformed to market oriented systems. Gerschenkron (1962) related development of economic structure to changing dynamics between financial intermediation, public/private realm and allocation mechanism. He argued that countries

which are relatively backward in economic sense compared to advanced economies, do not embark on the same stages of industrialization as the advanced countries have. One of his propositions is "the more backward a country's economy the greater was the part played by special institutional factors designed to [provide industries] with less decentralized and better informed entrepreneurial guidance; the more backward the country, the more pronounced was the coerciveness and comprehensiveness of those factors" (Gerschenkron, 1962, p. 354). The relationship between sources of financing and stages of economic development is presented in Table 2.7.<sup>20</sup>

Table 2.7. *Stages of economic development and financial systems*

Importance source of finance			
Stage of development	Market based ( <i>advanced area</i> )	Bank based ( <i>area of moderate backwardness</i> )	Institution based ( <i>area of extreme backwardness</i> )
Stage 1	Firm	Bank	Government
Stage 2		Firm	Bank
Stage 3			Firm

Note: Stage 1,2,3 are the subsequent phases of economic development. The columns shows the dominant source of finance during that phase. The terminology used by Gerschenkron for the different financial systems is between brackets.  
 Source: Gerschenkron, 1962, p. 355

Positioning evolutionary transitions from one financial system into another should be treated with some caution. Using a classification involving phases "could convey the image of a banking sector inevitably shrinking by way of a sort of Darwinian process in which markets will slowly absorb all functions at present carried out by banks" (European Central Bank, 2000, p. 9). It should not come as a surprise then that some authors depict market oriented financial systems as the inevitable marching route for bank oriented systems. This reasoning probably lies behind the research questions of a number of authors when comparing the US financial system to the European. Often the performance of the financial system in the United States serves as a benchmark of things in Europe to come, very seldom the other way around.

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<sup>20</sup> Gerschenkron probably has been the first to postulate a relationship between development of the economy and the role of financial intermediation. He also introduces a negative connotation between bank and government involvement in the financing activities of firms, probably inspired by the ideological divide after the second World War between communist and free market economies. The terminology also clearly suggest a deterministic transition leading in the ideal situation to economies where allocation and financing choices are predominantly made by firms. McCloskey (1990, pp. 70-82) analyzed the 'storytelling' of Gerschrenkron. One can detect echoes of Gerschenkon in for example Zysman (1983, p. 72), who noted that "[bank based and institution based] are solutions to late development, whereas [market based] is tied to an earlier transformation'.

The deterministic undertone when discussing the change in financial systems is commonly applied; take for example "Europe is undergoing a dramatic transformation, much faster than expected [...] Survival cannot be guaranteed" (Walter and Smith, 2000, cover). This Darwinistic appeal of phases has been applied to financial systems by Rybczynski (1997). In his framework the evolution of the financial systems consists of three main phases: the bank-oriented phase, the market-oriented phase with two sub periods, an early and mature phase, and finally a securitized phase which could also be described as an institutional phase. The roles of financial intermediaries during these phases are similar to the ones in bank and market oriented systems, albeit with the difference that in the securitized phase emphasis is laid on the importance of non-bank institutions as funding sources (mutual funds, pension funds) and that the monitoring function is delegated to investment banks specifically.

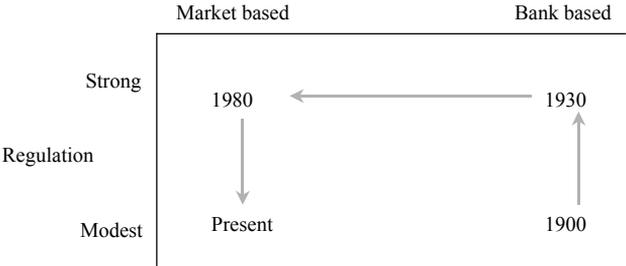
Rybczynski ascribes the transformation of the financial systems to increases in income and wealth, leading to societal changes. Second, advances in technology can directly affect the efficiency of banking operations, and finally changes in regulatory frameworks. All three explanations have in common that they have developed continuously over the last thirty years, facilitating the argument that transformation of financial systems is inevitable. The reasons Rybczynski lists have limited explanatory power though since financial systems have peacefully coexisted. The parallel growth of market oriented and bank oriented systems may have been principally due to the evolution of different regulatory environments determining major discriminating features between the financial systems such as the ownership of firms by banks (Berger, 2000). Advances in technology determined potential efficiency of banking operations. The actual efficiency however is restricted by the boundaries regulation sets. Finally, increases in income and wealth as an argument for transformation into another financial system disregards cultural difference between countries with regard to risk aversion, savings and investment. Similar increases in income and wealth between two countries may easily have profound different effects on the financial system concerned.

Also, regulatory environment and financial systems are closely related. The legal and economic framework of a country determine whether over time a bank-oriented system can change into a market oriented system (Berger, 2000, p. 47), resulting in an intricate shift in balance of power and development of financial intermediaries versus firms.

To illustrate this in some detail it might be useful to refer to the case of the United States. At the turn of the 19<sup>th</sup> and 20<sup>th</sup> century, the rise of the industrial system was greatly propelled by banking houses like J.P. Morgan who helped forge the first (and still large) industrial companies like International Harvester and US Steel. The banks became a powerful actor because they filled a finance gap caused by the unprecedented growth and construction of large firms, with financial strength and structure lagging behind.

In some cases these industrial companies were created by the banks themselves exerting control and providing finance.<sup>21</sup> Banks clearly were the leaders of the industrial sector. Over time the new industries created organizational structures to adapt to the new situations (Chandler, 1962). They did not only cultivate their own management, the financial structure also strengthened over time. Dependency on banks as main financiers diminished in importance, and at some points firms financed the expansion themselves.

Figure 2.5. *Financial systems: the United States*



American legislators have never felt quite comfortable with concentration of economic power; the Senate hearings in the 1920s focused on the undesirable market power of banks in the United States. In the aftermath of the stock market crash in 1929 a number of measures were taken to deal with the financial crisis separating investment and commercial banking activities was forced; this forced major banking institutions to divest activities or to split themselves up (J.P. Morgan for example). This established a shift from bank oriented to market oriented financial system which to a large degree was upheld until the 1980s, when gradual deregulation over time effectively dissolved has dissolved the separation at the end of the 1990s.

The power distribution as a result of the relationship is prone to external shocks, such as capital shortage. Until the Second World War, most industrialized countries shared a form of market oriented system. After the Second World War these similarities were abandoned. Continental European countries needed capital to rebuild their destroyed economies, and ties with financial intermediaries were strengthened re establishing bank oriented supremacy.

However if a transition from bank oriented to market oriented takes place a crucial element of bank-based systems, the long term relationship, probably also gives the financial intermediary a head-start in the transition. The usual argumentation is that having intimate knowledge of the client, the financial intermediary is ideally positioned to coax the client form bank-oriented to capital market-oriented products changing for instance the

<sup>21</sup> Drawing some analogies with Japan, if the current Japanese keiretsu are considered to be a ‘pull’ strategy of finance (creating an infrastructure to acquire capital when needed) this situation would surely classify as the ‘push’ variant of the keiretsu.

traditional bank loan for the assistance of public offering of bonds or equity. Finally, major shifts in financial systems can take place in the wake of major political changes or severe economic crises threatening. Nationalization took place in France, following the change from a Republican to Social Democratic government in 1982.

Table 2.1. *Transitions in financial systems*

		Transition from		
		Market oriented	Bank oriented	Institution directed
Transition into	Market oriented	-	Liberalization/ Mature economies	Japan, Korea
	Bank oriented		-	Rebuilding period after crisis/war Japan (1945-1955)
	Institution directed		Nationalization after (economic) crisis Sweden (1992) Thailand (1998) France (1982)	-

**2.6. Summary**

This chapter reviewed the theoretical foundations for the banks’ internationalization activities, starting out with a discussion of the role of banks: why do they exist, what do they do, and what is their role in economic society. Financial intermediation theories describe and analyze the role banks play. Risk management plays a central role for a financial intermediary (Allen and Santemero, 1998; Scholtens and Van Wensveen, 2000), transferring and managing risk. Investor and saver financial needs are matched, mitigating informational asymmetries. A distinction was made into functions (which are relatively stable throughout time, activities (carrying out the functions) and products (the actual service offered). A number of services also are location bound (such as financial advice), while others do not necessarily depend on location to be produced or consumed (brokerage).

Next, the role of financial intermediaries within economic society was discussed, and three financial systems were defined where the banks play different roles: bank oriented, market oriented and government directed. With market oriented financial system, the allocation process is mainly determined by the price process, and a substantial part of the banks’ main activities, matching savers and investors, is performed by capital markets.

There is a clear separation between firms, banks and government. With bank oriented financial systems, the price process still is important, but the bank also plays an important part in the allocation process. There is less separation between banks and firms; banks can actively steer the allocation and utilization of capital by participating in the firms. Finally, in government oriented systems, banks can be instrumental in achieving the governments objectives.

Economic growth is not influenced by a market oriented or bank oriented financial system, but rather by the level of financial development. Research indicated that financial development influenced economic growth in developing countries, and that the relationship breaks down for mature economies. In the 1990s a tendency was observed for financial systems to become more market oriented as the economies became richer. The discussion about dynamics of financial systems seems to a large extent normative, stipulating a desirable and in view of some authors inevitable transition to market based systems. The debate is also hampered to some extent by data availability: the transition of financial systems tends to go at a slow pace, and historical results might limit value for future prediction because of fundamental changes in the banking industry or economies. It might however prove an interesting framework to apply when considering longitudinal changes in (incentives of) internationalization strategies.



# 3 Incentives

Two questions are addressed in this chapter. First, what is international financial intermediation and what sets international financial intermediation apart from financial intermediation? Second, what incentives can a bank have to pursue internationalization? Incentives to internationalize are reviewed and clustered, and their relative importance as drivers to internationalize assessed.

## 3.1. International financial intermediation

International financial intermediation is defined in this study as

- assets and/or liabilities other than in the home country and/or home country currency,
- rights and/or claims other than in the home country and/or home country currency, part of which is
- issued and to be collected outside the home country.

This definition agrees with the one the Bank of International Settlements (BIS) uses for international banking statistics. International banking business is defined by the BIS as "banks' on-balance sheet assets and liabilities vis-à-vis non-residents in any currency or unit of account plus similar assets and liabilities vis-à-vis residents in foreign currencies or units of account" (BIS, 2000, p. 3). This means that banking positions can be classified by currency and residency, yielding the following 2-by-2 matrix (BIS, 2000, p. 17):

	Residents	Non-residents
Domestic currency	A	B
Foreign currency	D	C

Here, external or cross-border positions = B+C, foreign currency positions = D+C, international positions = B+C+D, and total positions = A+B+C+D. Ideally, the degree of internationalization should then be defined as  $(B+C+D)/(A+B+C+D)$ . In this study,

aggregated available information for individual banks on cross-border positions of banks is used to calculate  $(B+C)/(A+B+C+D)$ . This might lead to an underestimation of the "true" ratio with since foreign currency held by residents (D) is then not accounted for. In part II, the Trans Nationality Index (TNI) is calculated for banks to measure the degree of internationalization for the bank organization, using domestic versus non-domestic banking positions as one of the variables (see chapter 10). The potential underestimation does not affect the measurement of the TNI, since the index is composed of more variables.<sup>1</sup>

Additionally, the definition of international financial intermediation in this study is a slight expansion to the one given by Bryant and a broadening of Scholtens's definition (Bryant, 1987; Scholtens, 1991): any financial transformation that has a cross-currency and/or cross-country dimension. A more pragmatic definition stems from Casson who defined a multinational bank as a bank that owns and controls banking activities in two or more countries (Casson, 1990, p. 14). Robinson defined multinational banking as "operating a bank in, and conducting banking operations that derive from, many different countries and national systems" (Robinson, 1972, p. 4). With each of these definitions off balance sheet activities as well as balance sheet activities are covered. Gray and Gray (1981, p. 37) limited their definition to a financial corporation which acquired deposits and initiates loans from offices located in more than one country, excluding non-interest income.

In theory, international banking activities might be conducted in the home country when the financial intermediary only trades with other financial intermediaries who are active internationally. To exclude the possibility of a narrow interpretation of international financial intermediation a third condition has been added: there has to be actual cross-border activity implying real changes within the organization. With regard to the internationalization part of the definition, no restrictions are formulated with regard to the number of countries or the type of activities. It extends to the whole range of activities of a financial intermediary and international implies simply one or more foreign countries. This is more extensive than for example Cho (1985, p. 2), who defined a multinational bank as specifically having branches in one or more foreign countries, since more organizational forms than branches can be identified. An overview of the different types of organizational form to internationalize is presented in chapter 4.

In contrast to the growing body of financial intermediation literature, international financial intermediation has been relatively underexposed. A common denominator of international financial intermediation theories is that they incorporate a spatial dimension within mainstream economic analysis. A relatively small group of authors has explained the incentives to undertake international financial intermediation. Bryant (1987) presented an overview of reasons for financial intermediaries to internationalize. Peccioli (1983)

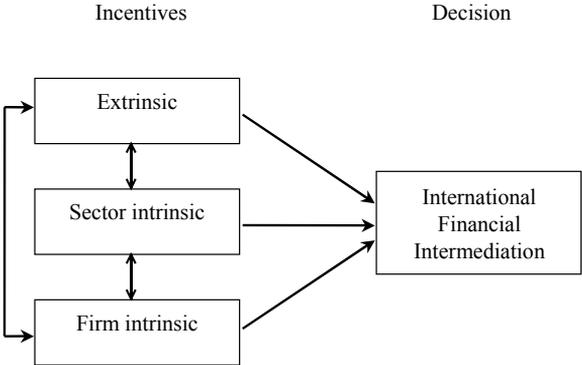
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<sup>1</sup> The index is expressed as a percentage and calculated as an unweighted average of 1) foreign assets to total assets ratio, 2) foreign gross income to total gross income ratio and 3) foreign employment to total employment ratio. See chapter 10 for an explanation on the construction of the index.

investigated the incentives within the OECD countries, addressing the recent surge of international banking activity in the 1970s. Aliber (1984) reviewed empirical literature published on international financial intermediation. Walter (1988) examined the internationalization process of banking while Scholtens (1991) identified building stones needed for an integrated theory of international financial intermediation.

Scholtens (1991, p. 12) classified explanatory theories for international financial intermediation in five categories: trade and foreign direct investment; industrial organization; internalization; portfolio; and eclectic explanations. The application of trade theories to this subject is an intuitive one. Here, a focus on the supply side of the economy and rigorous assumptions are elements of criticism. These disadvantages have given rise to explanations of international financial intermediation based on industrial organization theories. Furthermore the extension of existing financial intermediation theories with a spatial dimension - whether on a firm level or industry level - has proven to be a consistent line of reasoning. Developments in capital structure and finance theories have been applied to international financial intermediation with regard to internalization and the portfolio approach. Greenwood and Williamson (1998) developed an intergenerational model in which international financial intermediation arises as a means of economizing on monitoring costs. Finally the application of a multi national enterprise framework by Dunning (1992) combines three types of competition advantage that are a prerequisite undertake foreign activities: Organization, Location and Internalization advantages.

Figure 3.1. *Incentives to internationalize*



In choosing a framework to analyze various aspects of international financial intermediation, the incentives identified by Bryant, Scholtens and Aliber will be used as a starting point. It can be helpful to group the incentives according to influences the bank can or cannot control. As with any classification, it is to some extent arbitrary and some motives overlap but an ordering advantage should prevail. Incentives to internationalize are to a large extent rooted in international business literature. Van Tulder and Kolk (2002)

identified three major clusters of incentives that have emerged since the 1960s: *Extrinsic*, *Firm intrinsic*, and *Sector intrinsic/extrinsic* incentives (Figure 3.1).<sup>2</sup>

Research in the 1960s and 1970s introduced *Extrinsic* incentives for internationalization, stressing bargaining and game-theoretical approaches in relationships with host governments, and its effects on host economies. In the 1980s and 1990s focus shifted to the study of *Intrinsic* motives. A transaction cost approach became central, which encompasses minimizing costs, maximizing efficiency, optimizing competitiveness in combination with the internalization of markets. *Sector intrinsic/extrinsic* incentives represent research into common ground between extrinsic motives and intrinsic motives: internationalization depends also on the relative position it wants to attain relative to competitors, achieved by market power or visible through herding, and on what a bank can get by negotiations with governments and stakeholders.

Table 3.1 summarizes the incentives for banks to internationalize forwarded by several authors. The incentives are clustered as *Extrinsic*, *Firm intrinsic*, and *Sector intrinsic* incentives and are subsequently discussed in 3.2 (*Extrinsic* incentives), 3.3 (*Sector intrinsic* incentives) and 3.4 (*Firm intrinsic* incentives).

Table 3.1. *Incentives to internationalize*

Cluster	Incentive	Authors				
		Aliber (1984)	Bryant (1987)	Scholtens (1991)	Canals (1997)	Pecchioli (1983)
Extrinsic	Client	•	•	•	•	•
	Perception of the market	•	•	•		•
	Spreads	•	•	•		•
	Economic structure	•	•	•		
	Regulation		•	•		•
	Historic and cultural determinants	•		•		
Sector Intrinsic	Herding			•		
	Market power and concentration			•		
Firm Intrinsic	Economies of scale and scope			•	•	
	Cost of capital					
	Risk/return diversification			•		
	Shareholder return					

<sup>2</sup> See also Muller and Van Tulder (2002) for a discussion of intrinsic and extrinsic incentives of governments and firms to internationalise within a regional integration framework.

## 3.2. Extrinsic incentives

### 3.2.1. Client

Banks go abroad to serve their domestic customers who have gone abroad, described by Metais as a gravitational *pull effect* (Metais, 1979, quoted in Aliber, 1984, p. 664). The pull effect as an incentive can trace its roots to three explanations. The first is that domestic banks in foreign countries are poorly equipped to serve the branches set up by the entering firms. Thus, clients setting up activities in foreign countries only lead to an incentive for banks to internationalize if the financial innovation and sophistication in the foreign country lags behind that of the home country.

A rationale is that banks follow their domestic customer abroad to reduce the likelihood that they might lose their business to host-country banks. *Ceteris paribus* this likelihood increases if the financial sophistication of the host country is greater than that of the home country. If so, one would expect the services and organization of the foreign activity of the bank to be similar to that of the home country, since it merely serves as an extension.

A third approach is that banks follow their customer abroad to further exploit the internalization advantages built up in the home country, providing mutual added benefits for both bank and firm. "Having a presence [...] cements a relationship that already exists at home" (Walter, 1988, p. 27).

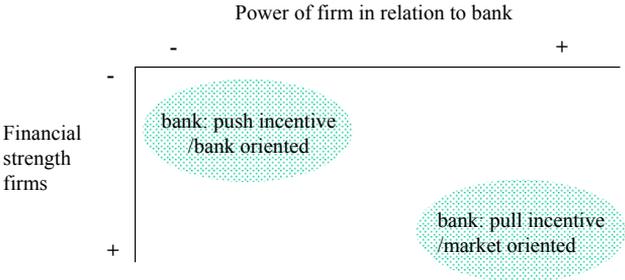
The *pull effect* can also evolve into a *push effect*: with a presence in a host country a bank can lead or even coax home customers into foreign activities. A bank that is well established abroad can provide the services need to facilitate the decision of a firm to enter a host market (Walter, 1988, p. 28). Bryant observed that "bankers talking about location decisions for foreign banks and subsidiaries often portray their organization behaving in an anticipatory way, seeking new customers and profit opportunities in advance of the current service requirements of existing customers" (Bryant, 1987, p. 72). In other words, to conclude that banks lead the way for foreign direct investments is perhaps one bridge too far. Since cross border financial transactions have been growing at a much faster relative pace than cross border real-sector transactions, among other, Bryant concludes that the pull incentive is a more plausible motive.

When is it a pull, and when is it a push incentive? Besides regulatory and tax policy changes, the transitions between bank-based and market-based systems are probably the result of an intricate shift in balance of power and bargaining relationships between financial intermediaries and firms (cf. Ruigrok and van Tulder, 1995, pp. 91-95). To illustrate this in some detail it might be useful to refer to the case of the United States. At the turn of the 19<sup>th</sup> and 20<sup>th</sup> century, the rise of the industrial system was greatly propelled by banks like J.P. Morgan who helped forge the first (and still large) industrial companies like International Harvester and US Steel. The banks became a powerful actor because they filled the financing vacuum caused by the unprecedented growth and construction of large firms, with financial strength and structure lagging behind (cf. Chernow, 1998).

In some cases these industrial companies were created by the banks themselves exerting control and providing finance.<sup>3</sup> Banks clearly were the leaders of the industrial sector. Over time the new industries created organizational structures to adapt to the new situations (Chandler, 1962). They did not only cultivate their own management, the financial structure also strengthened over time. Dependency on banks as main financiers diminished in importance, and at some points firms take on the expansion themselves. The following-leading argument apparently is closely intertwined with the discussion of bank versus market oriented systems.

Banks were clearly powerful agents stepping in the vacuum caused by the unexpected growth of new organizational types and production possibilities. The financial intermediary "leading" the firm probably stems from this era. Over time the position of firms strengthened decisively, especially after the 1960s when firms discovered that they could overtake the intermediation process themselves (Figure 3.2). The financial intermediary became a follower. From this point of view, bank oriented and market oriented systems are systems evolving from the relative power distribution between financial intermediaries and other economic agents, resulting in a distinctive capital structure and financing habits.

Figure 3.2. *Bargaining power between firm and bank*



This suggests that when the role of financial intermediaries changes within society from for example bank oriented to market oriented, the client - push motive might lose importance in favor of the client - pull motive, maybe even exhibiting stronger correlations with FDI movements. Fujita and Ishikari (1986, p. 200) discuss the outcome of a survey on internationalization activities among Japanese banks in 1977 and 1978. More than half of the banks interviewed (7 out of 13) thought that clients as a pull incentive was most significant to internationalize, 3 banks considered the push incentive - banks leading the clients - as the most significant one, while the other banks answered that their internationalization paralleled that of their clients.

<sup>3</sup> Drawing some analogies with Japan, if the current Japanese keiretsu are considered to be a 'pull' strategy of finance (creating an infrastructure to acquire capital when needed) this situation would surely classify as the 'push' variant of the keiretsu.

Berger et al. (2000) summarized a number of analyses which find that many foreign banks initially entered the United States to service home country clients. Goldberg and Grosse (1994) found that the amount of FDI was significant for attracting foreign banks assets in American states. Nolle and Seth (1996) examined the client as a pull incentive for banks from six countries (Japan, Canada, France, Germany, Netherlands, United Kingdom) in the United States between 1981 and 1992. Under the assumption that bank borrowing of foreign owned firms in the United States came from United States based offices of banks from the same country, the share of bank lending that could have been related to "following the client" is calculated. Their analysis suggests that for the larger part of the period investigated foreign banks did not solely rely on the pull incentive to expand their activities. Dutch and Canadian banks allocated an increasing proportion of their loans to non-home country firms, whereas the British did the opposite. Since the results cannot be treated dichotomously (rejection of the pull incentive is the non-rejection of the push incentive) they concluded that other explanations but the client motive need to be considered for a satisfactory explanation.

Berger et al. (2003) investigated the use of cash management services by foreign affiliates of multinational corporations in 1996 for 20 European countries. A finding was that two thirds of the affiliates chose a local bank for these services, and less than one out of five banks chose an affiliate from the bank of their home country. In other words, banks that are more familiar with conditions in the foreign local markets is more important to foreign affiliates of multinationals than knowledge of the domestic market.

### 3.2.2. Perception of market

Entering new geographical markets when a bank feels the boundaries in the home market are stretched or has limited further opportunities is an intuitive incentive, especially for banks with a small home market. A market can be defined a grouping of buyers having a demand for certain products or services and its close substitutes (Ferguson, 1988, p. 32). It is useful to distinguish different variations of what constitutes as a market for an incentive to internationalize along the two different dividing lines: the grouping of buyers and the services.

The grouping of buyers relates to what actually constitutes a geographical market. A bank views and accordingly treats a new geographical market as having significantly separate characteristics than the home market or it can extend the definition of its home market to include new geographical areas. The latter implies that these geographical areas do have similar characteristics to the home market. The second dividing line consists of services offered which are similar or are a natural extension to the services offered in the home country, versus services which are new and are/cannot be produced in the home country.

Table 3.2 shows for different combinations of markets and services as an incentive to internationalize. The first quadrant is a new (geographical) market with a grouping of buyers having a similar demand for certain products or services as in the home market. Management of the bank has an incentive to enter a new market with a group of buyers

demanding similar services in the home market to exploit existing internalization advantages, when the group of buyers in the new market has an organizational relationship to buyers in the home market. This is similar to the client as incentive to internationalize (3.2.1). The bank can also aim to exploit economies of scale and scope. Technologies, management and marketing techniques developed in the home market can be successfully exploited again in the new geographical market, lowering the average cost of capital and/or raising returns per unit, the subject of different incentives.

In the new markets the bank can also offer similar services as in the domestic markets, exploiting a difference in demand intensity for financial services. For example, an economy where individuals have to provide for their own retirement funds has a similar but greater demand for asset management services than an economy where pensions are built up through collective schemes. Moshirian (1993) found that differences in intensity of financial services is a two way street: it is an incentive for banks to undertake activities in a country with a higher intensity demand for services. On the other hand, banks in the country with a higher intensity of demand tend to export their services, probably because they might have a comparative advantage in producing the service more efficiently. Thus the application of a Heckscher-Ohlin-Samuelson framework using spreads as a major incentive (3.2) can be expanded with intensity of financial services. Finally, a bank can decide to offer similar services in new market, thereby reducing the cost of funding by diversifying country risk (3.4.3).

Table 3.2. *Markets*

		Geographically new market	Redefined home market
Services	Similar to home country	(1)	(3)
	New	(2)	(4)

The second quadrant in Table 3.2 is a new (geographical) market with a grouping of buyers from the home market having a demand for certain products, part of which cannot be generated in the home market. A good example of this is the Euromarket (Roberts and Arnander, 2001, p. 4). Eurocurrencies are deposits of major currencies with banks physically situated outside the home market of the currency. At the outset the Eurodollar market, i.e. deposits of US Dollars with banks outside the US, was located in European financial centers.

The third quadrant in Table 3.2 effectively rescales the boundaries of the (home) market. Financial intermediaries, as any economic agent, are prone to be influenced by large scale political and economic events. These events can change the perception of what is considered a home market, intuitively understood to be the boundaries of the home

country. These do however change. After the Second World War, banks in Europe engaged in international activities but their main focus stayed the home country. This began to change when advanced plans for a common economic union finally took off from 1991 onwards. This also shifted the strategic framework in which financial intermediaries had to think. The groups of buyers were not only domestic but could be found throughout Europe.

### 3.2.3. Spreads

A spread is the difference between the average rate charged on a loan and the average rate paid to depositors (Hempel, 1999, p. 79). Differences in spreads might be a location-specific advantage that reflects the relative factor endowments of a country rather than a firm-specific advantage owned by a group of firms (Aliber, 1984, p. 665).

Spreads can also be interpreted as cost differentials, and relative cost differentials can be exploited by trade benefiting both domestic and foreign banking market. The law of comparative advantage has been a straightforward explanation why international trade of goods and services take place and a convincing statement how trade can be welfare enhancing. The Heckscher-Ohlin-Samuelson framework can straightforward be applied to financial services (Scholtens, 1991). Countries that are endowed with different comparative costs for the production of goods and services have a potential comparative advantage in a number of goods and services which they can exploit by trade.

For financial intermediaries this advantage is visible through the loan-deposit spread. A lower spread would suggest more efficient financial intermediaries. A view on expansion is then that banks based in countries with relatively low spreads have an incentive to establish foreign activities because they have developed low-cost technologies for intermediation (Aliber, 1984). Thus spreads can serve as a push factor on the cost side (exploitation of low cost technology) but simultaneously as a pull factor on the earnings side, earning higher spreads elsewhere.

What then are these low cost technologies? On the interest expense side the foreign bank might profit from home country advantages that it can use in foreign competition: it might have lower funding costs because of its size (the pool of deposits is larger) or active balance sheet management. It is also an advantage when the bank enjoys state guarantees which similar banks in other countries do not have. A state guarantee might result in a higher credit rating lowering funding costs which can be exploited in the host country. French state banks or German "Landesbanken" have had this advantage in an explicit way. Given the level of net interest income, the bank might also have lower operating expenses. The offering of interest income services through a new distribution channel is a clear example of this. Finally, the foreign bank might have developed special monitoring skills decreasing the loan provision it has to reserve compared to competitors. There is not much empirical evidence which supports this though.

There other hurdles to exploit these differences in spreads, as these differences in spreads can also be the result of regulation combined with different local financing habits. To minimize the chance of externalities arising with financial intermediaries, government

can intervene in several ways through regulation. On a micro economic level price regulation and interest rate ceilings are commonly applied instruments. On an industry level regulatory authorities can shield off foreign competitors, allowing domestic competitors to gain above market returns resulting in a higher spread and in the process.

Differences in financing structure of firms and households between countries could also cause distorting signals for the use of spreads as a motive to internationalize. For example the term structure of the United Kingdom has shown a flat or even negative sloping term structure during the 1980s and '90s. In contrast to other European countries British households tend to finance their mortgages with short term loans, which ultimately results in a negative spread in contrast to other European countries which usually exhibit a positive spread. These differences cannot be exploited by international financial intermediation.

The use of spreads as cost differentials for comparative advantages is an intuitive explanation to engage in financial intermediation. However a main problem associated with using comparative advantages lies in the validity of the theory itself. The Heckscher-Ohlin-Samuelson framework has difficulty explaining why a large share of international trade takes place between similar countries, and a large share of trade consists of two-way trade in similar products and services (Lindert, 1986, p. 39). In other words, if differences in spreads are interpreted as a cost differential between countries, then the framework explains why differences in spreads are an incentive to internationalize. On the other hand, it does not explain why international financial intermediation takes place between countries with similar spreads.

#### 3.2.4. Differences in economic structure

The structure of the domestic economy compared to foreign economies is hypothetically an incentive to internationalize. Differences in economic structure and financial systems can be exploited, the existence of different economic cycles, as well as different demographics.

##### *Different characteristics economy and financial system*

Some of the structural differences in interest rate spreads are probably better explained by differences in institutional structure who determine for a large part the level and flow within a financial reservoir. Compulsory savings (through pension funds or other company funded schemes) are a strong impetus to raise a reservoir to a structurally high level. Structural changes in economic and financial structure can also be an important factor in the determinacy of different loan-deposit spreads. The transition from an industrial society to a service oriented society implies a shift in the structural composition of the financial reservoir as well as a change in the fundamental level of the financial reservoir needed. Emerging countries for example tend to focus in an earlier stage on the build up of industry which is capital intensive, creating larger borrowing needs for longer periods of time. On the other hand, economies which become more service oriented also become less capital intensive, creating larger saving surpluses.

Hypothetically, differences between financial systems and changes within financial systems might also be an incentive for banks to internationalize. In 2.4, the stylized characteristics of Bank oriented, Market oriented, and Government/institution directed financial systems were discussed. Table 3.3 presents incentives to internationalize from and to (countries with) different financial systems than domestically.

Table 3.3. *Financial systems and incentives to internationalize*

Effect on international activities banks	Bank oriented	Market oriented	Government/institution directed
Incentives for foreign banks to internationalize to financial system	<ul style="list-style-type: none"> <li>• Difficult to gain market share due to banking relationships,</li> <li>• Foreign banks compete in specialized services</li> </ul>	<ul style="list-style-type: none"> <li>• High market share</li> <li>• Competition in all services</li> <li>• Acquire product innovation</li> </ul>	<ul style="list-style-type: none"> <li>• Low market share, competition in specialized services</li> </ul>
Incentives for domestic banks in financial system to internationalize	<ul style="list-style-type: none"> <li>• Evade domestic regulation</li> <li>• Exploit advantage of long term banking relationship.</li> </ul>	<ul style="list-style-type: none"> <li>• Exploit comparative advantage gained by price efficiency and product innovation</li> </ul>	<ul style="list-style-type: none"> <li>• Create national champion</li> <li>• Evade domestic regulation</li> </ul>

In market oriented financial systems, the price mechanism plays a central role, allowing banks to securitize their loans but also forcing them to compete for strongly than in the other financial systems. For example, the environment for funding is more competitive, leading to financial innovations and new products. Banks operating in such a financial system can export this financial innovation to other countries (in bank oriented and government/institution led financial systems). For banks not located in a country with a market oriented financial system, the financial innovation might be an incentive to internationalize.<sup>4</sup> The long term banking relationships in bank oriented and government/institution directed financial systems can form a barrier of entry for banks from a market oriented systems, they are therefore likely to concentrate on specialized services based on the financial innovation achieved domestically.

Finally, internationalization of banks in a government/institution directed financial system might be promoted by government. Governmental goals such as power and prestige are visibly promoted, combined with escapist motives to evade strict government

<sup>4</sup> Cf. the transfer of resources as an incentive to internationalize (Canals, 1997, p. 268).

regulation at home. This combination serving both goals implicitly inhabits a moral hazard.

Table 3.4. *Change in financial systems as an incentive to internationalize*

		Transition from		
		Market oriented	Bank oriented	Institution/government directed
Transition into	Market oriented		(+) Larger and more liquid securities market (-) Decrease of spread between home and host (+) Price efficiency becomes more important than client relationship	(+) Larger and more liquid securities market / privatizations (-) Decrease of spread between home and host (+) Price efficiency becomes more important than client relationship
	Bank oriented	(+) Increase in spread between home and host country (+) Client relationship becomes more important than price efficiency		(+) Similar institutional relationship between financial intermediary and bank (-) High entry barrier to be part of institutional arrangement.
	Institution/government directed	(+) Increase in spread between home and host country (-) Increase in entry barriers for foreign banks, part of institutional arrangement.	(+) Similar institutional relationship between financial intermediary and bank (-) High entry barrier to be part of institutional arrangement.	

Note: (+) Positive incentive to internationalize, (-) Negative incentive to internationalize

When financial systems change, the transformation of the financial structure might create an incentive to internationalize. The (perceived) change from a bank oriented or institution directed system to market oriented system in a host country can be an important incentive to internationalize: a larger part of assets will be securitized, raising the volume and liquidity of the securities market. The change to a market oriented system increases first of all the size of the market, and might also lower entry barriers because activities related to long term relationships and strategic stakeholders diminish in importance. The argument for the home country is more complex. If the financial system in the home

country were to change from bank based to market based, the opportunities to raise funding for internationalization activities would increase. On the other hand, such a change would invoke an increase of the domestic securities market, in itself decreasing the need to internationalize.

Table 3.4 suggests some positive incentives to internationalize and negative incentives to internationalize (=to abstain from internationalization) when financial systems change. If a bank has operations in a country where the financial system changes, positive incentives then indicate motivation to further expand activities, whereas negative incentives indicate a motivation to decrease activities or even exit the host country.

### *Economic cycles*

Bryant (1987) forwarded differences in economic cycles as an incentive for banks to internationalize. He considered the case of a closed economy where households build up excess savings compared to firms having to borrow to finance their excess spending. The resulting savings flow into a financial reservoir from which firms can draw. Financial intermediaries maintain the flows into and from this reservoir through intermediation, maturity transformation and risk pooling. The level of this reservoir is strongly intertwined with expectations of real sector activity, increasing when expectations diminish and vice versa. The connecting link here is the interest rate, balancing aggregate savings and aggregate loans. However in an open economy aggregate savings do usually differ from aggregate loans. At the height of an economic cycle production capacity should be fully utilized. No new investment opportunities are found and savings start to outpace investments. Savings cannot be absorbed by investments and the money is stored in the financial reservoir through investing in financial assets like bonds thereby lowering interest rates. Financial intermediaries now face a situation where funding is abundant, but loan opportunities decreasing. The result is a decrease of operating results at home. If other economies experience a non-synchronous economic cycle, then it makes sense to transfer part of the wealth in the financial reservoir at home to the foreign reservoir.

### *Demographics*

A magnifying effect occurs if demographic factors are included: service oriented economies tend to have an aging population, who have had the opportunity to build up savings over a longer period of time. The consequences are far reaching: in an aging population the demand for mortgages will be reduced, shifting both the balance sheet composition of a bank and its product mix. Also, an aging population – neglecting immigrants for argument's sake - will eventually decline in size, naturally limiting the growth rate of financial services. Sebastian and Hernansanz (2000, p. 16), examining Spanish banks' strategy in Latin America, noted that the (aging) population of Spain is expected to decline by 0.5% annually over the next 50 years, whereas the (relatively young) population of Latin America is expected to increase by 0.8% annually. This was one of the incentives for Spanish banks to internationalize to Latin America.

### 3.2.5. Regulation

Regulation has always played an important part in the activities of the financial intermediary due to its apparent externalities. An externality arises when social costs and benefits do not coincide with private costs and benefits (Ferguson, 1988, p. 106) when a financial intermediary fails to take account of the effects of its own activities upon others. In order to prevent this, or at least mitigate the consequences, government can decide to regulate financial intermediaries. A problem in international banking complicating regulation is that the jurisdiction of national regulators is smaller than the geographical area of regulated financial institutions (Goodhart et al., 1998, p. 173). With regard to internationalization activities, regulation for financial intermediaries can be set up through four channels:

- Domestic regulation as an incentive for banks to internationalize
- Regulation controlling the entry and conduct of foreign banks in country
- International regulation
- Deregulation and privatization

These forms of regulation can have a profound impact on the development of the banking sector. For one, the extensive differences in regulation between countries not only are an incentive for financial intermediaries to engage in international activities but also gives rise to different moral hazard dilemmas which increases the sector's "susceptibility to recurring crises" signaling new rounds of regulation (Walter, 1988, p. 4). This view is not undisputed though. Benston (1994, quoted in Goodhart, 1998, p. 175) argues for example that international banking does not pose special problems that must be managed by harmonization of national banking regulation.

#### *Domestic country regulation as incentive for banks to internationalize*

Regulatory biases between countries can provide an incentive to conduct business through activities in foreign countries offering greater freedom from supervision than in the home country. The most relevant regulatory provisions relate to exchange controls, taxation, monetary policy, entry in the market and the relationship between different financial activities (Pecchioli, 1983, p. 53; Dicken, 1998, p. 404). Regulation as an incentive can be viewed as a push incentive, also known as escape motive, or as a pull incentive.

The differential fiscal treatment and double taxation conventions have always been an important factor to promote financial activities abroad. Banks in highly taxed countries may have an incentive to set up subsidiaries in countries with lower taxes, and channel business through there. Regulation might here be interpreted as a pull motive. Peccioli concludes that taxation is more important for the choice of booking location than the decision to conduct actual business. He constructs a table showing the cost advantage of offshore banking taking advantage of lower reserve requirements:

Table 3.5. *Cost advantage of off shore banking due to different reserve requirement*

borrowing rate (%)	differential reserve requirement (%)				
	1	5	10	15	20
5	5	26	56	88	125
10	10	53	111	176	250
15	15	79	167	264	375
20	20	105	222	353	500

Note: cost advantage displayed in basis points. Assumption is that no interest is paid on reserve requirements. Source: Pecchioli, 1983, p. 57.

A clear push incentive forms exchange controls and the long lasting restrictions on capital movements, as motives to set up a foreign based activity. By raising funding costs and/or limiting the scope for business expansion, monetary controls create an important incentive to book business elsewhere. A monetary authority can impose rules on the application of a reserve requirement, ceilings on interest rates, and other quantitative controls in domestic bank credit expansion. Strict implementation of these rules can promote off shore growth of business. Finally, opening international business can be used to circumvent domestic prudential regulation and reporting requirements. Alternatively, a country may restrict its banks from foreign expansion. For example, Sweden did not permit its banks to open branches abroad, and restricted foreign bank presence to representative offices (Tschoegl, 1987, p. 71).

*Regulation controlling the entry and conduct of new foreign banks in host country*

The regulator of the foreign country has also some instruments to control entry and conduct of foreign banks (Dicken, 1998, p. 404):

- regulation to govern the entry of firms: a barrier to entry in the market
- regulation to govern relationships between different financial activities: the influencing of market conduct.

The regulation to govern the entry of banks can result in a generic or specific regulation as a barrier to entry in the market. The generic one is through its macro-economic policy, combining exchange controls, monetary policy and differential tax treatments. It concerns all firms wanting to do business in the foreign country but hits financial intermediaries especially. Consider a hypothetical case where the foreign country upholds rigid capital in- and outflow restrictions, and the currency is not convertible. A financial intermediary might have a strong incentive to overcome these regulations in the following situations:

- Part of the financial intermediary's customer base has dealing in that country. This was the case with expanding US banking presence in Europe after the Second World War. This relates directly to clients as an incentive to internationalize, discussed earlier.
- The financial intermediary has a long term strategy in mind. There exists an expectation of above average returns as a long term investor which will materialize when reforms take place and capital can be converted. Current example might be the banking presence in China or other countries in South East Asia.
- The financial intermediary was there to begin with when the capital restrictions were introduced and now shows it long term commitment.

A special case of generic regulation is entry of foreign banks as a by-result of domestic regulation. When the American Franklin National Bank failed, there were few potential banks in the United States able to buy the bank because of interstate banking laws. In another cases, when GATX transport company was required to sell LaSalle National Bank of Chicago, United States banks could not acquire LaSalle because of Illinois and federal banking laws and restrictions (Walter and Gray, 1983, p. 579). Regulatory authorities can also issue specific measures as a barrier of entry for banks. These are measures not applied to domestic banks. The authorities can:

- demand additional reporting requirements from the banks
- additional reserve requirements
- guaranties from the regulatory authorities of the bank's home country
- demand reciprocity for entry of banks in the country.

Regulation to govern relationships between different financial activities influences market conduct. The most straightforward manner is to bar certain domestic activities for foreign banks. Most subtle, the regulatory authorities can force the entrant to choose just one activity, forsaking business opportunities in other areas. The market structure itself is also part of regulation: if financial participations or acquisitions are undertaken, they must by law be approved by the regulatory authority.

Here too, the regulatory authorities can use regulation as a competitive weapon, easing regulation controlling the entry and conduct of banks compared to other countries. Walter and Gray (1983) postulate that countries with a competitive advantage in the production of banking services are more likely to prefer open banking systems. Buch and DeLong (2001) find that in general, regulation has had a negative effect on foreign bank mergers and acquisitions between 1978 and 2001.

### *International regulation*

National jurisdictions do not always have the power to supervise cross-border banking activities adequately. International operations have the potential to increase the impact of systemic failures resulting from increasing interdependence of national financial systems (Goodhart et al., 1998, p. 174). As such certain forms of international regulatory

coordination can be desirable (Neave, 1998, pp. 330-333). Also, regulation can be used as an instrument to attract banking activities. Regulatory competition can also lead to undesirable results, also known as the Delaware effect. However, regulatory competition does not necessarily lead to downward pressures on regulation, but may also push the level of regulation upwards. Upward pressure of regulation may not only result directly from the dynamics of the competitive process but also from international cooperation, for example the successful multilateral standardization of banking capital requirements by the Basle Committee (Genschel and Plumper, 1997). International regulation encompasses the following areas:

- Banking supervision
- Lender of last resort
- Capital adequacy
- Transparency in financial accounting standards

Except for regional developments such as in the European Union, the only international coordination of banking supervision is carried out by the Basle committee, a group of central bank governors of the G-10 countries. Its goals are to coordinate national supervision to take account of banks' international business and to assist national authorities in monitoring the foreign operations of their own banks. Prior to the Basle Accord, bank supervisors agreed in the Basle Concordat to the following points:

- All foreign banking establishments should be supervised.
- Supervision is a joint responsibility of home and host authorities:
  - Supervision of liquidity of the bank is a host responsibility to assure conformity with local practice.
  - Solvency of the bank on the other hand is the responsibility of the authorities in the home country of the bank.
  - Information should be exchanged between home and host authorities to perform the tasks properly.

In the early 1980s, concerns increased about international banks' health and unfair competition; the Basle Committee on Bank Supervision started considering proposals to set capital standards for these banks (Santos, 2000, p. 17). The Basle Accord, agreed in July 1988 and implemented by January 1993 in 12 countries, concerned only large, internationally active banks. It was primarily concerned with credit risks (Karacadag and Taylor, 2000, p. 11); guidelines were developed to assess country risk, liquidity risk, solvency risk and risk-based capital adequacy standards. The Accord provided a simple

methodology<sup>5</sup> for assessing capital adequacy producing a single metric, the 8 percent capital ratio, against which banks could be compared.

From the standpoint of the bank, capital adequacy has also a strong signaling effect for its clients. A bank's capital is the source from which loan losses are covered, if current earnings are not sufficient. A larger bank's capital therefore signals strength: if unexpected set backs happen in the loan portfolio, depositors can be assured that this does not affect their wealth. It is a delicate balance though: if the bank's capital is too high, then this signals that management cannot or will not find enough opportunities to deploy the capital profitably, discomfoting shareholders. Government plays an instrumental role in this too. Management can reduce the amount of capital needed if government signals, through direct ownership or formal guarantees, that loan losses will eventually be covered.

Finally, coordination with regard to lender of last resort is a politically delicate one. A lender of last resort stands ready to provide credit to temporarily illiquid financial institutions. On an international scale the Bank for International Settlements has provided such funds, but since the 1980s organizations such as the International Monetary Fund and the World Bank have taken on this role. Besides international coordination of banking supervision, guidelines to disclose and supervise capital adequacy are instrumental to promote fair competition for banks operating worldwide.

Summarizing, regulation can heavily influence incentives to internationalize. Theoretically, relative lower operating costs arising from regulation in foreign countries increases the incentive of foreign activities.<sup>6</sup> Also, relative higher operating costs arising from regulation in foreign countries can be a barrier to undertake international banking activities.

### *Deregulation*

A discussion of international regulation would not be complete without considering deregulation. Deregulation is primarily aimed at three areas (Dicken, 1998, p. 400): opening of geographical markets, provision of new financial products and changes in the way in which prices of financial services are set.

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<sup>5</sup> Karacadag and Taylor (2000) and Santos (2000, pp. 11-15) reviewed criticism existing from the outset of the Basle Accord. The system does not generate a capital advantage for banks with well-diversified portfolios, although portfolio theory states that they should be treated as less risky. Other issues related to arbitrariness (only four risk buckets are identified, and what is the basis for the eight percent minimum capital ratio?). Although transparency has been achieved, perverse effects have also emerged, such as the evasion of capital requirements through new financial instruments.

<sup>6</sup> The emerging markets crises in the mid-1990s has sparked debate which foreign banking activities these should be. Large and sudden shifts in foreign exchange activities and short term international portfolio investments - both core activities of banks - in and out South American and Asian economies destabilized these regions considerably. Suggestions to at least discourage such movements included support for an idea first proposed by James Tobin in 1972 to levy an international tax on all foreign exchange dealings. This so-called Tobin tax might be small (for example 0.1% on transaction amount) but would be sufficient to dampen short term speculative movements (Tudor, 2000, pp. 212-213). Chile (and Colombia as well) applied a variant with a scheme requiring up to 30 percent of investment funds entering the country to be deposited in a non-interest bearing account at the central bank for one year, amounting to an effective tax on capital inflows and short term investments (Tudor, p. 214).

Dages et al. (2000) argued that there are several arguments in favor of deregulation by opening financial sectors in emerging markets to foreign ownership. First, a foreign bank presence increases the amount of funding available to domestic projects by facilitating capital inflow. This can also stabilize domestic lending patterns as the capital and funding base of the financial sector is diversified. This is quite relevant for countries with small capital markets or volatile economies. Dages et al. showed for Mexico and Argentina that foreign banks tend to show stronger and less volatile loan growth in the 1990s, reflecting more diversification on the funding side of banks; Crystal et al. (2001) found similar results for foreign banks in Chile and Colombia.

In periods of international financial crises, no significant retrenchments of US bank international claims is observed (Goldberg, 2001).<sup>7</sup> Second, foreign banks can improve quality, pricing and availability of financial services, both directly and indirectly competing with domestic banks.<sup>8</sup> Third, foreign bank presence is said to improve financial system infrastructure, and stimulate increased presence of monitoring agents. Naturally, all of these goals can probably be achieved autonomously by an economy, deregulation simply speeds things up.

All arguments in favor of deregulation can also be formulated oppositely; foreign banks may destabilize domestic capital markets, offering avenues for "hot-money" and capital flights. They might also cherry pick lucrative domestic customers and loans, leaving the domestic banks worse off.<sup>9</sup> Supervision also tends to become opaque when complex financial institutions are active in a number of areas. There is some research suggesting a pattern where financial deregulation tends to forebode financial crises, although no special attention has yet been paid to the role of foreign banks. However, Demirgüç-Kunt (1998) found that between 1988 and 1995 for a large number of countries foreign bank entry coincided with lower incidence of local banking crises.

### 3.2.6. Historical and cultural determinants

There are other incentives for internationalization which are non-economical. Strictly speaking they are not even incentives but determinants which lower the hurdle rate to take advantage of the other incentives. Geographic proximity, a former colonial period or immigration are important factors to explain why a bank decides to undertake activities in a foreign country. A shared common language, administrative system and culture are an enormous help for banks wishing to enter these markets (Sebastian and Hernansanz, 2000,

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<sup>7</sup> Another explanation could be that a number of financial crises between 1982 and 1998 have shown that the United States government ultimately bails out most banks which are in a difficult financial situation. The stability of these claims thus might merely be a demonstration of lesser need to react swiftly to changing market conditions for US banks with the knowledge of a safety net at home.

<sup>8</sup> Implicit assumption is that financial innovation is more developed in the home country than in the host country. This argument holds up for a limited amount of time, at least up until convergence is achieved.

<sup>9</sup> Western banks have off and on been accused of such a diabolic role, the argument being as follows: first the Western banks feed the country's economy with cheap capital destabilizing the economy and then help repatriate the capital of private customers when financial crisis is imminent.

pp. 24-25). The expansion of American banks setting up offices in London in the 1950s and 1960s has been advanced by the fact that both countries share a common language (Roberts and Arnander, 2001, p. 14). The presence of British banks in the 1970s in Africa can be explained by the former presence of British colonies there, with a similar case for French banks in Central Africa and South-East Asia or Spanish banks in South America. Australian banks sought markets where similar products and services could be offered as supplied through their domestic branches, leading the banks to internationalize to countries such as New Zealand and the Pacific islands, sharing a common British heritage (Merrett, 2002, p. 387).

These cultural and historical determinants offer several advantages when banks are internationalizing. First, banks can commercialize the same products with similar marketing techniques, lowering entry and sales costs of new banking services. The use of the same language facilitates the transfer of know how and could help the process of integration within the organization, when foreign expansion is achieved by acquiring local banks.

### **3.3. Sector intrinsic incentives**

#### **3.3.1. Herding**

Herding takes place when a bank imitates the actions of other banks; the bank must be aware of and be influenced by other banks' actions. The bank can be said to herd when knowledge that others are investing changes its decision from not investing to making the investment (Bickshandani and Sharma, 2000). There are several reasons to change its decision. First others may know something about the return of activities that the financial intermediary does not know. Second the bank may have an intrinsic preference for conformity.

There is always the possibility that the concentration of activities in time and space look like herding, but are in fact stimulated by intrinsic factors which are observable for every financial intermediary and which lead to an decision by the financial intermediary not influenced by the actions of the other financial intermediaries. Developments take place in markets which are generally among the market participants agreed upon as strategic, such as the growth potential of Asian and Latin American markets in the 1960s and 1970s. More recently the liberalization of Eastern European financial markets after 1989 could be an example.

Herding can be embedded in Vernon's and Hymes' framework of oligopolistic behavior of transnational corporations (Dicken, 1998, p. 184). Vernon found that the development sequence consists of three phases, innovation-based oligopolies, mature oligopolies and senescent oligopolies. Whereas the innovation based phase is still located in the home country, in the mature phase firms will try to react to match the actions of their major competitors. Locationally they will tend to pursue a follow-the-leader strategy

whereby a move of a firm to undertake activities in a certain country is likely to be followed by the other major competitors, leading to a clustering in time and space.

Bickshandani and Sharma (2000) discuss a number of rational herd behavior models. Key outcome is that such behavior is fragile - it may easily break with the arrival of new information - and idiosyncratic: the first few players determine the type of behavior on which individuals herd. Finally herding exhibits a strong path dependent element in itself. Upholding reputation is also an incentive to herd: if a financial intermediary is uncertain of its ability to exploit new opportunities, conformity with activities of other financial intermediary reduces this internal uncertainty. This benefits the financial intermediary and if other financial intermediary are in a similar situation then herding occurs.

The actual activity to be set up is just one of the considerations the herding financial intermediary has to make. By following the first mover the other financial intermediary can prevent the accumulation of a too large market share. The short term concern for the financial intermediary is that it cannot observe the opportunity the other bank has seized, and the accumulation of market power in the foreign market.

But in the long run he has to consider how this influences the relative market power in the home market as well. Consider for example a bank that specializes in underwriting. Expanding in foreign markets increases its distribution potential for securities. This does not go unnoticed by the large home clients who prefer a broad and successful securities distribution. One of the strategic options the competitor bank has is also to expand in foreign markets, to restore the balance of power at home. It can therefore be perfectly logical to observe the set up of loss making activities as a result of herding.

Naturally, herding also has its hurdle rates. Financing restrictions of current operations must not be binding. Herding is more likely to take place when financial intermediaries are endowed with surplus capital and cheap financing requirements such as below average interest rates and relative high valuation of equity.

Herding as an incentive to internationalize is an apt explanation for the cascade of activities following the first mover, leaving the incentives of the first mover itself in the dark. For the formation of financial centers, a long term exhibition of spatial herding, the originations have been described in more detail. The spatial combinations of trade, political power and minimization of transportation and communication costs between banks have been instrumental in the nurturing of such financial centers (Kindleberger, 1974). When payments require a physical relationship of either wealth transfer or administrative papers, the efficiency of a single center with intermediaries specializing in clearing is paramount. The rise of a number of financial centers is intertwined with the rise of trade activities in those cities. Kindleberger (1974, p. 7) cites the example of Liverpool, where the roots of many banks can be traced to trade firms. The geographical pattern of banks was closely linked to that of commerce.<sup>10</sup> Also, political and administrative

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<sup>10</sup> Besides that the international expansion pattern was also closely linked to the composition of the family, since many banks were set up as partnerships. Family members were sent out to establish overseas activities, as a very effective instrument to reduce agency problems. The organizational innovation of joint stock banks and the

concentration of functions in one city might help. The formation and growing duties of central banks has been an important thrust for many financial centers.

After the initial founding, the financial center might create its own momentum for structural herding over time: communication costs are structurally lowered, lags in communication time lowered (of crucial importance before the invention of the telegraph), pools of human resources for financial intermediation created and other infrastructure or tax related advantages. For example, London played an important role in international banking after the second world war, especially since the 1970s when the city became the major European financial center for securities trading and the Eurocurrency market. When the securities markets were deregulated in the 1980s, European, American and Japanese banks acquired or set up investment banking activities in London because the city had a well developed banking structure, and enjoyed attractive features<sup>11</sup> which helped it offset the disadvantage of not having a large domestic currency base like the financial center of New York or Tokyo.

### 3.3.2. Market power and concentration

Market power and concentration within banking markets can provide incentives for international activities. There are two different interpretations of concentration as an incentive to internationalize. First, an increase in concentration of banking activities can limit expected earnings growth a bank can achieve. An increase in domestic market share might be difficult to achieve because of the high(er) market shares of other banks; earnings growth is then more easily achieved outside the home country in markets where domestic limitations do not apply. Concentration as a single measure might be misleading to use in such an instance. For example, an analysis of the German mortgage market would probably show relatively lower concentration ratios than other European countries. Since a large number of the market participants (in particular the *Landesbanken*) are semi-government institutions, their share cannot be acquired or contested in a straightforward way creating few growth opportunities for the remaining banks.

Behind strategies to increase market share is an implicit hypothesis that a greater market share is always equivalent to greater profitability (Canals, 1997, p. 120). High concentration as a measure is forwarded in literature as an indication that higher returns

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possibility of holding stakes in other joint stock in the latter part of the 19th century provided a framework to structurally deal with the agency problems, although the partnership construction survived well into the 20th century, especially for private banking and investment banking, activities where discretionary personal communication is an unique selling point. Kindleberger notes that is surely is no coincidence that private banks are usually named after persons, suggesting trustworthiness, whereas 'common banks' take their name of the region of function they perform (1974, p. 4).

<sup>11</sup> Main features are: the informal regulatory framework of the Bank of England, a universally accepted language, good location well placed in the time zone to communicate with other major financial markets during working hours (Shaw, 1979). In addition to this, London enjoyed a concentration of financial information services, some of the world's leading money publications, specialist printers, and a substantial skilled labour forces. For American bankers, the use of English Law and English language was particularly attractive (Roberts & Arnander, 2001, p. 14).

can be achieved than under a regime of perfect competition with a large number of players. If this is the view taken, a bank can have an incentive to undertake activities in a country with a higher concentration ratio than its own. Of course the question stands out why this high concentration ratio exists in the foreign country. Barriers of entry and other regulations could prevent such differences to be exploited.

The second interpretation of concentration as an incentive to internationalize is that because some banks are more efficient or successful than others, they tend to gain more market share leading to a higher concentration ratio. Thus higher concentration is a sign that a number of banks are very efficient. Banks then could have an incentive to exploit this efficiency further outside the home country.

Efficiency gains may also be the result of merger and acquisition activity. Most commonly mentioned are the benefits which can be derived from lower costs if economies of scale and scope can be achieved (Pilloff and Santomero, 1998). Costs efficiency may also be improved if management of the acquiring institution is more skilled at achieving lower expenses for any given activity than that of the acquired firm. Third, analogous to the cost efficiency argument, additional revenues can be achieved as a result of larger market power. This argument can only serve as an incentive if the cross border M&A concerns a specialized and global financial service, where the number of competitors is limited. Examples are custody or investment banking.

Fourth, the bank can diversify its activities through mergers or acquisitions. Diversification in itself does not enhance efficiency; it broadens the geographic reach of a bank or increases the breadth of products. In theory this could lead to less variability in earnings raising the market value of the bank, although the nature of the diversification itself can also have negative repercussions for the market value of the bank. It may lead to a discount in market value reflecting agency problems between shareholders and management (Lins, 1999). This discount can be larger if the diversification is cross border with activities where shareholders have difficulties assessing them properly.

### **3.4. Firm intrinsic incentives**

Markets are imperfect; the greater the imperfection the greater will be the incentive for a bank to perform the function of the market itself by *internalizing* market transactions (Dicken, 1998, p. 187): it is more efficient or profitable for the firm to create an internal market within the firm and do the transaction then to do the transaction in the open (capital) market. Specific advantages result from internalizing a long term relationship with the client. A bank following its client can adequately be explained with internalization. Casson (1990) considered a bank with clients who want to be serviced outside the home country. The bank has three choices: export banking services from the home country, set up correspondent relations with foreign banks or establish subsidiaries in the foreign country.

The objection to export is that many banking services are location bound and require physical presence from a bank-employee: deposits and cash withdrawals are

difficult to handle at a distance. The objection to correspondent banking is that the correspondent bank may be inexperienced meeting the client's needs, and the bank cannot control the quality of the service. The favor may not be returned to the bank in the home country; the correspondent bank may not be able to reciprocate with new clients. Finally, there is the risk that correspondent relationship offers the opportunity for the correspondent bank to shape itself into a competitor in the home market. In short, both export and correspondent relationships may not be beneficial to the internalization of a long term relationship with a client. Under these conditions, the establishment of subsidiaries is an obvious strategy to capitalize of the internalized goodwill of clients.

Internalization has the potential to create a win-win situation for both bank and client. Consider a firm who wants to fund its activities in a foreign country. It can ask its bank in the home country to extend the loan in foreign currency. Mutual advantages start to appear. The financial intermediary is already monitoring the firm in the home country thus the extra loan adds to the monitoring costs at home, not in the foreign country.

The firm, realizing that this benefit falls to the financial intermediary, has a negotiation margin to lower the interest rate charged. Depending on the outcome of the negotiation and the amount of asymmetric information between financial intermediary and firm, some redistribution of the gains will take place. The financial intermediary can also apply the redistribution of benefits to other purposes. It can use part of the benefits to finance the underpricing of new loans in the foreign country by lowering its margin. Internalization can be generated by economies, cost of capital or risk/return diversification.

#### 3.4.1. Economies

The financial intermediary, engaging in international activities, can rationalize or base this decision on two major types of potential cost advantages: economies of scale and economies of scope. Economies of scale are generated when the average unit cost for a product decreases with the increase of production. The change in production is a decreasing one: each additional unit of output will generate less costs benefits than the previous one. At some point, no more cost advantages are to be had. This is the minimum efficient size. Organizations aiming to enter this market thus have to produce at least this amount in order to be cost-competitive.

A bank's management can strive to achieve economies of scale in two different ways; at product and at company level. At company level, economies of scale exist that cannot be attributed to one or more products. At product level, economies of scale can be identified and attributed to specific factors. For example, a common analysis to approach economies of scale in the banking industry is to analyze the funding costs, relating the amount of liabilities (usually deposits) to a measure such as cost rate on total funds or interest bearing funds.<sup>12</sup> The underlying hypothesis is that an increment in the amount of

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<sup>12</sup> Cost rate of total funds is defined as:  $\text{interest expense} / (\text{total liabilities} + \text{equity})$ . This is a measure for gross interest cost on aggregate funds. More detailed is cost rate on interest bearing funds:  $\text{interest expense} / (\text{interest-}$

deposits lowers funding cost, all other things equal. These studies bear resemblance to production plant studies, downplaying the complexity of financial services to some extent. Existence of economies of scale in this area is doubtful (Canals, 1993, p. 187).

Llewellyn (1999, p. 72) found that the results on research of bank economies were "at best, inconclusive and ambiguous". However, he pointed out that many studies on scale efficiencies in the late 1980s and early 1990s used United States data from the 1980s, finding in general a flat U-shaped cost curve with slightly more efficiency benefits for smaller than for larger banks. Also, more recent research using different econometric techniques suggests that there might be more substantial gains from consolidation. Another area which has increased in importance in relation to economies of scale is investments in information technology. Economies of scale have always been an important argument for management towards stakeholders to rationalize a merger or acquisition. Economies of scale to be found in the area of IT are increasingly mentioned as a driving force.

If it has been difficult to obtain a clear picture of economies of scale as an incentive to internationalize, economies of scope is in some respect even more complex. Though it seems to be a popular motive for bank managers to base their defense of a diversified organization upon, its effects are probably hardest to measure.<sup>13</sup> Economies of scope are potential advantages arising from sharing costs between different business units, so that the total cost of offering these activities by different units is greater than offering these combined. This cost reduction, sometimes denoted as (cost) synergy, can be reached by pooling technology or managerial qualities. Cost reduction can take place by closing overlapping branches. Indirectly, the capital of the firm might be employed for more profitable uses. Consider for example two business units that comprise an insurance and a commercial loan activity. In both cases, a portion of the firms' capital has to be reserved to provide for potentially bad outcomes. When the risk of those units is less than perfectly correlated, their combined provision for bad outcomes should be lower than separately considered, assuming regulators allow some kind of pooling of risk capital.

Another cost reduction with economies of scope results through cross-selling. Relationships between client and financial intermediary can be built through interactions over multiple products. The bank can spread any fixed costs of producing information about the client over multiple products, increasing the precision of the borrower's information (De Bondt, 1998, p. 279). In short, internalization advantages are more actively exploited. In short, it looks as though at best economies of scope lower costs by sharing (information) infrastructure and diversifying risk.

Here too, similar reservations as with economies of scale apply. "The alleged case for financial conglomerates is based ultimately on economies of scope which in practice

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bearing liabilities). This calculates the average interest cost of liabilities that bear interest cost (Hempel & Simonson, 1999).

<sup>13</sup> Shareholders seem to think so too. For example, diversified organization combining insurance and banking seem to be valued at a discount compared to their specialized banking- and insurance peers. Lack of measurability of economies of scope can explain part of this discount. Canals (1997, p. 104)

often fails to materialize" (Llewellyn, 1999, p. 75). Few cost savings have been found in research studies, most studies are inconclusive, and existing reports suggest modest gains that have been achieved.<sup>14</sup> Data availability and complexity of the research methodology to analyze this does not help either (Berger and Mester, 1999). As incentives for internationalization, economies can be an incentive to internationalize if it cannot be achieved domestically, or if it can be achieved more easily outside the home country:

- Economies as an incentive to internationalize are relevant if they cannot be achieved in the home market: the absolute growth potential in the home market is limited in size and/or market share
- Economies are more easily achieved in the foreign country than in the home country: structural difference in costs may originate because the bank has to politically commit itself to the country of origination

The first argument relates to physical or competitive boundaries. The market share of the financial intermediary is such that either government can prohibit further expansion in the home country, or that there are no further opportunities to expand. Even so, the opportunities to expand can result in diseconomies of scale when the market is overbanked. The marginal cost of acquiring market may be larger than the marginal cost reductions achieved by the larger market share. Small countries tend to exhibit high concentration ratio's, and also a strong incentive to internationalize (Netherlands, Switzerland).

This is not to say that economies of scale must be necessarily related to small countries. Ter Wengel (1995) examined factors explaining trade in banking services between countries, and found in a cross section analysis that the size of the home country significantly influences the export of bank services in a positive manner. This would then contradict the small home market as an incentive. This result substantiates according to Ter Wengel the hypothesis that explanations stressing economies of scale might be more useful in explaining international trade in banking services (Ter Wengel, 1995, p. 61).

Tschoegl (2002) found that size correlates with foreign expansion of banks; linking it to the client incentive. Large banks tend to have enough domestic multinational companies and clients engaged in foreign trade to justify going abroad. This suggests that banks have a hurdle rate for return on investments, income or number of clients in mind when considering internationalization to a country,

Second, the result could be a sharing of different product lines with regard to for example IT and back office functionalities. Why should this better be achieved in a foreign country than in the home country? Political commitment to the country of origination could be a reason, as there might be strong resistance to merge home country activities.

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<sup>14</sup> For example, Morgan Stanley Dean Witter published a report in 2000 finding that banks in the United Kingdom never managed more than two financial products each per client, out of an average number of six to seven financial products held by customers (UK Banks, Turbulence Ahead. (2000 May 9). Morgan Stanley Dean Witter: Equity Research Europe, p. 13

Assumption here is that labor unions have a stronger position in the country where headquarters are residing.

### 3.4.2. Cost of capital

Capital markets in different countries can impose very different capital costs on banks. In the 1980s, banks with high capital costs found it difficult to compete in the United States wholesale market with low margins and low market share, while banks with low capital costs gained market share (Zimmer and McCauley, 1991). An incentive for internationalization is that financial intermediaries strive to achieve a minimal acceptable return, for their total banking activities. If domestic returns start to fall, and there are no alternatives available in the home country, then foreign activities are sought after to supplement the return. An example of this is provided by a study of the Spanish banks' strategy in Latin America (Sebastian and Hernansanz, 2000, p. 27). Here, the success of these strategies is measured (among other factors) by the degree that increase of income from Latin America has compensated the fall of income in Spain.

Aliber (1984, p. 670) cited a number of authors who found that foreign banks expanded in the United States because American bank stocks were relatively low compared to bank stocks in other major stock markets. A depressed equity value could be interpreted as an indication that the cost of capital is relatively high. This opportunity can be grasped by foreign banks setting up activities in the United States with comparable or lower cost of capital as in the home country, an unlikely proposition according to research by Nolle (1995) or Peek et al. (1998). Another alternative route to profit is by acquiring the depressed stocks and creating subsidiaries. The combination of balance sheet and earning figures of home country and foreign subsidiary then provides a more favorable leverage, increasing market value at home.<sup>15</sup>

This argument can be extended with the shift from interest income to fee income. Financial intermediaries have been confronted with falling interest rates over the past ten years. This has turned out to be a two edged sword for financial intermediary with interest based activities. The financial intermediary has had opportunities to lower its cost of capital to evaluate potential new loans. On the other hand operating income for loans has decreased in line with the falling interest rates. In this view, extension into fee based activities with a higher expected rate of return has been a supplementary source of income to maintain the acquired rate of return.

Periods with a strong decline in interest rate will therefore create strong incentives to expand into fee based income. Why then should a financial intermediary engage in foreign fee based activities? An obvious explanation might be that given the amount of capital invested, foreign activities generate more fee income than domestically. An

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<sup>15</sup> Cost of capital linked to stock market value can also be an argument why domestic consolidation takes precedence over international expansion for certain periods. In the Netherlands the upsurge of international activities in the 1990s was preceded by a domestic consolidation wave. One of the main reasons for the

alternative explanation might be that banks profit from a temporary inaccurate assessment of shareholders. Fee based activities can generate higher income on average than interest, but can also be more volatile. This implies a relatively higher cost of capital all other things being equal. When a financial intermediary sets up fee based activities in combination with interest based activities, it raises future income but not the cost of capital in the same way: due to market failure market participants might not value the combination correctly; especially when fee based activity is foreign based. Additional estimates have to be made regarding country risk, currency risk and the general risk premium in the foreign country.

The result might well be a relative high valuation due to the relative lesser increase of the hurdle rate giving the financial intermediary temporary advantages not acquired in the home country. This advantage can be exploited by the financial intermediary to take on more risky projects and build up a stronger market presence. At some point however market participants do more accurately estimate the cost of capital by which time the financial intermediary must have capitalized on its internalized advantages through economies of scope or scale resulting in higher income to justify the valuation of the firm.

### 3.4.3. Risk/return diversification

Another approach to explain - more to rationalize - the internationalization of financial intermediaries stems from investment theory. The financial intermediary could be modeled as a portfolio manager in accordance with the modern portfolio theory, taking advantage of the low correlation between withdrawals by depositors and the loans extended. This has been developed by Pyle (1971); an investor with two types of assets with less than perfect correlation can achieve a better risk/return profile than with just one asset. In general, loans should have a positive expected excess return, and deposits a negative excess return. Since loans correlate less than perfect with deposits, the investor (the financial intermediary) could construct a mean-variance efficient portfolio as a combination of loans and deposits. As a result the risks and costs of organizing financial intermediation activities through the financial intermediary are expected to be lower than if these through open markets and economies of scope are achieved.<sup>16</sup>

This argument can be geographically extended. First it has to be established that from the viewpoint of an individual investor geographical diversification of the equity portfolio offers a superior return to a domestic equity portfolio. This being the case a financial intermediary could consider international activities as if it was constructing its own geographical portfolio of activities. The incentive to engage in international activities is if its return/risk profile turns out to be more profitable than the individual combination. A multinational financial intermediary then becomes a superior investment vehicle,

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consolidation was the relatively low share price valuation of Dutch banks compared to other foreign banks, making it more worthwhile for management to merge with another domestic partner than a foreign one.

<sup>16</sup> This analysis is not flawless since loans are non-marketable financial contracts. The non-marketability breaches some of the suppositions of the modern portfolio theory.

reflecting the fact that the market participants do not fully grasp the internal benefits from geographical diversification. The risks and costs of organizing international financial intermediation activities are lower than if these through open markets.

This argument has limited validation if geographical diversification takes place in countries who share similar economic structures resulting in market characteristics with high correlations.<sup>17</sup> However it can be a validation for diversification between different economic regions: the larger the geographical and cultural distance, the more chance a financial intermediary has that it is not properly valued. Furthermore, risk diversification can also be achieved by acquiring foreign activities not related to financial intermediation or by acquiring activities as purely financial investments. Portfolio theory as an incentive is therefore a more ex post reasoning.

Available empirical research suggests that some types of geographical diversified organizations are likely to improve their risk-expected return trade off. An early adaptation of modern portfolio theory is made by Rugman (1976), finding that a higher ratio of foreign to total operations is positively related to a lower variability of earnings to book value. He concludes that internationalization is risk reducing.<sup>18</sup> Literature on commercial banks in the United States generally finds that larger, more geographically diversified institutions tend to have better risk-return trade off (Berger et al., 2000).

As an example, Table 3.6 shows the correlation of net interest income (as percentage of average assets) for several large countries between 1980 and 2000. Strong improvements in the risk-return trade off would have been achieved for Dutch and English banks setting up interest based activities in the United States, with negative correlation between the countries. High positive correlations between the United Kingdom, Netherlands and Germany point to strong similarities in changes in net interest income over the years, supporting the argument that risk-return diversification as an incentive between countries with similar economic structure is flawed. The incentive is of limited value to Japanese banks also, not having a significant correlation with any of the other countries.<sup>19</sup> Table 3.6 shows that over the period significant correlations exist between the

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<sup>17</sup> That is not to say that a possible improvement in risk-return profile might be observed. This however can also point to a shift from banks to insurers of off- and on-balance risk (Czepliewicz & Millan, 2001). Benefits of securitization instead of geographical diversification are then explained.

<sup>18</sup> This is done for a sample of industrial firms in 1965, variability data is derived from 1960-1969. Rugman indicates that the results might be biased. The data only consists of United States firms, and the United States markets are large and well diversified. Japan and Europe should therefore show higher benefits from internationalization, since their variability in earnings must be higher than in the United States (Rugman, 1976, p. 78).

<sup>19</sup> Using net interest income is as an example for the possible trade off between risk and return has its limitations. It is one of the first items in an income statements, and therefore not influenced by a number of other factors. If one would take the correlations between profit before tax for the same period, a number of these relationships are not replicated. The difference lies in for example the fee income, and the operational expenses which one has to control for.

countries except Japan, and that diversification advantages should be theoretically possible.<sup>20</sup>

Table 3.6. *Correlations of net interest income, as percentage of total average assets between a number of countries, 1980 - 2000*

	Germany	Japan	Nether-lands	United Kingdom	United States
Germany	1.000				
Japan	0.166	1.000			
Netherlands	0.771 *	0.231	1.000		
United Kingdom	0.627 *	0.077	0.796 *	1.000	
United States	-0.485	-0.359	-0.714 *	-0.804 *	1.000

\*: p value < .05 (two tailed). Source: OECD Bank Profitability

Also, geographical diversification of activities tends to be associated with economies of scale. Goldberg (2001, p. 3) investigated determinants for American bank loan exposure in Latin America and emerging Asian countries for American banks between 1984 and 2000, and found that large American banks maintain claims on a larger number of countries than smaller banks. Finally, potential risk/return diversification benefits must be weighed against the introduction of currency risk and geographical diversification against the introduction of country risk in the overall portfolio (Shapiro, 1985). This argument has steadily gained more weight since the early 1980s.

#### 3.4.4. Shareholder return as an incentive to internationalize

A fundamental assumption in investment literature over the last decades is that the share price<sup>21</sup> is determined in a more or less efficient manner: all information, historic or forward looking, generated inside the bank from management or outside from investors, is reflected in the price of equity (Reilly and Brown, 2000, pp. 212-253). A change in equity price implies that new information has been assessed by the participants on the stock market and has been incorporated. This also implies that shareholder return can be influenced by an

<sup>20</sup> The stable relationship is not replicated when the same correlation table is set up for profit before tax. The difference lies in the cost structure, and the difference between interest income and non interest income.

<sup>21</sup> Share and Equity are terms used interchangeably. Equity either refers to the capital of a companies or the share in that equity. Equity is the residual value of a company's assets after all outside liabilities (other than to shareholders) have been allowed for. The equity in a company is the property of holders of ordinary shares, hence these shares are popularly called equities (Source: The Penguin dictionary of Economics, consulted on [www.xrefer.com](http://www.xrefer.com)).

overwhelming number of variables. It can be useful to cluster them into three areas, listed in Table 3.7:

- *Shareholder value drivers*: changes in performance that bank management can influence directly and are assessed by participants in the stock market, the so called value drivers in valuation models.
- *Investor relation drivers*: variables relating to the relationship bank management has with stakeholders. Bank management has to not only manage the bank's earnings, but also the expectations participants have regarding these earnings.
- *Stock market characteristics*: these are characteristics that cannot be influenced by either bank performance or its investor relations.

First, shareholder value measures the economic value of a shareholder's investments in a company. Economic value is based on the future income over the life of the bank's assets and activities; calculation of this economic value is based on discounting reflecting the fact that money has a time value. The income that a shareholder receives comes in two forms, cash dividends and capital gains. The rate of return that a shareholder requires from a share over the coming year will be the expected dividend plus the expected price appreciation over the year.<sup>22</sup> Any change in economic value is therefore reflected in shareholder return.

Over the years several valuation techniques have been developed to provide a basis for decision-making and control purposes, identifying drivers for management to increase shareholder value<sup>23</sup>, which in turn should positively influence shareholder return. Typical drivers for banks are cost of capital, capital employed, (residual or free) cash flow, gross income and operating expenses (Davies et al., 2000, p. 119). The relationship between shareholder return and the valuation drivers has yet to be empirically determined. Davies et al. (2000, pp. 147-148) cite research by consultancy firms determining the extent to which valuation models explain the change in shareholder return, however warning that little independent research support such findings.

Second, in order to achieve a higher shareholder return, management has more responsibilities than simply creating and executing a strategy based on drivers. The results have to be communicated to shareholders using investor relation drivers. Here management has to consider a multitude of factors. For example, shareholders do not like negative earnings surprises. Bank management can coach this to some extent by downplaying the estimations shareholders and analysts hold. More important, management has to control its organization in such a way that the variability of earnings is low. The bank's management has also to consider its position relative to its peer group. A well run bank based solely on interest income with high residual cash income might well be valued

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<sup>22</sup> Required rate of return =  $(DIV + P_1)/P_0 - 1$ . Where DIV is the expected dividend for the coming year,  $P_0$  share price at the beginning of the period, and  $P_1$  the expected share prices at the end of the period.

<sup>23</sup> Commonly used valuation models are Shareholder value analysis, Economic Profit, Economic Value Added, Cash Flow Return on Investment, Total Business Return (Davies et al., 2000, p. 97).

lower than banks with non-interest generating income, when shareholders come to believe that the long term prospects for non-interest generating business is far better. Both factors are important in the determination of the variability of the bank’s share price to general market movements.

Completely outside the control of bank management for shareholder return are the general stock market characteristics. Institutional factors, such as the liquidity of the market, restrictions on mergers and acquisitions, the financial structure in the country, and profitability of firms determine the relative attractiveness of such a stock market. Management is dependent on those characteristics for a number of (financial) decisions though. The cost of capital can be influenced by existing funding possibilities, and the valuations of the financial market compared to other markets determine the possible activities in the market of corporate control.

Table 3.7. Major drivers to increase shareholder return

Description	Scope	Drivers
Shareholder value drivers	Fully controllable by bank management	<ul style="list-style-type: none"> <li>• Cash flow generation</li> <li>• Loan quality</li> <li>• Cost-to-income ratio</li> <li>• Return on equity</li> <li>• Non-interest income to gross income</li> </ul>
Investor relations drivers	Partly controllable by bank management	<ul style="list-style-type: none"> <li>• Stability earnings</li> <li>• Earnings surprises</li> <li>• Risk management</li> <li>• Peer group performance</li> <li>• Beta bank compared to peer group<sup>24</sup></li> </ul>
Stock market characteristics	Not controllable by bank management	<ul style="list-style-type: none"> <li>• General return/risk characteristics stock market</li> </ul>

Shareholder value serves as an incentive to internationalize. In a stylized world shareholders provide the funding for the bank’s capital and are as stakeholders interested in propositions to internationalize if this leads to an increase of the bank’s capital and reserves, and an appreciation of the shareholder return during the process. Table 3.8 presents a possible relationship between factors driving shareholder return and how internationalization strategies might influence these factors. For example, if cash flow generation is a driver that management can influence to increase shareholder return, and higher cash flow generation cannot be achieved at home, then it might be a driver to

<sup>24</sup> Beta is a measure of variability of shareholder return compared to a (broader) market index. The determinants of Beta in an APT model can be based on a multitude of factors (which in itself constitutes a weakness of the APT model). Behm lists several significant factors based on research, such as industrial growth, change in yield curve, changes in short term and long term inflation rate, and changes in the credit risk by the bank itself (Behm, 1994, p. 117).

internationalize. By setting up or acquiring foreign activities, a higher expected cash flow might be achieved.

Table 3.8 shows drivers for shareholder return that can be (partly) influenced by internationalization. When implementing these drivers, bank management has to balance the negative and positive effects of internationalization activities for shareholder return. For example, management might decide that an increase in the non-interest income to gross income ratio is best achieved with banking activities in a foreign country. While this counts as a positive stimulus for shareholder value drivers which management can control, it can also be assessed by shareholders as a negative sign: variability of earnings might rise, increasing the chance of a negative earnings surprise. Bank management then has to balance between these variables.

Table 3.8. *Shareholder return drivers and internationalization*

Description	Drivers	Internationalization activities to influence factors
Shareholder value drivers	Cash flow generation	<ul style="list-style-type: none"> <li>Higher income host country</li> </ul>
	Loan quality	<ul style="list-style-type: none"> <li>Activities in host countries with higher economic growth</li> </ul>
	Cost-to-income ratio	<ul style="list-style-type: none"> <li>Activities in host countries with lower costs</li> <li>Similar activities in host countries for economies of scale</li> </ul>
	Return on equity	<ul style="list-style-type: none"> <li>Generate higher income with relatively same amount of capital outside home country</li> </ul>
	Ratio non-interest income to gross income	<ul style="list-style-type: none"> <li>Activities in countries with higher non-interest market</li> </ul>
Investor relations drivers	Stability earnings	<ul style="list-style-type: none"> <li>Lower variability through geographic diversification</li> </ul>
	Earnings surprises	<ul style="list-style-type: none"> <li>Lower variability through geographic diversification</li> </ul>
	Risk management	<ul style="list-style-type: none"> <li>Improve loan provisions through geographic diversification bad loans</li> </ul>
	Peer group performance	<ul style="list-style-type: none"> <li>Improve earnings</li> <li>Lower variability earnings</li> <li>Herding</li> </ul>
	Beta bank compared to peer group	<ul style="list-style-type: none"> <li>Improve earnings,</li> <li>Lower variability earnings</li> <li>Herding</li> </ul>
Stock market characteristics	Characteristics stock market: relative valuation	<ul style="list-style-type: none"> <li>Mergers and acquisitions in host country to improve earnings<sup>25</sup></li> </ul>
	Characteristics stock market: relative valuation: size, liquidity	<ul style="list-style-type: none"> <li>Funding bank capital outside the home country</li> </ul>

<sup>25</sup> Assuming that the relative valuation (for example, price-earnings ratio) in the home country is higher than in the host country.

Two issues remain to be addressed. First, how can herding positively influence shareholder return? And second, if internationalization positively influences shareholder return, can something be said about the optimal degree of internationalization?

### *Herding*

A bank with shareholders is part of the market of corporate control, where shares can be (publicly) traded and change ownership. If the bank were to undertake internationalization activities that lowered the market value of the bank, it would create the possibility of a takeover by another bank, whose management in general does not favor sitting management. International mergers may take place for strategic rather than wealth creating reasons, shifting explanations to strategic interdependencies of banks (Schenk, 1996, 1999).

In a rational world, one would not expect to see internationalization activities that destroy shareholder value and produce lower shareholder returns, unless strategic interdependencies are taken into account. Competitors might well engage in the same internationalization activity as competitors that lower their own market value. Not undertaking such an activity introduces the risk that the internationalization activity is actually a profitable one, and that the competitor has reaped first mover advantages thereby strengthening its own competitive position. Undertaking an internationalization activity makes sense if -at the very least- the decrease of market value is the same, or less, than its competitors. This does not change the status quo on the corporate control market. The internationalization activity should result in similar or better results than competitors; otherwise the bank's position on the corporate control market deteriorates.

In other words, herding can be viewed to some extent as a (relative) shareholder value driver. A syndicate can be considered as a formalized approach to herding: the lead bank has to convince other banks of the potential benefits to join in order to reap first mover advantages, in this case the principal fee. After the initial herding wave, to elements begin to play a role: there are more competitors around, and one would expect some kind of learning curve with competitors, resulting in skimming of the return. In the case of syndicates, economies of scale are triggered: the incumbent banks take on larger risks in a herding context to capture and maintain the first mover advantages.<sup>26</sup>

### *Shareholder return and optimal degree of internationalization*

Is there a degree of internationalization which optimizes shareholder return? Suppose that the equity price is determined by the reduced form of the dividend discount model:<sup>27</sup>

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<sup>26</sup> So herding can be viewed as an optimal response by an individual bank leading to a sub optimal situation (lower total returns, the bank has to take on more risk to achieve the same returns). If the shareholder is not able to appreciate these different states, he is probably inclined to base the equity price on the situation he knows (the optimal situation), where this information will probably elevate the equity price more than the sub optimal information.

<sup>27</sup> Introduced by Gordon (1962), discussed in Reilly (2000, pp. 448-452).

$$p = \frac{d}{k - g} \quad (1)$$

where

p = equity price  
d = payout ratio  
k = required rate of return by shareholders  
g = dividend growth

The required rate of return by shareholders can be determined by a number of factors:<sup>28</sup>

$$k = r_f + r_1\beta_1 + \dots + r_N\beta_N \quad (2)$$

where

$r_f$  = risk free rate of return  
 $r_{1..N}$  = risk premium factor  
 $\beta_{1..N}$  = sensitivity of required rate of return to factor N

The determinants of the required rate of return can be based on factors such as industrial growth, change in yield curve, changes in short term and long term inflation rate, and changes in the credit risk by the bank itself (Behm, 1994, p. 117). Other relevant factors might be earnings variability, earnings surprises in the past and general sector characteristics. International activities of banks make sense from a shareholder perspective if one or more of the following assumptions are expected to materialize:<sup>29</sup>

- Dividend pay out (*d*) will be higher as a result of internationalization. The bank generates more cash flow or more income with the same resources (higher efficiency, tax advantages).
- Dividend growth (*g*) will be higher as a result of internationalization. The bank generates more income and growth opportunities in foreign banking markets than domestically.
- The required rate of return (*k*) will be lower as a result of internationalization. Earnings are more diversified, decreasing variability of earnings and possibility earnings surprises. The lower sensitivities to these factors also lower the required rate of return.

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<sup>28</sup> This is the required rate of return as formulated by the Asset Pricing Theory (APT). It can also be determined by its predecessor, the Capital Asset Pricing Model (CAPM). This model is more restrictive however, allowing only the Beta as firm specific factor.

<sup>29</sup> This simplified example abstains from interactions between these variables.

If internationalization creates higher earnings growth with the same amount of capital, this could be translated in an increase in dividend growth. This represents another angle for risk/return benefits as an incentive to internationalize. Internationalization can lower the required rate of return if it one average lowers the sensitivity to one or more factors. If the correlation between return on bank activities in the home country and outside the home country is less than one, higher earnings can be achieved through internationalization activities with the same or lower risk. Internationalization then would reduce the bank's sensitivity to market developments, lowering the required rate of return.

Even assuming a stable dividend policy, it is unfortunately not possible to formulate a relationship between degree of internationalization, required rate of return and the (additional) market value. The figure below represents in the upper part the theoretical trade off between risk and return when increasing internationalization activities; the lower part shows a possible scenario for the change in market value. As long as internationalization is a minor part of bank activities, risk/return benefits are high. Once this increases, risk factors increase significantly too in the end lowering market value. A bank could also list its shares on more than one stock exchange in addition to internationalization activities (Figure 3.3). Multiple listings have the following advantages:

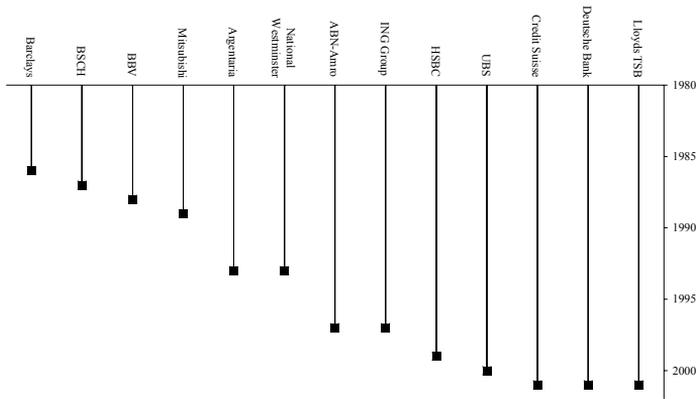
- The potential group of shareholders broadens. This increases the visibility of the bank as an alternative marketing concept, and demand for the share.
- The share may be listed on a stock market where more trading takes place than in the home market, increasing liquidity and therefore lowering the required rate of return.<sup>30</sup>
- Funding of an acquisition in a foreign country can be done by raising funds in the foreign country, reducing foreign exchange risk and increasing potential diversification benefits.

A disadvantage of multiple listings is that reporting requirements of the regulatory regimes probably differ, increasing administrative costs. If there is no active trade in the share, and no intention to raise capital in the foreign market the administrative costs outweigh the advantages. For example, by the late 1990s Japanese banks have increasingly de-listed their shares from different stock exchanges to save costs. Also, disclosure of information standards may be different, forcing the bank to provide information to the foreign regulator which it previously did not have to give to the local regulators. In the case of German and Dutch banks, hidden reserves had to be accounted for on the balance sheet raising their market value in the foreign stock exchange.

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<sup>30</sup> Fortis raised capital on the Dutch stock market for the acquisition of Belgian General bank in 1998, probably because the Dutch stock market was larger and more actively traded on than the Belgian stock market.

Figure 3.3. Initial listing year of non-US banks in sample on the New York Stock Exchange



Source: NYSE listing of foreign companies, 2001

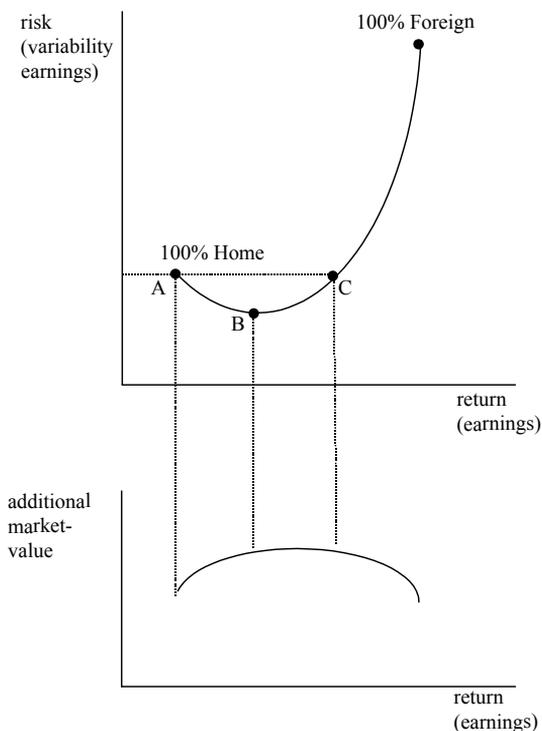
Summarizing, internationalization changes the market value of a bank. Is there a degree of internationalization which would optimize market value or share holder return? Hypothetically, internationalization can change the risk/return profile. In Figure 3.4, the upper graph represents the risk-return trade off for different degrees of internationalization. The addition of internationalization activities might lower risk and increase return (B)<sup>31</sup> compared to the initial situation (A), or increase return given the same risk (C) compared to the initial situation (A).

Returning to the dividend discount model, a change in return and risk changes both dividend growth as well as the required rate of return. Beforehand, we might assume that modest additions of foreign activities is valued by investors, but that a bank with 100% foreign activities is less valued by investors, due to a home bias. Combining the upper and the lower graph suggest that an optimal degree of internationalization might not necessarily lead to optimization of market value, whereas the optimization of market value might not necessarily lead to an optimal degree of internationalization.

Summarizing, shareholder return as an incentive to internationalize does not necessarily imply that banks have to increase earnings (growth) by internationalizing; the lowering of variability might be enough to increase shareholder value. In this view, support investments might be defined as internationalization activities that lower earnings, but are beneficial to the market valuation of the bank because variability of earnings is lowered. Also, internationalization activities focusing on activities with similar earnings, variability and high correlation between home and host country do not a priori create additional shareholder value. Either economies of scale are expected (lowering the required rate of return) or non-financial motives such as asset seeking are sought after.

<sup>31</sup> Assuming that return of foreign activities is higher than activities at home and that the correlation between the return of home and foreign activities is less than one.

Figure 3.4. Possible relationship between market value and degree of internationalization



In the market of corporate control herding behavior for internationalization activities is rational. Loss making activities do make sense as long as the relative risk/return deterioration is no worse than competitors, implying that the relative loss in market value is no more than banks in its peer group. Finally, optimization of shareholder value might not necessarily lead to an optimal allocation between home and host activities from a risk/return perspective and vice versa.

### 3.5. Summary

This chapter investigated incentives for a bank to internationalize. The incentives were clustered in three groups: *extrinsic*, *bank intrinsic*, and *sector intrinsic* incentives. *Extrinsic* incentives to internationalize stressed relationships with host governments and economies, and its effects on host economies. These incentives related to clients, net interest margins, economic structure, financial development and regulation. *Intrinsic* incentives to internationalize centered on the transaction cost approach, minimizing costs, maximizing efficiency, or optimizing competitiveness in combination with the internalization of markets. Hypothesized intrinsic incentives in this study related to economies, profitability

and capitalization as incentives to internationalize. Finally, *Sector intrinsic incentives* represented common ground between extrinsic motives and intrinsic motives such as the relative position a bank wants to attain relative to competitors, achieved by market power or visible through herding. Hypothesized relationships in this study were herding, market power and concentration.

A large number of these incentives can be assumed to be generic; they provide an explanation for different types of banking and non-banking organizations and have been applied here to banks specifically. This concerns incentives such as economies, risk/return, market or herding. A limited number is directly related to financial intermediation such as clients, spreads or regulation. In Table 3.9 incentives are summarized; it is also indicated when the incentive might be relevant for a bank to internationalize.

There are some methodological issues to be considered. First, have the incentives really initiated the international activity of the bank (ex-ante incentive), or have the incentives been instrumental to rationalize the realized international activity afterwards (ex post rationalization)? Taking expected risk-return incentive as an example, one might conclude that it would require accurate estimates from bank management of future economic and sector developments in the home and targeted host country over a longer period to make such a decision. Could the formulation of such an incentive therefore not be more revealing about the influence developments in financial management have exercised on the formulation of incentives in the last decade? If so, the incentive is an ex-post explanation of an incentive for an international activity. The same argumentation can be set up for cost of capital, economies and even the client "push" motive.

Second, is it possible to differentiate the effects of the different incentives: can incentives be separately observed or are some of them impossible to disentangle? For example, how does one distinguish between client-pull and client-push incentives to internationalize? Unless clients have been explicitly asked one must rely on possible relationships between observable measures such as foreign direct investment, assets of the bank in the host country, or performance.<sup>32</sup>

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<sup>32</sup> Obviously not banks, their answer might be blurred by frame dependency. "We are an active and client based bank, therefore we must have shown our clients the way in this country". See also Bryant (1987, p. 72).

Table 3.9. *Summary of incentives to internationalize*

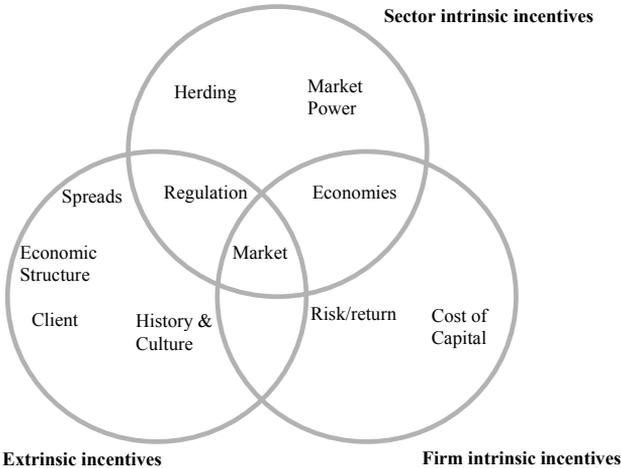
Incentive	Description	Relevance
1. Net interest margin	<ul style="list-style-type: none"> <li>Differences in spreads sign of more efficient banking, incentive to exploit outside home country</li> <li>Related to economies of scale</li> <li>Related to countries with differing degrees of financial innovation</li> </ul>	<ul style="list-style-type: none"> <li>Relevant for countries with different spreads, not relevant for countries with same spread</li> <li>Difference in spreads may not be exploited due to regulatory barriers</li> </ul>
<b>2. Perception of market</b>		
2A. New market, similar demand	<ul style="list-style-type: none"> <li>Exploit internalization advantages with existing internationalizing clients</li> <li>Exploit economies scale/scope</li> </ul>	<ul style="list-style-type: none"> <li>Relevant if characteristics of financial service can be easily replicated outside home country</li> </ul>
2B. New market, new demand	<ul style="list-style-type: none"> <li>Provide financial service that cannot be generated at home, for example in offshore markets or large financial centers</li> </ul>	<ul style="list-style-type: none"> <li>Relevant for countries without large financial centers.</li> </ul>
2C. Rescaling home boundaries	<ul style="list-style-type: none"> <li>Enlarging concept "domestic market", depending on political/societal framework</li> </ul>	<ul style="list-style-type: none"> <li>Relevant if banks operate in open economies</li> </ul>
<b>3. Differences in economic structure</b>		
3A. Different characteristics	<ul style="list-style-type: none"> <li>Differences in wealth causes different intensity demand: might be exploited</li> </ul>	<ul style="list-style-type: none"> <li>Relevant if entry takes place in developing countries (where financial intensity is supposed to grow), such as Eastern Europe</li> <li>Countries with different social security and/or financial systems: different wealth accumulating structures and different needs for financial services</li> </ul>
3B. Difference economic cycles	<ul style="list-style-type: none"> <li>Incentive based on risk/return diversification</li> </ul>	<ul style="list-style-type: none"> <li>Not relevant if countries are integrated in some way (eu)</li> </ul>
3C. Demographics	<ul style="list-style-type: none"> <li>Aging population vs. Young population</li> <li>Shift from interest to fee income (diversification)</li> <li>Uphold rate of return</li> </ul>	<ul style="list-style-type: none"> <li>Relevant if activities european banks into latin america, south east asia</li> <li>Not relevant if internalization in major western economies (similar demographics)</li> </ul>
4. Herding	<ul style="list-style-type: none"> <li>Rational reaction to potential opportunity loss caused by action first mover bank</li> </ul>	<ul style="list-style-type: none"> <li>Relevant if disproportional high investment allocation in certain activities/areas not relevant if explaining why the first mover is the first mover.</li> <li>Each bank independently formulates strategy, all coinciding (not measurable)</li> </ul>
<b>5. Regulation</b>		
5A. Incentive to internationalize	<ul style="list-style-type: none"> <li>Limited growth opportunities in home country</li> </ul>	<ul style="list-style-type: none"> <li>Relevant for relatively highly regulated countries.</li> </ul>

Table 3.9 (Continued)

Incentive	Description	Relevance
5B. Regulation as barrier of entry 5C. International regulation	<ul style="list-style-type: none"> <li>• Not incentive, rather disincentive to internationalize</li> <li>• Upward regulation to achieve stable international financial system</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant for banks with higher quality standards: signaling advantage is incentive</li> <li>• Not relevant for banks with low solvency: compliance with international regulation serves as barrier to entry</li> </ul>
<b>6. Market power and concentration</b>		
6A. Concentration as incentive to internationalize	<ul style="list-style-type: none"> <li>• Efficiency leads to market concentration, incentive to exploit abroad</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant for highly concentrated domestic banking markets</li> </ul>
6B. Concentration as pull factor	<ul style="list-style-type: none"> <li>• Concentration suggests higher margins to be earned</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if low barriers of entry</li> <li>• Not relevant if concentration is stimulated by regulatory authorities</li> </ul>
<b>7. Client</b>		
7A. Follow client	<ul style="list-style-type: none"> <li>• Fear of losing client (negative impulse) or capitalize on existing internalization advantage (positive impulse),</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if foreign banking market has higher degree financial innovation and/or lower cost structure</li> </ul>
7B. Lead client	<ul style="list-style-type: none"> <li>• Enhancing self image organization</li> <li>• Anticipate FDI and export flows</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if banks set up activities in countries expecting financial liberalization</li> </ul>
<b>9. Economies of scale and scope</b>		
	<ul style="list-style-type: none"> <li>• Marginal costs lower and/or revenues increase with each additional unit (per client) sold.</li> <li>• Defense for existence universal banks and financial conglomerates.</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if incentive if economies can only be achieved outside home country</li> <li>• Banks with small home markets</li> <li>• Not relevant if economies are aimed in areas such as retail banking</li> </ul>
<b>10. Cost of capital</b>		
	<ul style="list-style-type: none"> <li>• International activities are undertaken to lower current cost of capital and/or to uphold current rate of return</li> <li>• Combination of financial leverage and risk/return diversification</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if signs that current cost of capital is rising</li> <li>• Relative stock market valuation home country higher than foreign country</li> <li>• Not relevant if countries share same cost of capital, or no major differences in stock markets</li> </ul>
<b>11. Risk/return diversification</b>		
	<ul style="list-style-type: none"> <li>• Adding new activities in different countries lowers correlation between activities. This should stabilize earnings, and increase market value.</li> </ul>	<ul style="list-style-type: none"> <li>• Not relevant if activities are set up in countries with same economic structure/cycle.</li> </ul>
<b>12. Historical and cultural determinants</b>		
	<ul style="list-style-type: none"> <li>• Common language, administrative system knowledge of country lowers hurdle to undertake activities in foreign country.</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant if foreign country is former colony.</li> <li>• Relevant if foreign country shares perceived cultural or legal characteristics.</li> </ul>

In Figure 3.5 the incentives are clustered by extrinsic, sector intrinsic and firm intrinsic incentives. It is based on possible linkages between incentives found during the earlier discussion.

Figure 3.5. Clustering of incentives



## 4 Activities

When a bank internationalizes, a bank has made a choice which clients it targets in a geographical market. Additionally, the bank has to set up an organizational form to achieve its goal. This chapter reviews clients, products and market a bank targets for its internationalization activities. Also, the organizational form to perform these activities is discussed. Characteristics of different organization forms are reviewed, and studies on the choice of organizational forms discussed.

Banks aiming to expand their presence in foreign countries or plan to change their current arrangements in the foreign country have a broad choice for setting up formal arrangements to handle international activities. A formal change, and change in sophistication in organization are not only instrumental to the improvement of internal organizational operations but also serve as a clear statement of commitment to international involvement to competitors, clients, and regulatory authorities of the foreign country (Buckley and Ghauri, 1999, p. 88).

In general the process of setting up or changing such organizational arrangements outside the home country is analyzed through different approaches. On the one hand the internationalization process can be explained as a series of static choices dictated by efficiency considerations and relative costs and benefits. Another approach accentuates internationalization as a process of increasing involvement within and across national markets. For example, the "Uppsalla" model suggests that the process of internationalization is the consequence of acquiring *experiential knowledge*, in particular market specific knowledge (Buckley and Ghauri, 1999, p. 165). This does not imply that such a process is a continuous one. A chain of separate but linked processes is more likely, where the end of one chain represents the point of departure for the next (Nilsson et al., 1996, p. 164).

To structure the discussion of internationalization activity a separation will be made between the focus of the internationalization activity itself (Canals, 1997, p. 97) and the organizational form of the internationalization activity. For the focus of an internationalization activity, a bank describes in detail its targeted clients (which clients does the bank want to target), products (what products and services should be offered) and geographic scope (which market(s) does the bank want to service). The organizational

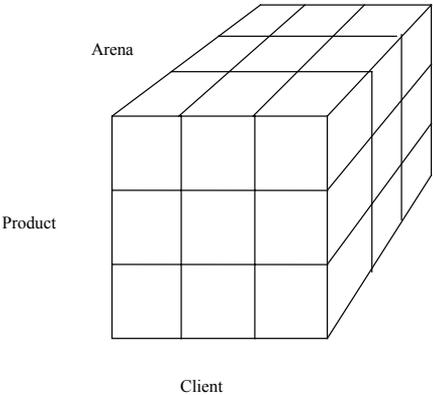
form describes the legal and organizational structure to implement the targeting of clients, products and geographic scope.

Focus and organizational form will now be discussed. A number of empirical studies will be reviewed, explaining the choice (and extent) of organization forms in a foreign country.

**4.1. Focus**

Walter (1988, 1999) presents a three-dimensional matrix to analyze the focus which can be drawn up for each banking activity: a client – arena – product matrix. Each cell in this matrix should have a distinctive competitive structure.

Figure 4.1. *Client-arena-product matrix*



Walter notes that the "inherent attractiveness of each of the cells [...] will depend on the size and durability of prospective returns that can be extracted from that cell, adjusted for the perceived risks involved" (Walter, 1988, p. 46). Walter furthermore links the analysis of the cell characteristics to the competitive forces within an industry as developed by Porter (1985).<sup>1</sup> The client-arena-product dimensions will now be investigated in some more detail.

*Client*

The traditional division of clients into wholesale and retail is not a helpful measure (Walter, 1988, p. 44). Walter categorizes clients into five types: sovereign, corporate,

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<sup>1</sup> The competitive forces are defined by funding leverage (the leverage depositors and buyers of securities can extol from the bank), client leverage (the degree to which clients are sought after by competitors and have monopsony power), availability of substitutes (any financial product can be replicated leading to a high degree of product substitutability in principle) and the potential new competitors.

financial services, private and retail. A bank can choose to service foreign operations of existing clients in the home country, and/or gain new corporate clients in a foreign country. As discussed earlier with incentives for internationalization, a bank can decide to follow or lead clients it already services in the home country abroad. The same bank can also aim to gain the accounts of corporate clients in a foreign country which are related to corporate clients they serve in the home country. A distinction can therefore be made between "de novo" clients targeted in a foreign country, and home-country related client targeted in a foreign country.

Table 4.1. Targeting of client types

Client	Non-domestic/ not home country related	Domestic/ home country related	Description
Sovereign	•		Nation states, (semi) governmental institutions
Corporate	•	•	Non-financial corporations
Financial services	•	•	Other financial institutions in the same industry category
Private	•	•	High net worth and high net income individuals
Retail	•		Mass-market financial services, aimed at individuals and households

There are some exceptions to this separation: foreign sovereign clients are usually not home-country related, unless in some historic dependency relationship like a colony. Further, foreign retail clients are also not home-country related. This contrasts with private clients, who have the resources to reallocate their wealth tax-efficient and can transfer wealth to off-shore havens or other tax-beneficial countries.

*Arena*

A market was defined (in 3.2.2) as a grouping of buyers having a demand for certain products or services and its close substitutes. This definition neatly circumvents the rigidity imposed by geographical boundaries, and agrees with the term "arena" used by Walter. Depending on the client needs, level of financial efficiency, regulatory conditions and other factors, geographical areas can be found to coincide with those factors. The term arena is thus more related to potential (geographical) market. In this context it will be defined narrower as one or more individual countries, one or more regions, a global scope or a combination of country and region. The potential scope is not included, only the observed.

### *Product*

The third building stone of the CAP framework categorizes financial products. Products are broken down by four dimensions: credit products (from general lending to project finance), financial engineering products (combination of several financial transactions into one package), risk management (redirection of exposure, and the tools to manage this) and arbitrage and positioning (own account trading to facilitate the first three products). Walter abstains from a broad classification of financial products, noting that banking "is a complex web of markets, services and institutions that is not easily subjected to systematic analysis" (Smith and Walter, 1997, p. 401). Smith and Walter do not derive general typologies from their framework, other than stating essential attributes for competitive advantage (1997, pp. 419-426).

#### **4.2. Organizational form**

Banks have a wide range of organizational forms to choose from when establishing a presence in a foreign country. First the characteristics of these organizational forms are reviewed. Next, the choice of organizational form for an international activity is considered (cf. Pecchioli, 1983, pp. 57-67; Robinson, 1972, pp. 19-32). International banking activities can have one of the following organizational forms:

- correspondent banking
- alliance
- representative office
- financial participation, also known as affiliate or associate
- joint venture, with consortium banks and project finance as variants
- syndicate
- subsidiary
- branch, with agency as a subset

Compared to other summarizations (cf. Anderson and Gatignon, 1999, p. 188), licensing or franchising as an organizational form to internationalize does not apply for banks. The lack of patent or copyright protection on most banking innovations means that banks are often constrained from exploiting them abroad through these forms (Ursacki and Vertinsky, 1992, p. 405). The characteristics of different organizational forms will now be discussed.

#### *Correspondent banking*

When a bank has only occasional transactions with banks or clients in a foreign country, it can choose to call upon a bank in the foreign country to act as its agent for the purpose of the particular transactions involved. A correspondent banking relationship is therefore a clearing and settlement agreement between banks to let clients use their networks. Typical correspondent services are acceptance of drafts or honoring letters of credit. In many cases

the correspondent banking relationship is a reciprocal one: the bank in the home country then also acts as a correspondent bank for the foreign bank.

The advantage of a correspondent banking relationship is that the bank does not need to have a foreign presence to extend services to customers in a foreign country, lowering investments and maintaining existing internalization advantages with clients. On the other hand, it cannot hope to profit from first hand information in that country. More important, it has no control over the services rendered. The service can be qualitatively low compared to services in the home country, which can damage client relationships. Also if the service is perceived to be qualitatively high compared to services in the home country, the client can be moved to take more business to the correspondent bank damaging existing client relationships in the process.

### *Commercial alliance*

Correspondent banking is an alliance: an agreement to cooperate on transaction issues without a capital commitment. This alliance can also be applied in a number of other ways. Cross selling alliances are one example. In Japan, Dresdner Bank and Japanese life insurance company Meiji set up an alliance in 1990. Meiji hoped to tap Dresdner's asset management skills while Dresdner expected this alliance to raise its profile in Japan and South East Asia. In 1997, Sumitomo Trust and Banking, one of Japan's leading trust banks, and Gartmore Investment Japan (a subsidiary of National Westminster) agreed to an alliance. Under the deal Gartmore would provide Sumitomo Trust with investment advice on European markets through its Japanese unit. Also, in the 1970s banking clubs were formed in the wake of the rise of consortium banks. These banking clubs usually aimed to exchange knowledge and research, without any formal cooperation agreements.

### *Representative office*

Correspondent banking or alliances still leave the bank with asymmetric information problems. The bank can overcome this to some extent by having a direct overseas presence and install one or more individuals in an office to represent the bank in the foreign country and sometimes in nearby countries as well (Ursacki, 1992, p. 405). In addition to managing the business of clients of the home country and local clients as well, the representative office seeks out new business and channels information to and from the country for which it is responsible. Representative offices act as an intermediary between the parent bank and customers without processing the financial transaction.

Having a representative office offers some advantages. As no banking business is transacted by the representative office, it can co-exist with correspondent relationships, taxation or other legal matters are dealt with directly by the main office in the home country. A representative office is in a better situation to gather and interpret information needed by a domestic client or by the bank itself, because of greater familiarity with the local situation. Also, if management decides that a branch or other stronger organizational form than representative office is preferable, there is already someone present to roll out and manage the process.

Certain disadvantages are also feasible. The channeling of business implies dependency on local banks, which may not always provide the best deal for the client. The representative office is meant to refer many issues to the head office, resulting in possible time delays. More seriously, a representative office cannot provide its own local currency funding. Currency and country risk are important issues for the head office to deal with. In terms of signaling, the goodwill of a local banking institution may be limited if clients assume that it is a predecessor of a branch bank which will eventually be established, offering a wider range of services (Robinson, 1972, p. 24). The previous internationalization activities of a bank are instrumental in such an assessment.

### *Financial participations*

Banks can hold an equity interest in a bank in a foreign country. This financial participation is not large enough to control the activities, implying a holding of less than fifty percent voting stock shares. A financial participation is referred to as an affiliated bank or an associated bank. The equity interest can be acquired in three different ways. First the foreign bank can increase its capital base by issuing new shares to the acquiring bank. Increasing the capital base is a strategic decision; the bank must have identified growth opportunities which it cannot obtain with the current balance sheet. Second, a bank can acquire equity interests from other shareholders, keeping the capital base the same. Third, the bank can set up a new activity in the foreign country, from the outset inviting other banks or financial institutions (not necessarily from the foreign country) to join, diminishing its shareholding to a minority one. This third option will be separately discussed as a joint venture.<sup>2</sup>

The choice for a non-controlling participation depends on control, time horizon and regulation. A bank might not want to actually control the foreign activity, but only prefers to control the referral of foreign business by its domestic clients. Aim is to control its internalization advantages. The bank also gains immediate access to local funding, beneficial for risk management at its head office. Also, by taking a financial participation, reciprocal business should be expected. Time frame can play a role too. A financial participation can be arranged in a short period of time, depending on by regulation in the home and host country and willingness of the firm and shareholders. Establishing branches for the same purposes could take one two years. Regulation is also a very important factor. Regulatory authorities can control activities by foreign banks by imposing that all potential participations all approved by the institution. Not especially catered for foreign banks but equally relevant are guidelines for participations. Thus regulation can cap the financial participation a bank wants to take in a foreign bank, stopping it short of control. On the other hand, a financial participation can be motive to appease regulators and competitors, since the fabric of local competitive structure remains unchanged. Over time, a controlling participation might then be considered.

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<sup>2</sup> This is technically not entirely correct. The usual definition of a joint venture is an association for a finite period of time. A financial participation does not have this time restriction. Otherwise, it warrants a similar discussion.

Chase decided that in order to obtain a sizable deposit base and experienced personnel it should buy in existing banking branches instead of establishing branches. Chase also reasoned that government would be more accommodating of the bank's presence if it shared ownership with local competitors (Madrid, 1992, p. 20). Finally, financial participations also have a signaling function, especially if the equity interest is too small to exercise any influence. Cross over participations of with small percentages (usually under 5%) were accompanied by announcements of alliances or other activities.

### *Joint venture bank*

A joint venture is usually an association for a finite period of time, for the purpose of applying joint efforts toward a particular activity or group of activities either lying outside the scope of one or more of the participant's principal activities or a project too large or too risky for any of them to undertake alone. In the case of a financial participation a bank has to allocate capital and has the possibility to refer business. With a joint venture bank, personnel or (parts of) existing organizations within the bank can be brought into the joint venture. For banks, two types of joint venture banks more commonly known: the consortium bank and the project finance.

Consortium bank is a special type of joint venture, set up for handling investment banking business of an international nature. Usually one partner brings in the skills, and other partners the capital and (promise of) a distribution network. The term is associated with the emergence of the Eurodollar market in the 1960s. Operations within the Eurodollar market included activities such as funding and lending, foreign exchange handling and underwriting securities. For example, the Amsterdamsche bank, Midland Bank, Deutsche Bank and Societe General of Belgium formed in 1963 the European Advisory Council EAC), with the aim to have a platform for mutual consultation, and to set up branches for large-scale international finance. In 1970 the members of the EAC took this co-operation a step further by setting up European Banks International Company (EBIC). Reasons for the choice of consortium banking as a form of internationalization ranged from domestic market protection to a unified European vision. Basically, participants/partner banks wanted to prevent competition with each other in the home markets, since most domestic banking networks were already fully developed. Also, start-up costs of opening their own networks in other European countries were avoided or at least substantially lessened. Finally, documents wager that co-operation was an opportunity to influence the shift towards full European integration (Vries et al., 1999, p. 364).

A disadvantage of consortium banks was that they suffered from a principal-agent problem. For example, goals of partner banks who founded the consortium bank EBIC in 1972 did not always coincide, especially when staff did not serve the interests of their parent bank, but of the consortium bank first. As a result, staff selection for EBIC became choosier and partner banks decided to develop independent activities (Vries et al., p. 367).

Project finance involves developing services in a larger number of banking services enabling the joint venture bank to offer comprehensive financial support and advice

through the life of a large-scale project. These projects can be the realization of pipelines, oil and gas production, roads, energy plants and office buildings. They all have in common the sheer size in financing, complex financial structuring needs and specialized risk-evaluation capabilities within a bank (Smith and Walter, 1997).

### *Syndicate*

A special form of joint venture is the syndicate. With the exception of private placements, corporations can issue new securities (equity or debt) that are sold to either public or institutions through an underwritten distribution and are subject to applicable disclosure, registration, and other regulations in relation to these securities (Smith and Walter, 1997, p. 316, pp. 22-50). Major issuances can be syndicated. A number of banks combine activities to either fund or distribute these securities. The issuing firm has the advantage of being able to raise a larger sum than any single bank would be willing to commit to, at lower costs. Also, the syndication process can amount to a short period of time.

### *Subsidiary*

Establishing a representative office, building up a financial participation or even engage in joint venture banking represent increasing degrees of involvement in the foreign country. Subsidiaries and branches stand out as an organizational form. They can bear the name (especially branches, not necessarily subsidiaries) and many of the distinguishing characteristics of the bank in the home country itself (Robinson, 1972, p. 28), offering opportunities to capitalize on the goodwill the name already has with (potential) customers.

Subsidiaries are local institutions incorporated under host-country law in which the bank has a direct or indirect controlling and/or majority interest. The subsidiary, just as the affiliate resulting from the financial participation, is a legal entity of the host country. Seen locally the banking subsidiary, normally emphasized by its non-local name and characteristics, is a different competitor in the local banking scene. The subsidiary has therefore a different type of attraction for clients.

Another important difference is that the bank in the home country has a controlling interest in the banking subsidiary. This has the distinct advantage for management that its guidelines and recommended actions will not be ignored by the subsidiary, a potential danger with financial participations or joint venture banks. This is not always the case though. Having a 50% stake of voting shares plus one does not automatically guarantee 100% control. Specific to each foreign country's corporation laws, dissenting minority shareholders can block decisions. Thus the bank in the home country can have a strong incentive to acquire a 100% ownership. The acquisition of controlling interest in a foreign bank can in many ways be viewed as an attractive alternative to the setting up of branches (Pecchioli, 1983, p. 62).

The establishment of a subsidiary in a foreign country can be done by setting up a banking subsidiary as a new corporate identity, taking all the issued voting stock, or through the acquisition of all the outstanding shares of an already existing banking

organization in the foreign country. This decision is among other reasons influenced by regulation, for example whether there are a limited number of licenses or banking permits in the foreign country.

Subsidiaries and financial participations have in common that they are investments. As such there is also the possibility that both organizational forms are not a sign of different degrees of involvement in the foreign banking markets, but rather that the banks may view their investment in a subsidiary as a financial investment. That is, as a profitable employment of capital instead of a strategic direct investment. Because of limited opportunities to invest in their country, banks with a small home market may be more predisposed to consider their investment to be financial instead of being instrumental in servicing their customers abroad (Heinkel, 1992, p. 254).

### *Branch*

By contrast, foreign branches are a legal extension of the parent bank in a foreign country and are not separately constituted, locally chartered corporations. Branches are an integral part of the bank and are subject to home-country control and regulation. Geographical considerations aside, the branch is treated like any other branch in the home country.<sup>3</sup> Legally, there is a significant difference with subsidiaries. The branch, in comparison to a subsidiary, is not a legal entity in itself and not distinct from the legal entity of the bank in the home country. This clearly imposes major risks. The bank itself can be sued by suing a branch in the foreign country, since there is no difference in legal entity.

It has a number of useful characteristics though. The first one is control. Establishing a branch is to exercise maximum control over the activities in the foreign country, compared to the other organizational forms discussed. Pecchioli notes that other things being equal, branches offer the best opportunities in terms of referral and new business whilst, at the same time, providing the parent bank with ample scope for in-house supervision and control over foreign business (Pecchioli, 1983, p. 62). On the other hand, the opening of a foreign branch may entail substantial investment and heavy administrative and manpower costs.

A special feature of a foreign branch is signaling to clients. A branch as an organizational extension of the parent bank signals that all the assets and net worth of the bank in the home country are put up as guarantee for its activities, a feature implying a direct and unlimited responsibility of the latter for all the commitments entered into by the branch. Throwing in the total balance sheet of the organization can attract large corporate borrowers, who would have been more careful with the limited guarantees of a subsidiary.

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<sup>3</sup> One exception to this is the agency, in many respects similar to a branch bank but unable by host law to take deposits (Robinson, 1972, p. 32).

### 4.2.1. Choice of organizational form

After the review of organizational forms for international activities, the next question is which form a bank might choose for what purpose. Adapting Pecchioli's summary of different organizational forms, the following table can be set up.<sup>4</sup>

Table 4.2. *Organizational forms*

	Correspondent Banking	Commercial Alliance	Representative Office	Financial Participation	Joint Venture Bank	Syndicate	Subsidiary	Branch	
Characteristics	Investment required	None	None	Modest	Moderate	Moderate	Depends (3)	Moderate/Substantial	Moderate/Substantial
	Control over operation	Minor	Minor	Direct	Minor	Minor/Moderate	Minor/Moderate	Substantial/Direct	Direct
	Referral business	Minor	Minor	Favorable	Minor	Minor/Moderate	None	Favorable	Favorable
	New business	Minor	Minor	Favorable	Limited Potential	Minor/Moderate	Favorable	Favorable	Favorable
	Flexibility of operation	Flexible	Flexible	Relatively Inflexible	Inflexible	Some Flexibility	Very Flexible	Flexible	Flexible (1)
	Resources required	No	Few	Few	Few	Modest	Modest	Few - Many(2)	Few - Many (2)
Organizational forms	achieved by								
	Alliance	•	•						
	Financial participation				•				
	Joint venture					•	•		
	Greenfield Acquisition			•			•	•	

Note 1: under certain circumstances subsidiaries can undertake business which cannot be undertaken by a branch. Subsidiaries also may have independent management decision-taking powers which give it more flexibility than a branch

Note 2: Depends on specific circumstances such as the characteristics of the business undertaken

Note 3: Depends on specific form of underwriting

Source: adapted from Pecchioli, 1983, p. 61

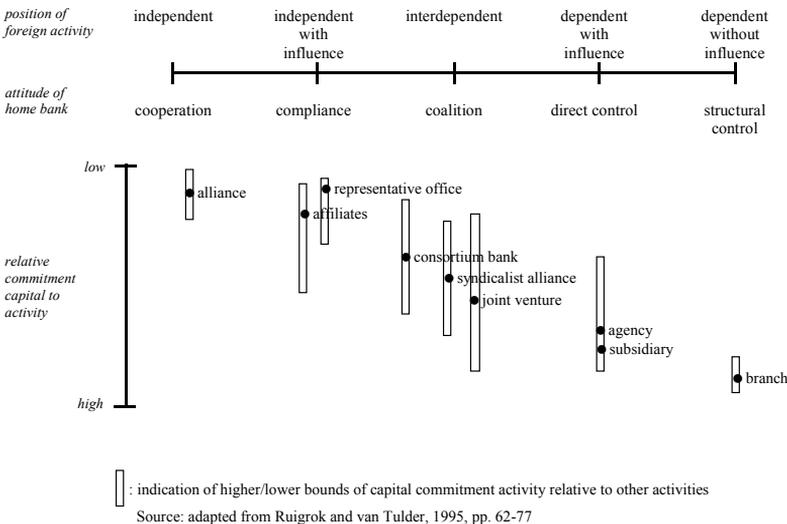
How do these different organization forms relate to each other? The previous discussion has shown that the foreign banking activity can have different dependency relationships with the home organization, which in turn depends on the potential capital intensity of activities that the organizational form needs (from the parent bank). In other words, the choice depends on the desired dependency relationship between home and

<sup>4</sup> In addition to the organization forms, the appropriate corporate activity for the organizational form is mapped:

- Acquisition: obtain controlling stake up to full ownership, at least more than 50% of voting stock.
- Alliance: joint activity without impact on existing organization, no equity stakes.
- Financial participation: obtain a non controlling stake, at the most less than 50% of voting stock.
- Greenfield: direct investment in foreign country, accompanied by the establishment of a new legal entity.
- Joint venture: creation of new legal entity with one or more banks or other firms. Certain existing resources can be transferred to the joint venture; at the most a 50% ownership.
- Merger: merger with other firm.
- Divestiture: sell-off of existing activities.

foreign activities. Ruigrok and Van Tulder (1995, pp. 62-77) developed a dependency scale, which shows the relative bargaining position at a given instant between the home organization and the international activity (Figure 4.2).

Figure 4.2. *Dependency scale organizational forms*



At the left extreme of the scale, the two actors do not interact, or only marginally and thus do not exert any influence over each other. A move to the right shifts the balance of influence in favor of the home organization. In the middle of the scale the balance of influence is in a state of equilibrium. Moving further the core firm clearly becomes the stronger partner. At the extreme right of the scale the international activity has no possibility of influencing the behavior of the home organization. In Figure 4.2, the vertical axis represents the relative capital commitment of the activity. Similar to Ursacki and Vertinsky (1992) or Blandon (1998) the assumption is made that the organizational form chosen by the bank in the foreign country might be a good indicator of the level of commitment in the host country, since it reflects the banks' willingness to make a costly and long-term investment.<sup>5</sup> Which organizational form will a bank choose, and if a bank has established an organizational form, why change from an organizational form representing balanced interests to one with dominant equity interests? The choice between the various organizational forms depends on a number of factors mentioned in earlier discussion: 1) regulatory and legal structure, 2) entry barriers, 3) strategy and 4) relative costs.

<sup>5</sup> A tentative clustering can be distilled from this (Anderson & Gatignon, 1999, p. 188): diffused interests (alliance, affiliates, representative office), balanced interests (consortium, syndicate, joint venture) and dominant equity interest (agency, subsidiary, branch)

First, the *foreign regulatory and legal structure* influences the choice of organizational form to a large degree. From the viewpoint of the home country, restrictions on the type of organizational form usually stem from considerations relating to problems with supervision and monitoring banks' positions booked in a foreign center, and the implications for the extension of parental responsibility (Pecchioli, 1983, p. 58). Specific requirements may determine the choice of organizational form (Curry et al., 2003, p. 44). For example, minimum capital requirements have to be met, perhaps different from the host country banks' capital requirements. Foreign taxation may also be an important factor in the choice of organizational form: the tax treatment of directly controlled foreign branches can differ from the tax treatment of foreign bank subsidiaries. Finally, the (desired) legal liability structure in the host country also influences the choice of organizational form.

Second, *entry barriers* in combination with the type of activity the bank wants to undertake are instrumental for the choice of organizational forms. Host countries may impose entry barriers with a view to retaining effective control over, and protecting the local banking system. Where limited entry restrictions apply, they are usually modulated to take account of the possible benefits to be derived from certain types of foreign banking presence. For example, the United Kingdom and Switzerland allow foreign banks only on condition of reciprocity, i.e. British or Swiss banks are guaranteed entry in the entrant's home market (Baldock, 1991 cited in Curry et al., 2003, p. 44).

Third, Decisions about the structure and organization of a foreign network are primarily based on a bank's overall *strategy*, in particular with regard to its involvement in trade-related business, global funding policies, the servicing of multinational customers and the extent of involvement in local currency business. Given the choice of organization form, the change of organizational form also has an important signaling effect to the customers in the home country. Signaling may be more important for relatively large banks. A priori it is to be expected that banks with more assets tend to establish relatively more subsidiaries and/or branches since they have the capital and therefore the opportunity to commit to such responsibilities. Another signaling factor (as well as a cost factor) is the publication requirements for regulators attached to different organizational forms.

The decision for a particular organizational form can also be influenced by *relative costs* on a firm level. Major costs are rents, salaries and communication costs. If the banking activity in the foreign country tends to require extensive face-to-face communication, communication costs tend to be disproportionately high if conducted from the head office for all but very large transactions (Ursacki and Vertinsky, 1992, p. 408). Banks seeking to gain market share for smaller transactions may have little choice but to establish subsidiaries or branches instead of representative offices, unless they are very close to the host market.<sup>6</sup> The relative costs of different organizational forms are a difficult

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<sup>6</sup> Vice versa banks engaging in foreign banking activities which consist of very large transactions should have lesser incentives to set up branches. Custodial activities, institutional asset management or bulge bracket investment banking activities are such activities.

to estimate<sup>7</sup>; relative costs can also be viewed on a more aggregated level: how large must the market in the host country be, or what potential exports from the home country can be accommodated to set up activities in the host country? Research on the choice of organizational form will be covered next.

#### 4.2.2. Research on organizational forms

Bank size, regulation, the relationship with its clients, the extent of other foreign activities and relative costs are all issues raised above to explain (modulation between establishing) organizational forms. Ursacki and Vertinsky (1992) examine the entry of banks in Korea and Japan between 1979 and 1986, focusing on variables determining the timing of banking entry as well as variables determining the choice of organizational form and commitment. They find that the size of a bank in the home country and the level of international diversification are positively related to early entry in both countries, for representative offices as well as branches.

The proxy Ursacki and Vertinsky apply for activities relating to clients in the home country (total trades with the home country) has no significant bearing on the results, suggesting that banks assess these markets based on their own merits rather than existing commercial ties with the home country (Ursacki and Vertinsky, 1992, p. 415). In other words, the "follow your client" incentive is not supported. As for the choice between establishing a representative office or a branch (other organizational forms were not allowed at the time of the analysis), the size of the assets of the bank in the home country do have explanatory value for establishing branches, but non for representative offices. This result leads also the way for an opportunistic explanation. An interpretation could be that when the bank in the home country feels that its balance sheet is large enough, it can take on the commitment to establish a branch with the full legal consequences.

Ter Wengel (1995) analyzed bilateral trade in banking services among 141 countries in a cross section study for 1989. He found for organizational forms that:

- Banks tend to use representative offices rather than subsidiaries in foreign countries which are relatively large compared to the home country.
- Banks tend to have subsidiaries rather than representative offices in the OECD countries. Ter Wengel explains this by remarking that the OECD enjoys a strong and continued deregulation of capital movements.
- Banks tend to use subsidiaries in richer countries and representative offices in the poorer. This seems quite plausible since a subsidiary represents a higher capital commitment, which can only represent a profitable investment opportunity if the relative income per capita is high.

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<sup>7</sup> Channon (1977, p. 159) attributed the relative modest success of regional banks entering Great Britain to lower earnings due to intensified competition and the relative high cost of maintaining a branch in London, estimated at 1 million US dollar per year in 1975.

Heinkel and Levi (1992) examined the organizational form of foreign banking activities for 60 countries operating in the United States in 1985. The choice of organizational forms was explained by export activity, total outstanding claims of foreign banks' US customers on foreigners from each country (as a proxy for merchant banking activity), and security market capitalization of the foreign countries (as a proxy for capital market development). They find that the number of representative offices in the United States is positively related to exports, private lending and the size of the foreign capital market. The size of agencies depends on private lending and the size of the foreign capital market, while the number of branches solely depends on the size of the foreign capital market.

Heinkel and Levi also found that market capitalization in the home country has a negative impact on the number of subsidiaries in the United States (1992, p. 260). This gives rise to two tentative thoughts: this finding supports the small home market as an incentive to internationalize, and banks from countries with a small home market undertaking foreign activities may use subsidiaries relatively more as financial investments rather than strategic investments.

For Spain, Bandon (1998) investigated different organizational forms of foreign banking between 1988 and 1992. He found, similar to Ursacki and Vertinsky, that bank size in the home country and previous multinational experience are positively related to the level of commitment. Large and more internationally experienced banks tend to establish branches or subsidiaries rather than representative offices. Distance serves as a barrier of entry, negatively influencing the level of commitment. Also similar to Ursacki and Vertinsky, foreign direct investment was insignificant as an explanatory variable. Also, Bandon differentiated between the quality and quantity of the balance sheet of the bank in the home country as a signal. Bank size had explanatory value while a proxy for financial soundness is insignificant as an explanatory variable.

The finding of Bandon that financial soundness is of lesser importance can be attributed to the fact that the bank itself has formulated its strategy around asset gathering, which could result in periods where market share growth is more important than return on capital. Peek, Rosengren and Kasirye (1998) examined the asset growth of foreign banks by acquiring subsidiaries in the United States. Examining foreign-owned bank subsidiaries before and after their acquisition between 1984 and 1997, they found foreign subsidiaries exhibit poor performance in relation to domestic banks. Many of the problems are already present at the time of the acquisition. Changes in strategy by the new owners have in general not been successful in raising the bank's performance level to that of its peers. This finding contradicts the possible acquisition of a subsidiary as a financial investment rather than strategic. If the acquisition is strategic, it is also an opportunistic one at that. Buying into - relatively cheap - banks with poor prior performance aiming to transform them into more profitable ones turns out to be a variant of the "no such thing as a free lunch" hypothesis.

Nolle (1995) found similar results for branches of foreign banks in the United States between 1983 and 1993. In terms of efficiency and cost of capital, foreign branches have lagged behind those of domestic branches in the United States. Also, the loan portfolios of foreign banks in the United States were more unbalanced and of lesser quality than American banks, resulting in larger losses during economic downturns. In short, the findings of Nolle (1995) and Peek, Rosengren and Kasirye (1998) suggest that subsidiaries and branches are the main vehicles for asset seeking strategies of foreign bank. The result has been additional asset accumulation, but not additional profitability or efficiency.

### **4.3. Summary**

In chapter 4, the focus of internationalization activities was discussed - which combination of client, arena and product to target - and the organizational form needed to implement the internationalization activity. The organizational forms each serve different client and product purposes, and have different degrees of capital commitment and control opportunities for the parent bank. Eight different organizational forms were identified, ranging from correspondent banking (requiring no capital commitment and no control opportunities) to foreign subsidiaries and branches (requiring substantial capital commitment but also providing direct control opportunities for the parent bank).

Four major factors influence the organizational form a bank chooses for its internationalization activities. First, legal and regulatory framework of the home and host country is an important factor encompassing restriction in the choice of organizational forms in the host country, differences in taxation, regulatory capital requirements and desired legal liability structure. Second, there are entry barriers of the host country to consider. Third, there are strategic issues to consider. In particular, the choice of organizational form can signal the level of commitment the bank aims for in the foreign country. Fourth, relative costs to conduct transactions from the head office compared to cost of conducting transaction in the foreign country also play a role in the choice of organizational form. The research reviewed, with data samples spanning 1983 - 1997, could be summarized as follows:

- Exports are an explanatory variable influencing organizational form, foreign direct investment is not. Trade flows, not investment flows, determine the choice of organizational form.
- The larger the bank size in the home country, the stronger the commitment in the host country and resulting organizational form.
- Previous experience in other countries positively influences commitment in the host country.
- The richer the home country, the stronger the commitment.
- A larger market in the host country in relation to the market in the home country has a negative effect on the level of commitment.

A combination of these findings does not necessarily lead to results with clear directions; for example, what is the net effect of setting up activities in a larger, richer country? This implies that regulatory and legal framework, strategy and entry barriers probably cast a deciding vote on which organizational form to choose.

## 5 Strategic objectives

What strategic goals can be formulated for banks? Literature review shows that such a summation has not been developed for banks specifically, so existing typologies for strategic goals are adapted for the internationalization of banks. The build up of strategy literature as a sub-discipline of economics are freshly rooted in the aftermath of the Second World War. Internationalization strategy itself has been investigated from the 1960s onwards; literature on internationalization strategies of banks as a further sub-branch has been developed since the 1980s but is relatively scarce.

After having formulated incentives that may lead to a strategic activity, and the organizational form in which it can be molded, the question now is which strategic goals can be formulated in general for banks. Strategy classifications relating to banks and internationalization strategies are reviewed. One finding is that a cohesive framework specific for internationalization strategies of banks is difficult to find in current literature.

### 5.1. Formulation of internationalization strategies for a bank

The definition of strategy has been a long-time subject of debate.<sup>1</sup> Chandler defined strategy as "the determination of the basic long term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals" (Chandler, 1962, p. 13). For the purpose of this study, an internationalization strategy of a bank then implies 1) an incentive to form long term goals resulting in 2) organizational objectives and 3) an activity outside the home country, or in the home country in relation to activities in a foreign country or region.

This definition suits other definitions of strategy as well, for instance Mintzberg's, who viewed a strategy as the organization's conception of how to deal with its environment for a while (Mintzberg, 1989, p. 52). Incentives for a strategy have been discussed in chapter 2, and activities in chapter 10. This chapter will discuss the formulation of organizational objectives as part of an internationalization strategy.

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<sup>1</sup> See Moore (1992) for an overview of strategy literature.

Four areas of strategy literature are relevant for internationalization strategies of banks: a general typology of what a strategy actually encompasses, the description of banking strategies in general, authors describing internationalization strategies, and authors describing internationalization strategies for banks. Ideally the focus would only be on literature about internationalization strategies for banks. This area has so far only been covered by Canals (1997, 1993) and to a lesser extent Walter (1999, 1988), and Smith and Walter (1997).

Table 5.1. *Strategy literature*

	General Strategy	Internationalization strategy
Bank	UNTNC, 1991 De Carmoy, 1990	Walter, 1988 Canals, 1997 Smith and Walter, 1998 Fujita and Ishigaki, 1986
Firm	Ansoff, 1965 Porter, 1980 Mintzberg, 1988	Dunning, 1993

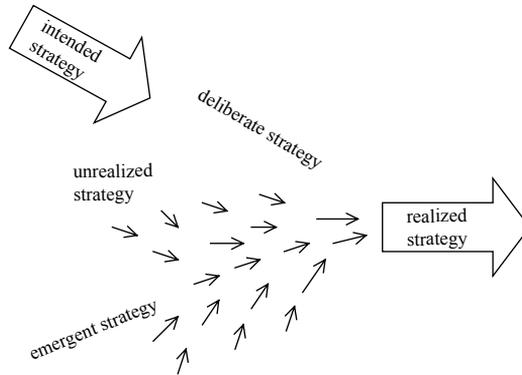
The strategy classifications of the authors in Table 5.1 above will be summarized, focusing on the relevance for banks if the authors have not done this already. The classical strategic framework is provided by Ansoff (1965), Mintzberg (1988) and Porter (1980). A short description of their typology of strategies is presented, without the aim to be complete but striving to introduce elements that might be relevant for further discussion. The overview proceeds with Walter (1988), and Smith and Walter (1998). These authors have in common that they described a framework for either analyzing or executing a strategy, but refrain from providing a typology of internationalization banking strategies. De Carmoy (1990) on the other hand described different phases of organizational development. These are not strategies in itself, but provide a framework. A similar approach has been pursued by Fujita and Ishigaki (1986). Other authors such as the United Nations Center on Transnational Corporations (1991) analyzed international banking behavior from the viewpoint of event studies.

*Ansoff, Porter and Mintzberg*

Defining strategy as a plan is not sufficient: plans can go unrealized, while a stream of actions can be presented as a strategy. A more apt formulation is that strategy translates into consistency in behavior, whether or not intended (Mintzberg, 1995, p. 14). This broadens the perspective on strategies. If the plans for a strategy are labeled "intended strategy" and the stream of actions are labeled "realized strategy", then Mintzberg further distinguishes between deliberate strategy (where the intended strategy is realized that

existed previously) and emergent strategy (where patterns develop in the absence of intentions).

Figure 5.1. *Strategy concepts*



Source: Mintzberg, 1995, p. 15

There are several generic strategies a bank can develop, as identified by Ansoff (1965), Porter (1985) or Mintzberg (1987). Ansoff developed a "mission" matrix with four corporate strategies - market penetration, product development, market development and diversification (Moore, 1992, pp. 14 - 29). In 1980 Michael Porter introduced the best-known list of generic strategies: cost-leadership, differentiation and focus. Focus has two variants, cost focus and differentiation focus. With cost leadership, the firm aims to be producer with lowest costs in its industry; differentiation requires the firm to be unique in its industry for some specific attributes of its services or products which are highly valued by its customers. A price premium exceeding the extra costs incurred for differentiation should be the reward.

Focus implies a strategy where a segment or small group of segments in the industry or customers is chosen to serve them exclusively. Even though the firm might not possess a competitive advantage overall, the focused firm achieves a competitive advantage in its target segments. If a firm wants to position itself structurally above the industry average, it has to make a choice between these strategies. "Being all things to all people is a recipe for strategic mediocrity and below-average performance, because it often means that a firm has no competitive advantage at all" (Porter, 1985, p.12). His framework clearly does not smile favorably upon the phenomenon of universal banks.

Mintzberg (1988) clustered families of strategies around the core business of an organization: locating the core business, distinguishing, elaborating, extending and recovering it. In his view Porter's generic strategies are part of distinguishing the core business.

*Smith and Walter, Canals*

Walter (1988), Smith and Walter (1993), and Canals (1997) have developed strategic frameworks for banks. Smith and Walter (1997, pp. 401-436) developed a three dimensional matrix, which can be drawn up for each banking organization: a client – arena – product (C-A-P) matrix, discussed in 4.1. The C-A-P classification is useful to analyze the activities of a bank or any firm in general. Smith and Walter do not derive general strategic typologies from their framework, although it seems to build on the strategy research of Porter. Banking "is a complex web of markets, services and institutions that is not easily subjected to systematic analysis" (Canals, 1997, p. 401). Instead, they state essential attributes to exploit opportunities within the C-A-P framework. These include the adequacy of the institution's capital base, the institutional risk base, quality of human resources, its access to information and markets, its technology base and managerial culture, and the entrepreneurial quality of its people (Canals, 1997, p. 419).

Canals (1997, pp. 266-269) investigated internationalization strategies of banks and presented an internationalization model which is based on three main incentives (Table 5.2), the combination of which he hypothesizes to be instrumental for the internationalization of banks. In his view scale, customer service and resource transfer are the main motives for international activity.

Table 5.2. *Motives for international activity*

Incentive	Description
Scale	<ul style="list-style-type: none"><li>• Banks expect that size generates more revenues.</li><li>• Increasing investment in technologies can only be recouped by larger scale.</li><li>• Scale prevents a bank from becoming a target for a hostile takeover.</li></ul>
Customer service	<ul style="list-style-type: none"><li>• Offer service to its customers abroad with the same quality at home.</li><li>• Enter markets with a lower degree of financial innovation to offer services that national banks do not.</li></ul>
Resource transfer	<ul style="list-style-type: none"><li>• Transfer physical and/or intangible resources or skills from headquarter or a unit in one country to another (such as financial resources, technology, branding, management skills).</li></ul>

Source: Canals, 1997

Canals (1997, p. 250) further linked motives to organizational form of internationalization activity. Alliances are the best way to transfer resources or skills, and acquisitions are a *modus operandi* for increasing scale. If on the other hand customer service is an important objective, then the development of branches are quite likely. Canals stressed that "the strategic options banks have open to them vary depending on their resources and their home country [...]. The reason for this variety of strategic options is related not only to each bank's starting position, resources, skills, and weaknesses, but also

to the financial model in which it operates." (Canals, 1997, p. 329). Banks in the industrial countries reacted to deregulation and financial disintermediation by formulating one or more of the following strategies (Canals, 1997, pp. 333-337):

- *Transformation into universal banks.* Main drivers are to achieve economies of scope, prevent customer erosion and uphold the rate of return by increasing fee income relative to interest income. Canals summarizes the discussion of the advantages of universal banks vs. specialized banks by noting that if financial authorities make such a choice there is no guarantee that this will be the right one. Also, there is no conclusive evidence that universal banks fare better than specialized. The bank specific key drivers more than outweigh the organizational model in the attribution of results (1997, p. 334).
- *Achievement of larger scale.* Another strategy is to achieve a larger market share through mergers and acquisitions. Behind this lies the implicit hypothesis that a larger market share is matched by greater profitability (see also the discussion about incentives for internationalization). Mergers and acquisitions are complex processes, of which the result is difficult to assess. Canals (1997, p. 335) identified two key drivers: the degree of compatibility between the two merging organizations, both from a market viewpoint and from an organizational viewpoint. Second, a proper planning and implementation of the merger is needed.
- *Diversification towards non-bank or non-financial activities.* Advantages mentioned here are the possible achievement of economies of scope between different financial services activities and the mitigation of the capital market's information problems. Among the options are directly investing in the capital of firms.
- *Internationalization of activities.* The main driver for internationalization of activities is the globalization of the international financial system, pushed forward by financial markets.<sup>2</sup>
- *Use of new organizational forms to respond sooner and better to industry changes.* The final critical strategic option for banks can be the modeling of a new organizational design for the whole bank. The implementation of each model (such as the divisional model, matrix model or the federated model) depends more or less on the group's history, dominant management style, resources available, and the weight of the business units.

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<sup>2</sup> Canals subsequently discussed organizational forms; these have been discussed in chapter 4.

### 5.1.1. De Carmoy

De Carmoy (1990, pp. 186-208) wrote about banking strategies in general, and combined strategies and conduct of banks into three phases: conquest, change and consolidation:

- **Conquest**  
The strategic intent to become predominant in several activities in the markets chosen.<sup>3</sup> Market share and size are important measures of success. This strategy can only be adopted by a limited number of institutions. This offensive strategy presupposes a solid base in the country of origin.
- **Change**  
A change strategy is driven by some sort of crisis. There are several signs that foreshadow such a crisis: financial losses, decline of market share, key personnel departure, inability to position it successfully in new markets. The main motive of change is survival. A traditional recovery plan includes sale of assets, replenishment of equity, and elimination of unprofitable sectors in which it does not appear possible to acquire a lasting competitive advantage in the short or medium term. The most important part of a change in strategy is refocusing on activities where the firm traditionally excels.
- **Consolidation**  
This is an intermediate strategy. It may precede a strategy of conquest, corresponding to a phase of accumulation of resources (capital, staff, technology). Consolidation can also take place right after an offensive period where resources have been fully deployed. Enhancements are made sparingly; new events are fitted within existing moulds.

The classification of strategic conduct into phases is appealing in its simplicity, but is only useable if refined and more specified.

### 5.1.2. Fujita and Ishigaki

Japanese internationalization activities took off with extraordinary speed in the late 1970s. This spurred research on the subject. Fujita and Ishigaki (1986), analogous to De Carmoy, combined banking strategies and conduct into phases; they are one of the few authors specifically writing about internationalization strategies of (Japanese) banks, examining the results of a survey kept on the subject in 1977 and 1978 for Japanese banks. They identified four phases: national banking, international banking, international full service banking, and world full service banking (Fujita and Ishigaki, 1986, pp. 206-208).

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<sup>3</sup> Actually, de Cormay specifically wrote about the domestic banking market, not focusing on other markets.

In the first phase, internationalization activities are restricted to foreign exchange activities connected with foreign trade, and correspondence contacts with foreign banks. In the second phase, banks step up their medium- and long term loans relative to the foreign exchange business to Japanese-affiliated foreign companies. One step further, business is extended to Japanese and domestic customers, creating a multinational banking organization. International business is also extended with other merchant banking or leasing services. Optimization of fundraising and bank lending becomes pre eminent. The fourth phase sees a deepening and strengthening of activities taken on in the third phase.

The framework incorporates many aspects relevant for describing an internationalization strategy. For example, Arora (1995, p. 87) studied activities of Japanese banks in Europe, and applied a large number of elements of Fujita and Ishigaki's framework. It is somewhat of a conceptual problem though that the authors describe the framework without further elaboration while there are implicit assumptions behind the framework, such as an inevitable sequentiality in phases, without arguing why.

Table 5.3. *Phases of internationalization of banking*

Phases	1st phase (national banking)	2nd phase (international banking)	3rd phase (international full service banking)	4th phase (world full-service banking)
Internationalization of customer companies	Export-import	FDI in host country	Multinational corporation	
International operations of banking	Foreign exchange operations connected with foreign trade. Capital transactions are short term	Loans and investments in host country become more important, capital transactions are medium - long term.	Other banking activities set up such as merchant banking, leasing, consulting.	No retail banking      retail banking
Methods of internationalization	Correspondence contracts with foreign bank	Strengthen own branch offices in host countries	Optimal, global fund raising and lending by strengthen own branches and offices, financial participations, diversifying in non-bank activities	
Customers of international operations	Mainly domestic customers	Mainly domestic customers	Customers are of various nationalities	

Source: Fujita and Ishigaki, 1986, p. 207

### 5.1.3. United Nations

The United Nations published a study of the international LDC debt crises in the 1980s (United Nations Center on Transnational Corporations, 1991). This study is somewhat an anomaly compared to the previous authors since it relates to an event. Still, it contributes to the area of strategies as a response to (anticipated) strategies of other banks in its arena. In this analysis the principal 25 banks organizing syndicated loans to LDC's are divided into three separate groups (1991, p. 28):

- *Leaders*: a few big banks dominating syndicated lending
- *Challengers*: a number of banks which are on the list of principal organizers
- *Followers*: banks that are not part of the main group organizing syndicated loans, and have fewer assets than the "followers".

Leaders are a small group commanding control over the majority of the syndicated loan market. Their success is based on their distribution power and knowledge of the market. More important, a strong historical dependency effect is noticeable: success breeds success. Challengers, aiming for a top 10 ranking in the syndicated loan market, find it difficult to shake up the vested market positions of the large US banks (the leaders). To further their growth and boost their market share, loans are granted to institutions with a lower credit rating in combination with a lower margin, hoping to climb a position on the league table and reap the rewards of a leader.

The difference between Challengers and Followers is more subtle: the size of follower banks is smaller and more important; their involvement in the business (in this case loan syndication) is more strongly interwoven with the economic cycle. In short, they hold a shorter term view, and are not as committed as Challengers and Leaders to accept periods of lesser returns.

### 5.1.4. Dunning

Dunning has published extensively on the internationalization of enterprises. He is best known for his OLI paradigm, which he developed to offer a general framework for determining the extent and pattern of foreign owned activities undertaken by domestic firms and also domestic activities owned by foreign firms. It describes a conceptual framework for the "ist" state rather than the "soll" state of level and structure of foreign activities. (O)wnership specific assets are unique resources capable of generating a future income stream. These assets may be specific to a particular (L)ocation in their origin and use, but available to all firms. Market failures may cause the firm to diversify its value-adding activities and realign the ownership and organization of these activities, to fully capture the perceived advantages of control due to (I)nternalization advantages. Thus, the level and structure of foreign activities can be based on a rewarding combination of O-L-I,

which is consistent with its long term strategy (Dunning, 1992, pp. 75-80).<sup>4</sup> For internationalization strategies, Dunning identified seven different types of investment a firm could make outside the home country (1992, pp. 56-64). The summarization is adapted to the bank specific case.

### 1. Resource seekers

A bank invests abroad to acquire specific resources at a lower real cost than could be obtained in the home market. Or the bank wants to invest abroad to acquire specific resources that cannot be obtained at the home market. The motivation for the investment is to make the investing bank more profitable and competitive in the markets it serves or intends to serve. Growth per se is then not a motive. For banks resource seeking strategies usually relate to activities which are concentrated in financial centers outside the home country (investment banking or securities distribution) or tax related (off shore haven as a specific resource).

### 2. Market seekers

Firms that invest in a particular country or region to supply services or products to these markets are considered to be market seekers. The markets are new and not the services, they are merely adapted to local customs and tastes. Market seekers have several incentives to internationalize. First, the bank's main customers set up foreign facilities. To retain their business, banks need to follow overseas. Second, services need to be adapted to local needs because of legal requirements and other matters not easily done from the home country. Third, a bank may consider it necessary to have a physical presence in the leading markets serviced by its competitors. Finally, production and transaction costs may be significantly lessened by supplying the services locally.

### 3. Efficiency seekers

With efficiency seekers, the bank rationalizes the structure of resource or market seeking investment (the first two activities) in such a way that the bank can benefit from common governance of these multinational activities. The bank aims to reap rewards from the resulting economies of scale and scope, enhanced by risk diversification. Dunning notes that usually large and diversified firms producing standardized products, engaging in internationally accepted production processes, perform this kind of activity (1992, p. 59). In order for efficiency seeking strategies to take place, cross-border markets must be both well-developed and open. This strategy should then flourish in regionally integrated markets.

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<sup>4</sup> Cho (1985) investigated the internationalisation behavior of American banks with the OLI framework for expansion in Singapore and Korea in the 1970s. He concluded that the OLI framework was applicable for service firms like banks as well (Cho, 1985, p. 153).

#### 4. Strategic asset seekers

A bank acquires assets of a foreign corporation to promote long term strategic objectives, especially that of sustaining or advancing their international competitiveness. The exploitation of cost advantages to scale or market specific advantages over competitors are the lesser motive. Asset growth and/or market share are important indicators for a strategic asset seeking strategy. The perception is to strengthen its own, or at least weaken its competitors, position. An asset seeking strategy is likely to be set independently from a large number of variables in the host country. Molyneux and Seth (1996), investigating determinants of foreign bank profitability and commercial loans growth in the United States, find that the only significant explanatory variable for commercial loans growth for foreign banks between 1987 and 1991 is the lag variable of commercial loans growth itself.<sup>5</sup> This points to hysteresis and could be interpreted as supporting evidence for asset seeking strategies.

#### 5. Escape investments

In the home country, restrictive legislation or macro-organizational policies lead to either a physical relocation of activities or an increase of foreign investment in relation to domestic investment with the sole purpose to evade the restrictive (political) situation in the home country. Dunning mentions that he is not concerned with "flight capital", which may be associated with political unrest or dire economic situations. However, some lenience should be applied to banks in this case. An example of escape investments is provided by French bank Paribas in 1981. To stave off the threat of nationalization by the French government, a semi independent Swiss subsidiary is established to transfer assets outside France.<sup>6</sup>

#### 6. Support investments

The purpose of these investments is to support activities of the rest of the bank. Such facilities are rarely self contained profit centers. A case could be made to classify this as a start up phase of the market seeking activity, where foreign units have to be set, without a clear profit goal in sight. An example could be the setting up of back office activities outside the country where the activity is located.

#### 7. Passive investments

The direct involvement with passive investments is farther to the background. The only purpose is to earn profits or gain capital appreciation, just like a portfolio investment. In the longer term however, added benefits are more inside information into the shareholding as a result of shareholder rights derived from the equity stake. This might speed up learning curve of the bank in this (new) activity or country. It can also be a move designed to signal to further cooperation in the future (or a larger equity stake). Third, the passive

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<sup>5</sup> Albeit with a low explained variance, the adjusted R Square was 0.6%.

<sup>6</sup> Paribas was nationalized in 1982 and privatized in 1987, see the case study of Paribas (page 344).

investment may prevent third parties from outright buying the firm. Protecting its relative position is an important objective for the bank.

## **5.2. Discussion and Summary**

A bank's strategy is determined by a large number of variables which cannot be easily molded into a framework (Canals, 1997). However, the risk of simplifying strategic nuances may weigh up to the analytical advantages of creating a comparative framework to develop general observations. Authors who published on (bank) strategies were reviewed. Although each framework has its merits, there is no general framework which can be straightforwardly applied to internationalization strategies for banks.

A consideration for the strategy framework is the measure of observation: the degree of internationalization in the study is measured on a bank level (see chapter 10). This implies that strategies should be analyzed on a total organizational level too.

Finally, the strategy framework developed by Mintzberg points to intended versus realized strategies. A choice in this study is made for realized strategies: information on realized strategies is publicly available and the measurement of realized strategies allows more comparisons between banks.<sup>7</sup> Based on these considerations, a choice has been made to use strategic phases, combining the phases of Fujita and Ishigaki, and the Carmoy. This is shown in Table 5.4.

In total, seven different phases are distinguished that can be identified by public information. No specific sequence in phases is assumed, in contrast to Fujita and Ishigaki. Organizational commitment describes the organizational involvement into international activities: how much capital is allocated to foreign bank activities relative to domestic activities. This provides a link with the measurement of the degree of internationalization, to be introduced in chapter 10.

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<sup>7</sup> Volberda et al. (2001) also base their analysis of management strategies on realized strategies. They cluster realized and published activities of firms by two dimensions (internal vs. external and exploitation vs. exploration) to create a measurable framework to compare realized strategies between banks.

Table 5.4. *Organizational commitment to international activities*

Strategy phase	Description	Effect on bank organization
1 entry	refers to a) a new activity in a new market, b) a new activity in an existing market or c) an existing activity in a new market.	Change/expansion of organizational structure, new strategic goals
2 expansion	broad	above average growth of capital commitment to activities
	focused	above average growth of capital commitment to activities, combined with selective disinvestments in activities and/or markets
3 consolidation	balanced growth	average growth of capital commitment to activities, aiming to maintain current market position and/or financial targets.
4 restructuring	refocus	period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Restructuring of activities does not lead to disinvestments and serves to increase profitability and/or lower the cost base
	refocus & exit	period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Average growth of capital commitment to activities, combined with selective disinvestments in activities and/or foreign markets to increase profitability or lower the cost base.
	exit	period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Sale or shut down of activities and markets to raise capital and/or reinvest in other existing activities.

## 6 Performance

This chapter reviews what relationships have been investigated between performance and international banking activities, market structures or country characteristics. Performance plays a pivotal role in almost any strategic framework, *ex ante* as well as *ex post*. Reported performance is *ex post* a consequence of intended and unintended activities resulting from a strategy. Important keywords are measurability and accountability of that strategy. Performance *ex ante* on the other hand serves as an incentive for a (strategic) activity.

The performance of internationalization activities of banks has become a research topic since the 1970s. Simultaneously, disclosure of financial information has also increased, providing the necessary data to analyze international activities. To start, opportunities have been created since then to analyze performance through financial disclosure.<sup>1</sup> Regulation in host countries, notably the United States, forced public disclosure of financial results opening the way for comparative analysis of bank performances. The growing use of organizational forms as the joint venture for international activities (the consortium banks) has given a financial insight for different business lines.

On a more aggregated scale comparing the performance of financial systems has been an important research topic since the 1960s. This discussion also has an ideological background - United States government institutions and the IMF have coaxed countries in financial stress into financial reforms based on the premise that the development of a financial system in such a country should best be modeled resembling the United States.<sup>2</sup> Perhaps to the dismay of European economists, there are few studies in international banking to be found where the United States does not serve as the measure of things. The previous discussion of (international) financial intermediation, incentives and strategies suggested different levels of performance: on a bank level, industry level and country level; four groups of performance studies are distinguished:

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<sup>1</sup> See Van der Tas (2001) for an overview of the development of different accounting measures.

<sup>2</sup> Dubbed the 'Washington consensus'. See for example Susan George for a critical review on the Worldbank (1994). The role played by the United States and the IMF in the different emerging markets crises between 1994 and 1999 is portrayed by Gill Tudor (2000).

- Performance related to financial systems
  - A) Performance comparison between countries
  - B) Relationship between industry structure and performance
- Performance related to individual banks
  - C) Performance of banks vs. peers
  - D) Performance of foreign bank activities in host countries

Before reviewing the performance studies, definition issues of performance are addressed.

*Performance, some definitions*

Banks in general are for profit organizations, and performance can be defined as economic performance as measured by a host of financial indicators.

Table 6.1. *Major Performance indicators*

Performance indicator	Examples
Profitability	<ul style="list-style-type: none"> <li>• Return on equity</li> <li>• Return on assets</li> </ul>
Stability, macro-economic	<ul style="list-style-type: none"> <li>• % Bad loans</li> <li>• Number of insolvent banks</li> <li>• Bank runs</li> <li>• Claims vs. GDP</li> <li>• Total assets banks</li> </ul>
Shareholder value	<ul style="list-style-type: none"> <li>• Share performance (vs. Benchmark)</li> <li>• Beta, alpha</li> <li>• Tobin Q</li> <li>• Cash flow</li> <li>• EVA</li> </ul>
Cost indicators	<ul style="list-style-type: none"> <li>• Cost-to-income ratio</li> <li>• Unit wage cost per employee</li> <li>• Interest rate on liabilities</li> </ul>
Industry structure	<ul style="list-style-type: none"> <li>• Concentration measures (H statistics, C statistics)</li> <li>• Growth measures</li> </ul>

Traditional measures of performance are related to an item, or a combination of items, from the profit and loss account, balance sheet, or security characteristic if the bank is publicly quoted. These measures can be dissected in return indicators (return on assets or equity, Tobin's q, the bank's price-earnings ratio, the bank's beta or alpha) and financial risk measures containing credit risk, liquidity risk, interest rate risk, leverage risk and international risk (Hempel and Simonson, 1999, p. 95). To analyze these measures in

relation to each other and make the results comparable to that of other banks, ratio models widely known as DuPont models can be used. For example, Figure 6.1 shows a straightforward application of a DuPont model for a bank to decompose the return on equity ratio into profitability and cost ratio's relevant to gain further insight in the bank's performance (Choo, 1999).

Figure 6.1. *Decomposition of Return on Equity*

$$\begin{array}{ccccccccc}
 \text{Return on Equity} & = & \frac{\boxed{\text{net profit}}}{\boxed{\text{earnings before tax}}} & \times & \frac{\boxed{\text{earnings before tax}}}{\boxed{\text{total income}}} & \times & \frac{\boxed{\text{total income}}}{\boxed{\text{net interest income}}} & \times & \frac{\boxed{\text{net interest income}}}{\boxed{\text{total loans}}} & \times & \frac{\boxed{\text{total loans}}}{\boxed{\text{total equity}}} \\
 & & \underbrace{\hspace{1.5cm}} \\
 & & \text{tax} & \times & \text{cost} & \times & \text{fee} & \times & \text{lending} & \times & \text{lending} \\
 & & \text{burden} & & \text{efficiency} & & \text{multiplier} & & \text{margin} & & \text{leverage}
 \end{array}$$

This model gives an indication how Return on Equity (ROE) can be actively steered within an organization. The ROE is divided into five ratios. Tax burden shows the percentage of profit after taxes have been paid. Cost efficiency captures the percentage of income after operational costs have been taken into account. This ratio is closely related to the cost-to-income ratio banking analysts use. The third one, fee multiplier, captures the income generated by a bank's non-lending activity. Lending margin calculates the gross spread a bank makes from taking deposits and issuing loans. Finally lending leverage shows how many times the loans the bank makes are larger than the bank's equity base.

The performance indicators can be extended to the (stock)market where the security of the bank is publicly traded. Alpha and Beta are common risk indicators.<sup>3</sup> Combining stock market and financial analysis creates measures such as the price-to-earnings ratio. Tobin's Q - the ratio of market value to replacement cost - is a measure of the firm's incentive to invest and this can be interpreted as an indicator of its long term performance. For banks whose stocks are publicly traded the Q ratio measures the market capitalization of a firm's franchise value or goodwill.

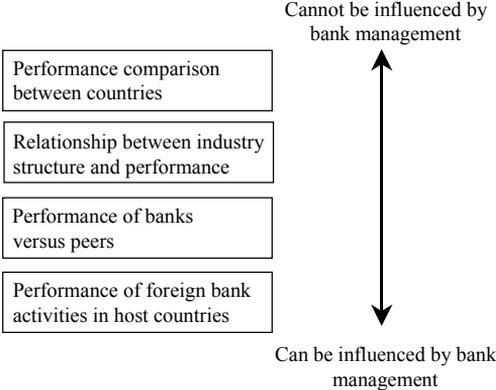
A serious setback for the management of a bank to use these measures, as opposed to some of the ratio's shown in Table 6.2 with the decomposition of the ROE, is that management cannot influence a large number of the shareholder value measures<sup>4</sup>: they

<sup>3</sup> See for example Brooks and Del Negro (2003) who studied the link between beta and internationalization, although not for banks specifically. The study covers all constituent firms in the Datatream country indices between 1985 and 2002 for 42 developed and emerging country market indices; a factor model decomposes stock returns into global-, country-, and industry specific shocks. They find that a firm who raises its international sales by for example 10% raises the exposure of its stock return (i.e. beta) to global stocks by 2%, while the exposure to country -specific shocks is reduced by 1.5%.

<sup>4</sup> See also 3.4.4 for shareholder return as an incentive to internationalize.

measure the market's reaction to the actions of the bank, but the bank cannot (re)act on this knowledge (Harker and Zenios, 2000, p. 11). The performance literature to be discussed can also be seen in this light:

Figure 6.2. Influence sphere of bank management on performance



Since the early 1970s an additional framework has been developed to examine (potential) performance on a micro-economic level, basically reputing the cost-to-income ratio as a black box; laying bare the underlying processes and even benchmarking them. The so-called X-efficiencies describe all technical and allocation efficiencies of a bank that are not scale or scope dependent. It views a bank as a factory that consumes various resources to produce services and determines the efficiency with which the transformations take place (Harker and Zenios, 2000, p. 13).

When determining the efficiency of such transformations it naturally is a small step to extend the research to normative analysis. Within frontier analysis one can select "best practice" banks within the industry, assign numerical efficiency values to the banks then rank them. If there is a limitation, it is that "frontier analysis will generally tell informed industry participants little they do not already know" (Berger and Humphrey, 2000, p. 33). While the knowledge may not be new, the quantification of the knowledge is.

**6.1. Research on performance**

After discussing key characteristic of performance measures, (selective) empirical research is reviewed. Performance comparison between countries is discussed, where the clustering of countries gives rise to generalized remarks about financial systems, and a separate discussion about the relationship between industry structure and performance warranted. Third, the focus moves to a more micro-economic level looking at performance of banks vs. peers. Finally, literature on performance of foreign bank activities in host countries is reviewed.

### 6.1.1. Performance comparison between countries

The design of a financial system influences long term growth of an economy (Gerschenkron, 1962; Goldsmith, 1969). King and Levine (1993) found a strong correlation between the size of the financial system and the level of economic development. Goldsmith (1969) conducted a comprehensive cross-country study, finding that the relative size of the financial system is positively related to economic growth.<sup>5</sup> As economies develop, the growth of the relative size of the financial system tends to level off. Goldsmith explains this observed relationship through savings and investments. Separation of the functions of saving and investment is made possible by the introduction of financial instruments, increasing the total market value of financial instruments and broadening the range as well. This increases the efficiency of investment, raising capital formation and stimulating economic growth (Goldsmith, 1969, pp. 390-392).

Beck et al. (2001, pp. 189-241) conducted a cross country approach to assess whether economies grow faster with bank-based or market-based financial systems, analyzing the relationships between indicators of financial development and financial systems with average economic growth rates between 1980 and 1995 for 48 countries. They found that the distinction between market based and bank based did not offer any additional information; in other words economic growth is not different for market-oriented or bank-oriented financial systems (Beck et. al, 2001, p. 212).

An additional question to the positive correlation between financial development and economic growth is the way the causality runs. Fase and Abma (2003) examined the causality of the relationship between economic growth and financial development, measured by aggregate financial assets in a country. For 9 emerging South-East Asian economies for a period covering more than 25 years, Fase and Abma found that financial development mattered for economic growth and that growth in financial development led to economic growth. However, Fase (2001) performed a similar long run analysis between financial development and economic growth for the Netherlands. The Dutch economy has reached a mature stage of economic development compared to the Asian economies, and there the causality changed; between 1950 and 1999 economic growth influenced financial development.

Expanding on the relationship between financial development and economic growth, Cetorelli and Gambera (2001) examined the influence bank concentration has had on economic growth for a sample of 41 countries between 1980 and 1989. Their results suggest that bank concentration has a negative effect on economic growth, affecting all sectors in the same way on average. When the analysis is expanded to include industry specific variables for external finance dependency, an industry specific effect relating to bank concentration is found. Sectors which are more dependent on external finance benefit

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<sup>5</sup> The relative size of the financial system is measured as a ratio of total market value of financial instruments to net national wealth. Goldsmith used data of thirty five countries for a number of (financial) variables, constructing three to nine measurement dates between 1860 and 1963 per country (1969, pp. 178-182).

more from a concentrated banking sector. This result suggests that banking market structure has some influence in shaping the industry composition of the country.<sup>6</sup>

Grubel (1977, quoted in Gray and Gray, 1981, p. 57) identified three types of efficiency gains that can be attributed to internationalization of banks: increased competition in the domestic banking market, economies in serving multinational clients, and greater allocative efficiency as a result of better integration of capital markets.

The comparison of market oriented systems to a bank oriented system has resulted in a stream of research with interesting implications. In bank-oriented financial systems bad projects persist too long, whereas good projects are terminated too early in market-oriented (Dewatripont and Maskin, 1990). Allen and Gale (1997) argued that risks that cannot be diversified might be averaged out over time reducing the impact on individual welfare. A bank oriented system would then provide better risk sharing between periods, whereas market oriented systems provide better cross-sectoral risk sharing.

Saunders and Walter (1994) compared the performance of universal banks in Europe with specialized banks in the United States and Japan. They found evidence of diseconomies of scope between commercial and investment banking, and some evidence of economies in very large specialized banks.

Precedents and comparisons over a longer period for financial systems are difficult to come by in this field of research. Fohlin (2000) extended the time horizon by examining bank oriented system - Germany - to market oriented systems - United Kingdom, United States - from 1880 until 1914. Although the German banking industry showed higher concentration, profitability measures did not markedly differ from the other two on average but did show large deviations in single years. Her concluding suggestion is then that the broader economic significance of financial system design might be smaller when examined over longer periods.

### 6.1.2. Relationship between industry structure and performance

An important topic in the existing literature is the investigation into structure and performance, a possible relationship between bank profitability and a measure of market structure. A number of hypotheses have been developed to underpin the phenomena investigated. The hypotheses for possible determinants of a structure-performance relationship can be divided into two categories, market-power and efficient-structure (Punt and Van Rooij, 1999, pp. 2-4).

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<sup>6</sup> The authors also conduct the analysis differentiating between younger and older firms, finding a more substantial role for facilitating credit to younger firms which - assuming that younger firms introduce more innovative technologies - implies that banking structure influence the pace of technological progress as well (Cetorelli and Gambera, 2001, p. 646). A more concentrated banking industry may introduce some deadweight loss to economic growth but be instrumental to industrial policy. A further question would then be whether the industries benefiting from facilitating credit are also ones being targeted by government with subsidies. If so a concentrated banking industry would be beneficial during economic rebuilding phases (after for example the second World War in Europe) or economic restructuring (transition from centrally planned to market oriented economies in the early nineties).

The market power hypotheses state that market power is the main variable to influence changes in profitability. In concentrated markets, market imperfections may exist as a result of collusion, (regulatory) entry and exit barriers. Banks operate in a market that deviates from perfect competition enabling them to exert influence on the price of their services. Through price setting banks can achieve higher profits at the expense of their customers. The question then is which market structure variable is the best proxy for market power. This depends on the market-power hypotheses one chooses: structure-conduct performance, relative market power, or quiet life.

#### *Structure-conduct-performance (SCP)*

This assumes that market concentration is the best proxy for market power and that more concentrated markets show larger market imperfections which enable banks to set prices at levels that are above those set by perfect competition. Through market-wide price setting each individual bank is able to realize higher profits.

#### *Relative market power*

In contrast to the SCP, this assumes that only banks with large market shares have the power to set prices and thus to earn supernormal profits. There is no market wide price setting, but only price setting by dominant banks with large market shares. Banks with smaller market shares are forced to operate as if under perfect competition and are unable to earn the same supernormal profits. Firm specific market share is the better proxy for market power.

#### *Quiet life*

It may also be possible that no relationship between market power and performance can be established. In that case a third option presents itself, the quiet life hypothesis, which is a special case of the market power hypothesis. As banks have more market power, either through market share or industry wide concentration, the management is less focused on efficiency, since setting prices at more favorable level can increase revenues. As a result of increased market power, revenues do increase, but because of higher inefficiencies this does not lead to higher profitability.

Early studies focused on the relationship between structure, conduct and performance, mainly in the United States. They were empirically shaped as performance indicators to be explained with structure providing explanatory variables. Gilbert (1984) examined 44 studies that tested the influence of market structure variables on different bank performance indicators on (panel) data ranging from 1955 to 1978. The majority of those studies support such a positive relationship.

Relative market power is a research avenue explored by De Bandt and Davis (1999). They examined the relationship between market structure and profitability measures for banks in the EMU countries and the United States between 1992 and 1996.

Market power is measured by the extent to which factor prices are reflected in revenues.<sup>7</sup> The United States shows a higher level of competition than the EMU banking markets. Countries like Germany and France tend to show monopolistic competition for large banks and monopoly for small ones. In Italy there is evidence of monopolistic competition for small and large banks. The short sample period prevents and conclusive remarks on trends. Jansen and de Haan (2003) analyzed the relationship between concentration, competitiveness, efficiency and profitability in the European banking markets for selected years between 1980 and 1997.<sup>8</sup> Neither evidence at the macro level between concentration and competition nor evidence for a robust relationship between market concentration and profitability was found.

Market power is one avenue of research relating structure to performance, efficiency measures are another. The efficient structure hypotheses explain the positive relationship between profitability and concentration or market share with efficiency measures. Efficiency causes more profits and increasing market share. If one controls for efficiency, the link between profitability and market structure variables become insignificant. Efficient structure hypotheses consist of two nodes, X-efficiency and scale efficiency:

### *1. X-efficiency*

Banks are able to realize higher profits as a result of superior management. X-efficiency determines the level of managerial efficiency, measuring to what extent management is successful in earning maximum profits given input and output prices, or in minimizing costs given input prices and output quantities. Higher X-efficiency may result in higher profits and more efficient banks increasing their market share over less efficient banks, resulting in a higher level of concentration. Because X-efficiency has a positive effect on market structure and on profitability, the relationship between profitability and market structure may be positively significant but economically useless as causality.

### *2. Scale efficiency*

Differences in profitability between firms are not caused by differences in the quality of management but by differences in the level of scale efficiency at which the bank is operating. Banks may operate below their efficient scale given input prices and product mix. By moving towards a fully efficient scale the bank should realize higher profits per unit of output, higher market shares and possibly higher levels of concentration. A spurious relationship between market structure variables and performance may be the result.

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<sup>7</sup> Based on the methodology suggested by Panzar and Rosse. To this end an index (the H statistic) is computed as sum of elasticities of gross revenues to unit factor costs (unit wage cost per employee, interest rate on liabilities, other costs in proportion to assets). H can tend to 0 indicating inelasticity and monopoly power, or to 1 indicating perfect competition.

<sup>8</sup> For market concentration, both the C5 ratio and the Herfindahl Index was used; competitiveness was measured by the H statistic of Panzar and Rosse (see also note 7). For profitability, ROE and ROA are used; efficiency measures are derived from other studies, using estimated cost functions to measure the X-inefficiencies.

Berger and Humphrey (2000) surveyed 130 studies that apply efficiency analysis to financial institutions in 21 countries. They summarized the results as follows: 1) deregulation of financial institutions can either improve or worsen efficiency, depending on market conditions before the regulation; 2) a similar result applies to cost efficiency after mergers and acquisitions. On average no significant cost improvement is measured; profit efficiency may however improve due to the changed mix of services and products. The surveyed research does not favor efficiency or market power as the main variable to influence profitability. They found that cost efficiency is more important than market concentration in explaining profitability, but both influences do not explain much performance variation. Market power apparently has little effect on performance, supporting to some extent the "quiet life" variant where management is less focused on efficiency. Finally, they noted that most studies are related to the United States and that more cross country comparisons should be considered, restrained by the difficulty that comparative datasets are hard to get by.

Van Dijke (2001) reviewed 22 studies on banking efficiency in Europe and the United States for data samples broadly between 1985 and 1995 and concluded that in general X-inefficiencies are much larger than Scale-inefficiencies and Scope-inefficiencies. This suggests that in order to increase performance banks had better emulate the banking industry's best practice, than to increase size or diversify (Dijke, 2001, p. 308). He applied the cost to income ratio and its dispersion as a proxy for (in)efficiency for EU banks between 1995 and 1998. Drawback is that this cost ratio does not account for the fact that some product mixes cost more than others to produce, which is compensated somewhat when the ratio is set against the bank's main competitors and similar banks. Residual analysis from regression may then indicate possible (in)efficiencies. Explaining the variance in cost to income ratios van Dijke finds that increasing scale or changing scope has a limited impact on the cost to income ratio. Also his analysis suggests that a reduction of cost to income ratio is decelerated to some extent due to the consolidation process, though changes in efficiencies vary strongly across EU countries (Van Dijke, 2001, p. 325).

Punt and van Rooij (1999) reviewed a selection of existing studies which explored the relationship between market structure and performance published between 1992 and 1998. They concluded that no specific hypothesis emerged as the dominant explanation for the structure - performance relationship. Their own analysis, a panel data set of commercial banks in 8 European countries in the period 1992-1997, provided the strongest support for the X-efficiency hypothesis. They also find that although significantly positive relationships between profitability and market structure variables exist, the variance explained is typically on the low side.<sup>9</sup>

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<sup>9</sup> Ordinary Least Squares estimates with Return on Assets or Return on Equity as dependent variables and market share of the individual bank, market concentration indicator (Herfindahl index or the C5 concentration ratio), and annual growth of GDP result in adjusted R-Square of less than 3% (Punt & van Rooij, 1999, p. 9).

Berger and Mester (1999) examined the cost and profit performance of banks in the United States between 1984 and 1997. One of their findings was that cost productivity worsened, while profit productivity improved substantially. They attributed the worsening of the cost productivity in part to the applied model, which did not account for great shifts in revenue changes. Also, adding additional services or providing a better quality service may have raised costs. Otherwise the findings are consistent with the hypothesis that banks try to maximize profits by raising revenues as well as trying to lower costs. Furthermore Berger and Mester found that merged banks showed greater cost productivity deterioration and higher profit productivity than non-merged banks, though they warn that the sample investigated to base this finding on was limited. This might point to a shift into higher risk-expected return investments to reap diversification advantages from the merger.

### 6.1.3. Performance of banks vs. peers

Literature on the relationship between internationalization strategy and performance is scarce. A number of studies highlight difference in efficiency between countries; thus merely highlighting potential motives for internationalization strategies. Event specific cross-country or cross-bank studies are carried out which are triggered by special events in an international context such as the emerging markets loan crisis (United Nations Center on Transnational Corporations, 1991), economic recession (OECD, 1992), or the upcoming and on-going European integration (European Central Bank, 1999, 2000).

The link between shareholder value and internationalization activities has been selectively investigated. An analysis relating internationalization strategy to shareholder value has been presented by van Wensveen, van Eerden and Mahieu (2000). Consultants are interested in this subject too, for example Accenture (2001) and McKinsey (1999).

The study by Accenture (2001), a consulting firm, linked internationalization to shareholder performance. The sample included 31 financial firms worldwide selected on their geographical presence (at least three continents), revenues (at least 25% outside the home country), assets (at least 35% outside the home country) and a market capitalization larger than 1 billion US dollar during a 10 year period ending 1996. A finding was that 14 of the 31 firms achieved an annual average growth rate of 4.6% above local market indices, and 5 out of 14 even achieved growth rates higher than 9.4%. Successful firms tended to take a pro-active stance to their foreign operations, and pursued a focused entry strategy. However, no sensitivity analysis was done, for example controlling shareholder return for the degree of internationalization.

Van Wensveen, van Eerden and Mahieu (2000) performed a qualitative analysis of 29 European banks between 1994 and 2000, linking relative performance above local market indices to financial indicators (cost to income, Return on Assets) and strategic profile of the banks. They find that universal banks, especially those heavily involved in investment banking and high risk international activities crowd the lower ranks of the performance ranks. Banks focused on national or regional (retail) activities are on the other hand consistently rewarded, as well as banks with a clear low cost approach.

#### 6.1.4. Performance of foreign bank activities in host countries

Empirical literature typically finds that foreign institutions are generally less efficient than domestic institutions (Berger et al., 2000, p. 2). Claessens et al. (2001) examined the effect of foreign bank entry in domestic markets for 80 countries between 1988 and 1995. They found that foreign banks tended to have higher interest margins, higher profitability and higher tax payments than domestic banks in developing countries, while the opposite was true for foreign banks in developed countries. Their research provides evidence that in general a larger share of foreign banks improves the efficiency of the national banking market, reducing the profitability of domestically owned banks (2001, p. 908). Claessens and Laeven (2003) estimated competitiveness indicators for a large cross section of countries between 1994 and 2001. Greater foreign bank presence and fewer activity restrictions in the banking sector were found to be related to more competitive banking systems.

Molyneux and Seth (1996) investigated determinants of bank profitability for subsidiaries of foreign banks in the United States between 1987 and 1991. Growth of the loan portfolio, risk adjusted capital ratio and the loans to assets ratio were significant variables (with p values < .05) to explain the variance for return on equity. Evidence that larger foreign banks fared better than smaller ones was not supported, suggesting absence of economies of scale.<sup>10</sup> Molyneux and Seth suggest that capital strength is one of the most important factors determining foreign bank performance in the United States. Soundness, not size, is the signal clients in the United States responded to (or perhaps the foreign bank is simply endowed with cheap cost-of-capital (Molyneux and Seth, 1996, p. 5).

Peek et al. (1998) examined acquisitions of banks in the United States by host banks, comparing financial performance before and after the acquisition to determine what effect the change of foreign ownership has brought in comparison to peer groups. They examined foreign owned bank subsidiaries in the United States between 1984 and 1997. They reinforced the findings of earlier studies that foreign owned banks in the United States perform less well than their domestic competitors in the United States. Foreign banks tended to acquire less well-capitalized banks than their domestic competitors. Other portfolio differences usually identified as causes of poor performance, such as greater reliance on purchased funds and less reliance on core deposits, were confirmed by Peek et al. (1998, p. 21). Also, problem loans tend to increase immediately after the acquisition. In short, foreign banks seem to acquire the less financial solid banks in the United States. Also, once acquired, foreign owner have difficulties narrowing this performance gap (supposing that this is their intention). Changes of business strategies, improvement of the loan book and shoring up the capital ratios generally have not led to better results than domestically owned banks.

Is therefore performance comparable to peer banks not possible for the foreign bank, or simply not the intention of the foreign bank acquiring a bank in the United States? Due to the apparent structural character of these findings, authors like Peek et al. (1998, pp. 22-24) tended to emphasize the latter explanation. First, foreign banks may have a

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<sup>10</sup> Perhaps can such a relationship be found if the size of the total bank in the home country is also incorporated.

broader concept of profit, following their clients. Overall profitability of the clients relationship matters, not the results achieved in the United States per se. Naturally this argument only holds ground if a substantial amount of business in the US subsidiary is related to (subsidiaries of) these home clients. Second, the US acquisition may provide some kind of competitive advantages to the bank for its domestic competitors. Besides being able to service its customers abroad, such an acquisition may be considered a type of R&D investment intended to upgrade techniques and technology that can be exported back to the home country. Third, such operations may signal quality or prestige to domestic customers. Fourth, reported profits in a country may be affected by tax considerations with the bank using transfer pricing to book profits to the banking operation in the lowest tax region. Fifth, the foreign banking organization may expand its overseas operations to avoid restrictions on lending or funding at home. Finally, international diversification may be achieved.

## **6.2. Summary**

Performance of banks was addressed in chapter 6. On the one hand performance is the result of a combination of activities, objectives and incentives, on the other hand it is an influence for incentives or objectives. The previous chapters showed that performance could be interpreted from different levels relevant to this discussion: performance of financial systems, performance of foreign banks, and shareholder performance.

The reviewed studies can be summarized in four stylized conclusions. First, financial development in general is positively related to economic growth. For emerging economies, the causality might run from financial development to economic growth while this possibly is not the case for mature economies.

Second, there are distinct differences between bank oriented and market oriented financial systems. This supports differences in financial structure as an incentive to internationalize. However, different financial systems do not lead to different economic growth rates in the long term.

Third, measures of concentration of banking market structure tend to show a positive relationship with performance, suggesting price setting behavior and lower cost efficiency in European countries compared to price competition and high cost efficiency in the United States, tipping the overall performance quite consistently in favor of the United States.

Finally, the performance of foreign banks in the United States has been the subject of research. The general conclusion is that foreign bank subsidiaries in the United States tend to show lower performance than their American peers. This might be caused by several factors, such as a failed attempt to exploit internalization advantages, or an extension of quiet life where the foreign bank applies the same cost efficiency as in the home country where market power reduces the need to focus on costs.

## 7 Summary of Part I and Framework

The first part of this study is ended with a brief review of the previous chapters, and an integration of the results in a framework that will be used to assess internationalization strategies of different banks in Parts II and III.

Part I reviewed the theoretical foundations for the banks' internationalization activities, starting with a lay out of the role of banks: why do they exist, what do they do, and what is their role in economic society. Financial intermediation theories describe and analyze the role banks play. Essentially, risk management plays a central role for a financial intermediary (Allen and Santemero, 1998; Scholtens and Van Wensveen, 2000), transferring and managing risk. Investors and saver financial needs are matched, mitigating informational asymmetries. A distinction was made into functions, activities and products. On a macro level, financial systems can be defined where the bank plays different roles: bank oriented, market oriented and government directed. With market oriented financial system, the allocation process is mainly determined by the price process, and a substantial part of the banks' main activities, matching savers and investors, is performed by capital markets. There is a clear separation between firms, banks and government. With bank oriented financial systems, the price process still is important, but the bank also plays an important part in the allocation process. There is less separation between banks and firms; banks can actively steer the allocation and utilization of capital by participating in the firms. Finally, in government oriented systems, banks can be instrumental in achieving the government's objectives.

Chapter 3 defined what internationally active banks do, by extending the definition in chapter 1 to *international* financial intermediation. A workable definition is that a bank has assets/liabilities and/or rights/claims outside the home country that have been issued, or should be collected outside the home country. Next, a review was presented of incentives to internationalize: what is the advantage over staying at home? Literature has produced a number of incentives, some specific for banks, and others developed for firms and extended to banks. The incentives were clustered in three groups: *Extrinsic*, *Bank intrinsic*, and *Sector intrinsic* incentives.

*Extrinsic* incentives to internationalize stressed bargaining approaches in relationships with host governments, and its effects on host economies. These incentives

related to clients, net interest margins, economic structure, financial development and regulation. *Intrinsic* incentives to internationalize centered around the transaction cost approach, encompassing minimizing costs, maximizing efficiency, optimizing competitiveness in combination with the internalization of markets. Hypothesized intrinsic incentives in this study related to economies, profitability and capitalization as incentives to internationalize. Finally, *Sector intrinsic incentives* represented common ground between extrinsic motives and intrinsic motives such as the relative position a bank wants to attain relative to competitors, achieved by market power or visible through herding. Hypothesized relationships in this study were herding, market power and concentration.

In chapter 4, the focus of internationalization activities was discussed - which combination of client, arena and product to target - and the organizational form needed to implement the internationalization activity. The organizational forms each serve different client and product purposes, and have different degrees of capital commitment and control opportunities for the parent bank. Eight different organizational forms were identified, ranging from correspondent banking (requiring no capital commitment and no control opportunities) to foreign subsidiaries and branches (requiring substantial capital commitment but also providing direct control opportunities for the parent bank). Four major factors influence the organizational form a bank chooses for its internationalization activities. First, legal and regulatory framework of the home and host country is an important factor encompassing restriction in the choice of organizational forms in the host country, differences in taxation, regulatory capital requirements and desired legal liability structure. Second, there are entry barriers of the host country to consider. Third, there are strategic issues to consider. In particular, the choice of organizational form can signal the level of commitment the bank aims for in the foreign country. Fourth, relative costs to conduct transactions from the head office compared to cost of conducting transaction in the foreign country also play a role in the choice of organizational form.

The classification of bank strategies was discussed in chapter 5. Several authors have developed strategic frameworks for internationally active banks (Walter, 1988; de Carmoy, 1990; United Nations Center of Transnational Corporations, 1993; Canals, 1997; Fujita and Ishigaki, 1986), each with different insights into the internationalization strategies of banks. Walter introduced a Client-Arena-Product matrix, providing opportunities for banks to analyze their competitive strengths and weaknesses at a product level, the United Nations Center of Transnational Corporations developed a framework combining herding and game theory elements. Fujita and Ishigaki, and De Carmoy described different phases of organizational changes and focus, while Canals identified basic elements for pursuing an internationalization strategy. Chapter 5 concluded by presenting a framework of *realized* (as opposed to *intended*) internationalization strategies was presented as an analysis tool for this study.

Performance of banks was addressed in chapter 6. On the one hand is performance the result of a combination of activities, objectives and incentives, on the other hand is it an influence for incentives or objectives. The previous chapters showed that performance

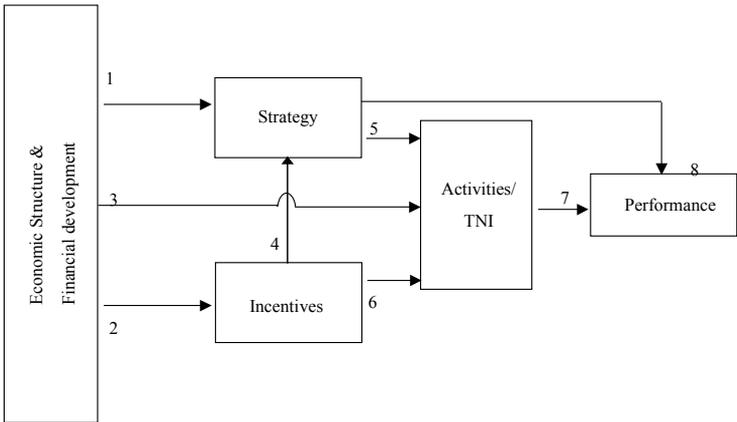
could be interpreted from different levels relevant to this discussion: performance of financial systems, performance of foreign banks, and shareholder performance.

Major research findings were that financial development in general is positively related to economic growth. For emerging economies, the causality might run from financial development to economic growth while this possibly is not the case for mature economies. Also, there are distinct differences between bank oriented and market oriented financial systems. This supports differences in financial structure as an incentive to internationalize. However, different financial systems do not lead to different economic growth rates in the long term. Another research finding was that measures of concentration of banking market structure tend to show a positive relationship with performance, suggesting price setting behavior and lower cost efficiency in European countries compared to price competition and high cost efficiency in the United States, tipping the overall performance quite consistently in favor of the United States. Finally, foreign banks' subsidiaries in the United States tend to show lower performance than their American peers. This might be caused for several reasons, such as a failed attempt to exploit internalization advantages, or an extension of quiet life where the foreign bank applies the same cost efficiency as in the home country where market power reduces the need to focus on costs.

**7.1. Framework internationalization strategy**

The discussion in the previous chapters centered around the relationship between a bank and the financial systems, incentives to internationalize, realization of internationalization activities, the strategies and resulting performance. The framework in Figure 7.1 summarizes the possible relationships.

Figure 7.1. Framework of an internationalization strategy



The remainder of the study is centered on this framework, which consists of five different building blocks. The arrows indicate the direction of the investigated relationship. The description and typology of *Strategy* will be the outcome of Part II. Are different strategic typologies for the realized internationalization activities discernible, and what is their relation with realized activities and the degree of internationalization? Also, have they had different incentives to internationalize? Individual case studies are developed in chapters 12 through 18, and their activities are analyzed by applying the strategic realized internationalization phases developed in chapter 5.

Possible relationships between strategy, incentives, activities and performance are investigated in part III, *Effectiveness*. *Incentives* encompass the firm, sector and extrinsic incentives discussed in chapter 3. The relationship between Incentives and Activities, the degree of internationalization, is investigated in chapter 20. The *Structure* block includes country specific variables: GDP per capita, regulation. It controls for the outcome of the other relationships. While some of the variables are directly used as incentive to internationalize, it is also considered what the role is between financial development and activity. Finally, *Performance* is measured as profitability and shareholder return. The relationship between bank performance and the degree of internationalization is investigated in chapter 21, while the relationship between the degree of internationalization and shareholder return is the subject of chapter 22.

The breadth of the research subject poses some restrictions on the analysis of the framework. A choice has been made to use separate models to test the different relationships. While a unified model might provide more coherencies in the results, it would also be a large model. The use of several models allows more flexibility in the use of data. Robustness of results in some cases is achieved by using additional analyses. Next, the hypotheses are summarized.

## **7.2. Hypotheses**

The incentives to internationalize were clustered in chapter as 1) sector extrinsic, 2) sector intrinsic and 3) bank intrinsic. The corresponding hypotheses to test the relationships between the incentives to internationalize and the degree of internationalization are presented in Table 7.1; a measure for the degree of internationalization will be introduced in Part II.

Table 7.1. *Hypotheses for incentives to internationalize*

Number	Hypothesis	Analysis
<i>Extrinsic incentives</i>		
HYP20.1	1. <i>Client hypothesis.</i> An increase in outward foreign direct investment (FDI) and/or exports leads to an increase in internationalization activities of banks.	Chapter 20
HYP20.2	2. <i>Spreads.</i> An increase in internationalization activities is negatively related to interest margins and profitability in the home country.	Chapter 20
HYP20.3	3. <i>Economic structure.</i> An increase in internationalization activities is positively related to GDP growth and to GDP per capita.	Chapter 20
HYP20.4	4. <i>Small home market.</i> Banks in smaller countries and/or higher market concentration show a higher degree of internationalization than banks in larger countries.	Chapter 20
HYP20.5	5. <i>Financial development.</i> An increase in internationalization activities is positively related to the size of the stock market, or the non interest income earned by banks as a share of total income.	Chapter 20
HYP20.6	6. <i>Regulation.</i> A relatively high degree of regulation in the home country is positively related to the degree of internationalisation.	Chapter 20
<i>Sector intrinsic incentives</i>		
HYP20.7	7. <i>Herding.</i> An increase in internationalization activities is positively related to an increase of internationalization activities of bank sample.	Chapter 20
HYP20.8	8. <i>Market power and concentration.</i> An increase in internationalization activities is positively related to home countries with low ratio's of banking assets to GDP and high concentration ratio's of banks.	Chapter 20
<i>Bank intrinsic incentives</i>		
HYP20.9	9. <i>X-efficiency/economies.</i> Banks with lower cost-to-income ratio's show a higher degree of internationalization.	Chapter 20
HYP20.10	10. <i>Profitability.</i> Banks with higher levels of profitability show a higher degree of internationalization.	Chapter 20
HYP20.11	11. <i>Capitalization.</i> The degree of internationalization is positively related to higher capital ratio's for banks.	Chapter 20

Performance is measured as profitability and shareholder return. The hypotheses test if the variability of profitability is more stable for higher levels of internationalization (HYP21.4), if a higher degree of internationalization improves the return-risk trade off of banks (HYP21.3). Return is here defined as profit before tax as a share of capital and reserves, while risk is calculated as the standard deviation of return.

Table 7.2. Hypotheses for performance and internationalization

Number	Hypothesis	Analysis
HYP21.1	1. <i>Degree of internationalization</i> . A higher degree of internationalization is positively related to a higher performance of the total bank.	Chapter 21
HYP21.2	2. <i>Performance differential</i> . Profitability of foreign banking activities is higher than profitability of domestic profitability.	Chapter 21
HYP21.3	4. <i>Risk/return</i> . A higher degree of internationalization of banks is positively related to the return-to-risk ratio's; there is an optimal degree of internationalization for the return-risk ratio of banks.	Chapter 21
HYP21.4	3. <i>Variability earnings</i> . A higher degree of internationalization lowers the variability of earnings of the total bank.	Chapter 21
HYP22.1	5. <i>Degree of internationalization</i> . Banks with a higher level of internationalization tend to show above average shareholder returns.	Chapter 22
HYP22.2	6. <i>Change in internationalization</i> . Banks with an increase in degree of internationalization show above average shareholder returns	Chapter 22
HYP22.3	7. <i>Volatility shareholder return</i> . A higher degree of internationalization lowers the volatility of total shareholder return of the bank.	Chapter 22
HYP22.4	8. <i>Return / risk</i> . A higher degree of internationalization of banks is positively related to the return-to-risk ratio's; there is an optimal degree of internationalization for the return-risk ratio of banks.	Chapter 22
HYP22.5	9. <i>Large TNI changes</i> . A large change in the degree of internationalization compared to an earlier period is followed by period of higher shareholder return and/or lower volatility of shareholder return.	Chapter 22

Similarly, it is tested whether the volatility of shareholder return is more stable for higher levels of internationalization (HYP22.3) or if a higher degree of internationalization improves the return-risk trade off of banks (HYP22.4). Return is here defined as the annualized total shareholder return (i.e. price return including reinvested dividends), while risk is calculated as the annualized standard deviation of the monthly total shareholder return.

Diversification advantages of internationalization may not be fully grasped by shareholders, especially when the bank initiates large foreign acquisitions (HYP22.5). Additionally, two hypotheses investigate if stock market participants consider the degree of internationalization as one of the variables to influence the bank's share price (HYP22.1 and HYP22.2).

The next tests examine the relationship between the degree of internationalization and incentives, shareholder return and realized internationalization strategy types. It is tested whether the strategy types are more important than the country of origin (HYP23.1), and it is hypothesized that different strategy types generate different shareholder return (HYP23.2). The next three hypotheses deal with the characteristics of different strategies: is there a home bias visible (HYP23.3), and do different strategies exhibit different financial ratio's (HYP23.4). Also, how have these ratio's changed over time (HYP23.5). Next, changes in strategy are addressed, and do banks engage in herding (HYP23.6). Finally, it is hypothesized that regional strategies are specific to European banks (HYP23.8). The strategy types which the hypotheses refer to are presented in chapter 19.

Table 7.3. *Hypotheses for strategies, internationalization and performance*

Number	Hypothesis	Analysis
HYP23.1	<i>1.Incentives.</i> The relationship between incentives and TNI is better explained when banks are clustered by strategic type then by country of origin.	Chapter 23
HYP23.2	<i>2.Shareholder performance.</i> In general, <i>Retreating</i> banks have created the highest total shareholder return, while <i>Accelerating</i> and <i>Imploding</i> banks have delivered the lowest results.	Chapter 23,
HYP23.3	<i>3.Home bias.</i> The relationship between staff, assets and gross income is more stable in the home country than in the foreign country.	Chapter 23
HYP23.4	<i>4.Support strategy.</i> The ratio of assets and/or income per staff is higher for <i>Moderate</i> banks throughout the period and accelerating banks in the 1980s.	Chapter 23
HYP23.5	<i>5.Convergence.</i> The ratio of assets and/or income per staff for foreign activities converges over time to the ratio for domestic activities.	Chapter 23
HYP23.6	<i>6.Herding.</i> Changes of strategy in the bank sample are concentrated in time.	Chapter 23
HYP23.7	<i>7.European regional strategies.</i> Internationalization in the geographic home regions is specific for European banks.	Chapter 23



## **Part 2**

# **Patterns**



## **Introduction to Part 2**

Part I reviewed the framework to examine the internationalization strategies of banks. Incentives to internationalize, the organizational form, strategic goals and performance were reviewed. How these strategies evolve, why they (suddenly) change and what their specific outcome is varies between different banks and countries. For one, their strategic orientation may vary within and between financial sectors. Also, the effect of involvement of government and regulators has not been the same for all banks, allowing full banking competition in the domestic banking market yielded different results for internationalization patterns than in a protected banking market. In some cases regulators or government even actively stimulated banks to undertake international activities.

Part II analyzes the realized internationalization strategies of banks. Which internationalization strategies emerged, how have they interacted with other banks, and what effect this has had on the degree of internationalization. In total 44 banks will be examined, most of them having experienced strong shifts in internationalization activities between 1980 and 2000. The 44 banks are the 3 to 5 largest banks for the United States, the United Kingdom, the Netherlands, Germany, France, Japan, Switzerland and Spain between 1980 and 2000.

First, a general overview of banking developments is presented in chapter 8 where economic developments affecting banking activities and incentives to internationalize are reviewed. Disintermediation is discussed, suggesting a declining role for banks. Although the role of banks has declined, banks still play a major role in financial intermediation; diversification of banking activities combined with asset growth has been the banks' answer to disintermediation. Additionally, financial crises relevant to the internationalization of banks are discussed, especially the lending boom to emerging markets in the 1970s. The subsequent financial crises in emerging markets have had a profound effect on the internationalization of American and British banks and also shaped regulatory developments such as the Basle Accord, specifically designed for international active banks.

The composition and characteristics of the bank sample are discussed in chapter 9. A finding is that the banks in the sample dominated the international banking scene between 1980 and 2000; the number may be limited but their financial impact is not.

Furthermore, the sample has through mergers and acquisitions become more concentrated in terms of assets. The financial key indicators determining profitability are examined in more detail.

The Trans Nationality Index (TNI), a combined index of foreign assets, foreign income and foreign staff is introduced in chapter 10 to measure the degree of internationalization of banks. With this measure a broad overview of internationalization is presented. Internationalization for the whole sample remained stable from 1980 to 1990, and increased in the next decade; the major changes in internationalization between 1980 and 2000 and its causes are analyzed.

The subsequent chapters (chapters 11 through 18) analyze the realized internationalization strategies of the banks grouped per country: Japan, the United States, Germany, Netherlands, United Kingdom, France and Switzerland. Each chapter highlights economic and regulatory developments in the various countries that might have had an effect on the internationalization of banks, but also on the entry of foreign banks in that country. Are there country specific incentives to be found, have they been caused by changes in market structure, government policy, foreign competition or other motives? Next, strategies and internationalization of individual banks will be analyzed in more detail.

In chapter 19 an integrative approach is applied to the case studies: the case studies show that there are strong similarities observable between the realized internationalization strategies, in terms of organizational commitment to international bank activities. Five types of realized internationalization strategies are identified and discussed.

## 8 Banking since the 1980s

This chapter discusses the main developments that affected the internationalization of banks between 1980 and 2000. The discussion serves two purposes. First, it provides a common background for the banks in the sample when discussing patterns of internationalization in chapters 11 through 18. Second, a majority of the discussed developments will reappear as explanatory variables in the analyses in part III, where the effectiveness of internationalization is analyzed. Four areas of main developments have influenced the internationalization activities of banks that will be discussed in this chapter (cf. Smith and Walter, 1990, p. 643; Mullineux and Murinde, 2003, p. 11); three of them are external: economic, institutional, and financial developments. The fourth area relates to clients, products and organizations (Table 8.1).

Table 8.1. *Developments influencing internationalization of banks*

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<b>Economic</b>	<b>Financial</b>
<ul style="list-style-type: none"><li>• Economic growth</li><li>• Regionalisation</li><li>• Growth of securities markets</li></ul>	<ul style="list-style-type: none"><li>• Monetary regime</li><li>• Regulation</li><li>• Financial Crises</li></ul>
<b>Institutional</b>	<b>Clients, products and organization</b>
<ul style="list-style-type: none"><li>• Disintermediation process</li><li>• Financial structure</li></ul>	<ul style="list-style-type: none"><li>• Financial innovation, products</li><li>• Technology/distribution channels</li></ul>

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### *Economic developments*

Differences in economic growth and inflation between the United States, Japan and Europe have been drivers for internationalization; differences in economic development offer banks the opportunity to diversify geographically. For bank internationalization between developed countries, these diversification advantages decreased between 1980 and 2000. Economic developments have also been shaped by regionalization, one of the major economic and political events in the last decades (cf. Van Tulder et al., 2001). This

determined trade and investment flows, influencing client push- and pull motives for banks to internationalize. Further, growth of the securities markets not only created direct competition for bank funding, but also new opportunities for non-interest income. Setting up activities in financial centers became a key element in the bank's strategy.

### *Institutional issues*

On an institutional level, disintermediation and financial structure are addressed: how has disintermediation changed between 1980 and 2000, and did changes or differences in financial structure have consequences for international activities? Differences in financial development, not financial systems may have influenced international activities.

### *Financial issues*

The 1980s can be characterized by the controlling of inflation through changes in monetary regimes, and the ongoing efforts to stabilize exchange rate fluctuations, either through concerted actions of central banks or the further development of exchange rate regimes. This affected the structure and income of the international activities of banks in several ways. Other notable achievements were the international regulation and re-regulation of the financial services markets. Within a relatively short period, financial regulators have removed many barriers for banks to undertake new activities, albeit for different reasons. Re-regulation also took place for international banks, formed by the internationally applied rules for capital adequacy. Regulation is a reaction to, or anticipates financial instability. Banking crises have occurred from time to time. The LDC debt crisis is singled out for discussion, marking the reorientation of (American) bank's international strategies, and the increasing role of international organizations.

### *Clients, products and organization*

Changing needs of clients, (de)regulation increasing financial sophistication has caused a large growth in financial products to cater for the clients' needs. Technology has been an important enabler in this process: new distribution channels were created, and process oriented activities were heavily automated. Production of services has become less location bound. The new distribution channel increasingly allowed banking to be "footloose".

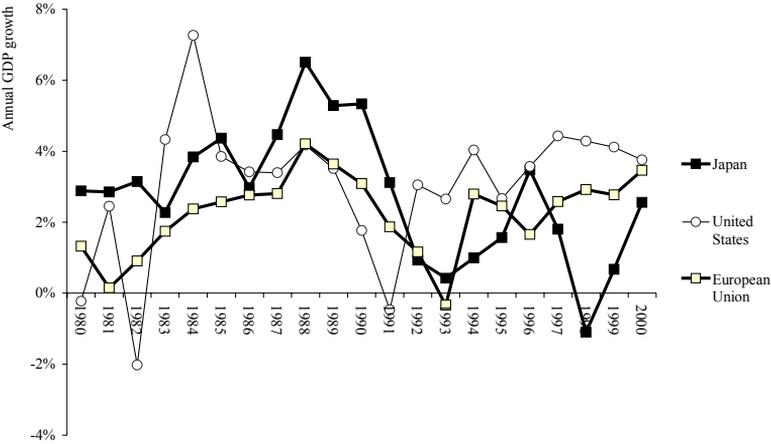
## **8.1. Economic issues**

### **8.1.1. Economic growth**

Differences in economic growth are a driver for internationalization activities; higher economic growth in foreign countries implies theoretically a lower level of provisioning for bad loans, an increase in loans and a stronger capitalization of the balance sheet. On average, economic growth and GDP per capita are positive drivers for bank profitability

(Demirgüç-Kunt and Huizinga, 2001, p. 253). The world economy in 1980 is a natural demarcation point for a discussion of economic development. At the end of 1979, to prevent a spur in inflation similar to 1973-74 after the abrupt oil price increase, the Federal Reserve introduced a tight monetary regime. Strong effects were felt in the real economy. Higher cost of lending lowered credit growth, the change in oil price raised input prices, and adjustments of consumers and firms to the new monetary regime lowered consumer spending and investments. From 1980 to 1982, most European economies slowed down while the American economy slipped into recession in 1982. An exception was the Japanese economy, which maintained average growth rates of 2.9% between 1980 and 1982.

Figure 8.1. Real GDP growth, 1980-2000



Source: OECD Economic Outlook.

The changing monetary regime and the economic slowdown had several long-term consequences. The first was that oil prices and other commodity prices fell dramatically. Compared to the earlier oil price hike of 1973-74, economies had readjusted themselves, decreasing their dependence on oil. Lower economic growth reduced the need for oil products strongly, negatively affecting the income of oil producing countries. On the same note, commodity prices were hurt badly. This meant that the main source of income of developing countries, using this income as collateral for loans and interest payments, dried up. Banks and supranational agencies such as the IMF and Worldbank would spend considerable amounts of capital in the 1980s to resolve this financial crisis because of this development.

Economic growth rebounded in 1983 when lower inflation and easing wage pressure helped increase profits. Exports to the United States helped European economies considerably, while the United States economy maintained both a current account deficit and government deficit from 1982 onwards. In Europe, governments did not on average reduce their spending, although the growth in deficits declined. A notable exception was

the United Kingdom, where the government achieved a budget surplus in 1988 and 1989. It would take nearly a decade for European governments to actually decrease their deficits from 1995 onwards, as one of the requirements for the migration path to the single European currency. Inflation fell steadily while unemployment also fell, from 9% to 7% for the European economy as a whole. Compared to the unemployment levels in the United States, the result seemed meager however.

Organizations such as the OECD and other experts regularly pointed out the rigidities within the European economies, causing this gap: relatively high unemployment benefits, barriers to labor mobility, higher taxes and low innovative capacity compared to the United States. This did cause worries among policy makers. The European economy depended on American deficits on the one hand for export led-growth, while Asian economies threatened both innovative (technology) sectors and capital and labor intensive sectors. Europe's answer to these challenges became integration: setting the goal to create a single market and currency, accelerated by the Whitebook in 1985 and the Delors report in 1989. The urgency became greater when West Germany and East Germany reunited in 1990. This unification created a double legacy for the 1990s: sluggish growth in Europe because of the huge amount of capital transfers former West Germany donated to the rebuilding of former Eastern Germany, and (monetary) unification to maintain a balance of power within the European Union.

In the United States, economic growth was already receding from 1989 onwards, exposed to some weaknesses. Although the growth from 1983 was impressive by many standards<sup>1</sup>, it was partly financed with trade and government deficits, creating large current account surpluses in the European economies and Japan. Consequence was however that the raised interest rates from 1989 onwards to curtail inflation were not lowered. This reflected the Federal Reserve's worries that relatively high interest rates in Europe (raised since and due to the cost of German unification) would further slow the flow of capital to the United States. Moreover the stability in the energy market was rudely disrupted with Iraq's invasion in Kuwait, leading to a sudden price increase in oil, increasing inflation. The shortage of capital and reduced willingness from abroad to supply capital led the Bush administration to make a historic deficit reduction agreement (Aho, 1991). American banks added to the economic downturn, restricting lending after a decade of regional bank crises; but they also restricted lending in to meet the international capital adequacy guidelines.<sup>2</sup>

The beginning of the 1990s marked two recession years: in 1991 the United States and the British economy showed negative growth rates, while the German, French, Swiss and Spanish economies slipped into recession in 1993. Although Japanese economic growth virtually came to a halt in 1993, it rebounded but slipped in 1998 into a recession.

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<sup>1</sup> The prolonged period of economic growth raised hopes of an era of economic growth where business cycles played no role anymore (Aho, 1991, p. 161), an argument revived in the mid 1990s with the increasing dissemination of ICT innovations in Western economies.

<sup>2</sup> This mainly concerned repatriation of Latin American loans (Aho, 1991, p. 165) that were neither re-lent domestically nor foreign.

The German recession, spilling over to other European countries, originated with the unification of Germany. The five new states from the former Eastern German Republic underwent dramatic structural changes, having lost 45% of their annual GDP between 1989 and 1991 while unemployment soared to 14%. To avert social and economic tensions, sums amounting to 140 billion Deutschmark were transferred to the new regions, financed by an increase in the public sector deficit. The spending boom fuelled the inflationary spiral in prices, where German unions in the West compounded to the problem by pressing for an upward convergence of Eastern and Western wages. The Bundesbank raised interest rates at the end of 1991 to contain inflation, slowing down an overheated economy (Muehring, 1992, p. 48, 51).

The recessions in Europe and the United States were short term. The rebounding of the American economy from 1992 onwards helped the European economy build an export driven recovery. Fiscal austerity began in earnest; the United States had begun a debt reduction program initiated by the Bush administration. In 1992 European governments agreed to the Maastricht treaty, committing them to do no more monetary financing, maintain stable inflation rates and reduce government deficits and debts below a certain level.

For the Japanese economy, the 1990s might well be remembered as the lost decade. In 1990, the Japanese economy ranked as one of the largest economy in the world, having extended its influence worldwide through reinvesting its current account surplus in the other countries. In 1990, Japanese banks controlled 25% of the banking assets in California (The Banker, 1990), and the yen's role as an international reserve currency rose dramatically as a recognition of its economic power.<sup>3</sup> The receding economic growth from 1990 onwards was preceded by the deflation of a stock market bubble, which started in 1983, accelerated in 1987 and was finally deflated in 1989. The Japanese economy showed favorable conditions in the mid-1980s, reporting above average economic growth and near zero inflation. Share prices soared in Tokyo, pushed by a loose monetary policy, falling inflation and a simultaneous rapid rise in land prices, serving as a collateral for share investments as well as rising assets values for firms owning land (The Economist, 1991, p. 35). Financial liberalization and deregulation was accelerated in the 1980s, relaxing interest controls, removing capital market barriers and loosing restrictions in previously tightly segregated institutions (Kanaya, 2000, p. 5).

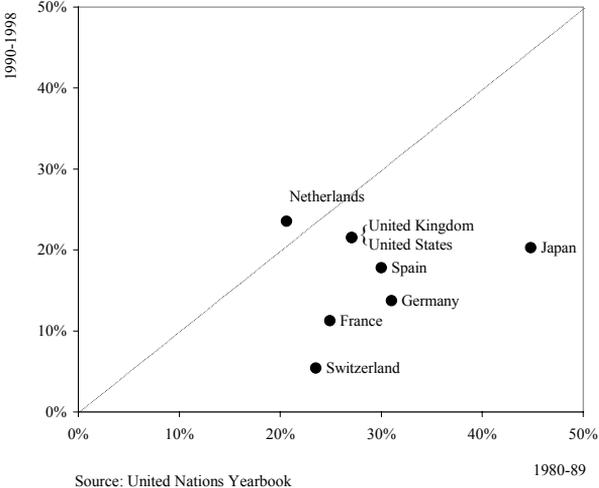
The Bank of Japan ended the stock market bubble, deliberately raising interest rates five times from mid-1989 to mid-1990 (The Economist, 1991, p. 39). The economy slowed down considerably from 5.3% GDP growth in 1990 to 0.4% in 1993. A minor recovery was staged in 1996, when economic growth briefly rose to 3.4%, but eventually the Japanese economy slipped into recession in 1998, the first time since 1974. What had started of as containing a stock market bubble, laid bare some fundamental flaws in the Japanese economy that made it unable to recover. The credit growth receded, partly because of the raised interest rates in 1989-90 but also due to the Japanese implementation

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<sup>3</sup> By 1990 the Japanese Yen was the third most important reserve currency, with a share of 9.1% in 1991 of official foreign exchange reserves from IMF countries, compared to 0.1% in 1973 (Arora, 1995, pp. 48-49).

of the capital adequacy rules. Lowering share prices reduced the amount of capital, forcing more prudent loan practices.

Figure 8.2. Cumulative real GDP growth rates, 1990-2000 compared to 1980-1989

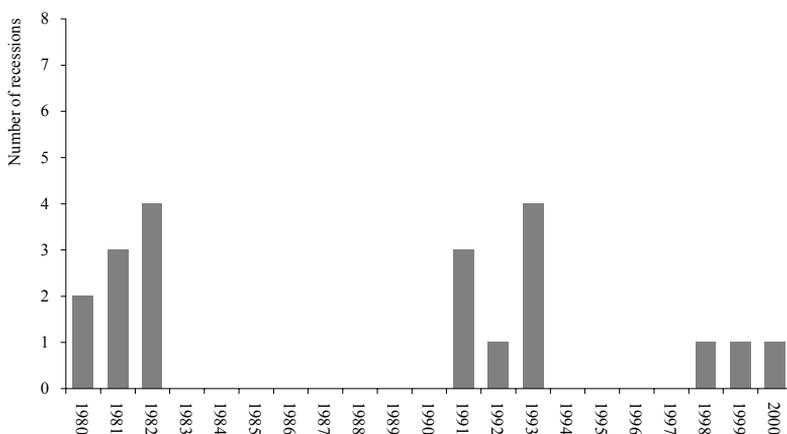


Summarizing, between 1980 and 2000 a divergence of growth occurred. Figure 8.2 presents the total real growth for selected countries in the 1980-89 period (horizontal axis) compared to the 1990-98 period (vertical axis). Economic growth generally slowed down in the 1990s, only the Netherlands achieved higher growth rates than a decade earlier. Apparently, for the internationalization activities of banks being in the right geographical market at the right time might make a difference.

With regard to geographical diversification as an incentive to internationalize, internationalization would not necessarily be a guard against recessions at home. Furthermore, geographical diversification benefits have been decreasing for OECD countries, especially since the 1990s. Figure 8.3 shows the number of recessions counted in the economies of the sample investigated. This suggests that recessions are concentrated in time: between 1980 and 1982, a bank could have been confronted with operation in two or more countries in recession. Two or more consecutive recession years have been experienced in the Netherlands (1981-1982), Switzerland (1991-1993) and Japan (1998-2000).

The effect of geographical diversification has also been decreasing over time. Dalsgaard et al. (2002) found that for the business cycles of OECD, the divergence in output gaps has decreased between 1980 and 2000, caused by a reduced importance of stock building and more stable private consumption. Also, divergence in output gaps across OECD economies has diminished since the 1960s, with a particular strong tendency since the 1990s. Regional integration and financial integration could explain this tendency (Dalsgaard et al., 2002, pp. 43, 55).

Figure 8.3. Occurrence of negative real GDP growth in countries of the sample



Source: United Nations Yearbook. N=8: countries are the United States, the United Kingdom, France, Germany, the Netherlands, Switzerland, Spain and Japan

### 8.1.2. Regionalization

The emergence of regional economic blocs has been as significant element in the world economic system. The fundamental basis of such blocs is that of trade. Trading blocs, depending on their degree of integration, have played an important role in trade and investment flows, determining the (push and pull) client incentives for banks to internationalize. Also, the emergence of regional blocs redefines the perception of banks what constitutes their (home) market, which also triggers internationalization. Trading blocs are essentially discriminatory in nature: they attempt to gain scale advantages in trade by creating large markets for firms, while offering protection from outside the bloc. From all existing regional economic blocs, the European Union is the furthest developed economic bloc and will be discussed in some detail.<sup>4</sup>

The European Economic Community (EEC) was created by the Treaty of Rome in 1957, with the intention to create an integrated Common Market within which goods, services, labor and capital would move freely. The implementation first focused on the elimination of tariff barriers between member countries, while barriers affecting labor mobility were greatly reduced. 1985 marked the initiative to eliminate all remaining barriers to intra-EC trade, referred to as the single market program or “1992”.

<sup>4</sup> See Bongini (2003) for analysis of the relevancy of EU financial liberalization for multilateral liberalization within the WTO framework.

Table 8.2. *Developments European Union*

Year	Development
1979	European Monetary System (EMS) formed
1981	Greece joins European Community
1985	White Paper on completing the internal market published
1986	Spain and Portugal join European Community
1987	Single European Act is ratified
1989	Delors Report, calling for Economic and Monetary Union (EMU) including a single currency
1990	United Kingdom joins the Exchange Rate Mechanism (ERM)
1991	Maastricht Summit. Final stage of EMU will begin by January 1, 1999. A single currency will begin by this date. An independent central bank will be set up.
1992	EMS crisis. Britain and Italy leave the ERM, their currencies being devalued. Band for other ERM currencies is widened.
1993	Second Banking Coordinating Directive, Own Funds Directive, Solvency Ratio Directive take effect.
1998	Establishment European Central Bank
1999	Irrevocably pegging EMU currencies
2002	Conversion to Euro

A complex interplay between existing commitments to coordinate exchange rates, rigidities in the labor market accelerated the European integration process in the mid-1980s (Eichengreen, 1996, pp. 167-168). After readjustments in the European Monetary System (EMS) between 1979 and 1983, governments were committed to pegging their exchange rate to the EMS low inflation anchor. This reduced the freedom of European countries to use independent macro economic policies to pursue their domestic objectives. Their alternative to realize income distributional objectives and social goals was to turn to micro economic policies of wage moderation, enhanced job security, and increasingly generous unemployment compensation. This in turn hampered the flexibility and efficiency of the labor market, leading to high and rising unemployment.

High unemployment provided the impetus for the Single Market Program in 1986. This program sought to bring down unemployment and creating economic growth by less regulatory structures, intensified competition and facilitation of European firm's scale and scope. Prior to removing restrictions on cross border trade of financial services, exchange controls were removed by the Capital Liberalization Directive of June 24, 1988. Many countries maintained exchange controls for capital account transactions, even if they had liberalized current account transactions. Without a free flow of financial capital, free trade of financial services would be restricted too. For most countries, the Directive was to be implemented before mid-1990.

A further step to integration was taken in December 1991, when member states of the European Union agreed to create a single currency. At that time, twelve currencies co-

existed within the EC, tied together by exchange rate target zones of the European Monetary System. A measure of coordination of European exchange rate was first created in 1972 when the European exchange rate “Snake” agreement was formed, followed by the European Monetary System (EMS) in 1979 creating the Exchange Rate Mechanism and the European Currency Unit. Obviously, the foreign exchange market, and related to it the costs of currency conversion, would be eliminated. International accounting would be simplified, having to report and consolidate in fewer currencies. To be successful, the economies forming the single currency must show convergence in fiscal and monetary policy: targets were set for the relative level of government debt, government deficit, inflation and interest rates.

Banks were early in recognizing and formulating a strategic response for the developments leading to European integration. In the 1970s European banking groups were formed; while some were more research or information exchange oriented, others did pursue cooperation through intensified correspondent relationships and joint ventures. Besides the intention to operate together, these clubs also limited banks to expand in the home country of a partner bank. Their legacy played a minor role in the 1990s, when cross shareholdings became important in the increasing number of cross border mergers and acquisitions. Also some banks preferred acquisition in former banking group member, perhaps due to an intimate knowledge of their operations built up over the years.

Banks were - as any market participant - caught up in the belief that (European) market share mattered, and aided by raising stock market prices and falling equity risk premiums, stages a number of acquisitions. Although European banks greatly increased in size between 1990 and 2000, the relative market position for most of the largest European banks did not materially change over the period. A single market in financial services does not necessarily imply a homogenous market for all services. Chrystal et al. observed in 1992 that “retail customers will continue to do business with their familiar institutions in their countries, while wholesale market arbitrage and potential competition ensure that product prices are brought closely into line throughout the EC” (1992). Or as *The Economist* observed in 1992, “the merger wave is a pre-emptive strike at competition that has not materialised” and “as merged banks [in the European Union] reduce local competition, they raise the level of competition on a European scale” (The Economist, 1992, pp. 30, 35).

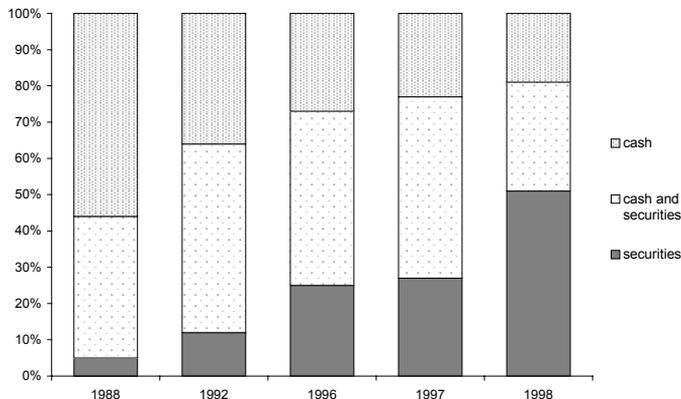
Subsequent publications (Dietsch and Weil, 1998; Davis and Salo, 1998) also pointed in similar direction: additional concentration without clear signs of efficiency effect through increased competition within Europe, and a segmentation of products and clients in local vs. regional markets. Between 1992 and 1996 European integration had low positive effect on banking efficiency, with decreasing scale efficiency and increasing technology efficiency, suggesting that any productivity increase was mainly due to technical progress (Dietsch and Weil, 1998). Davis and Salo (1998) support this for the 1989-95 period finding excess banking capacity in the European Union and concluding that the EMU increases the importance of an orderly removal of banking capacity.

### 8.1.3. Growth of securities and derivatives markets

Between 1980 and 2000, the size of the securities markets in most developed countries increased significantly. For the equities markets alone, market capitalization worldwide increased from 4,667 billion US dollar in 1985 to 27,462 in 1998, roughly doubling in size every five years. This has been the result of a combination of several factors:

- Firms increasingly sought the securities markets as a source of funding.
- Institutional investors became larger and adapted a more active approach, increasing the turnover of shares, enhancing liquidity and increasing its attractiveness as a source of funding.
- The market for corporate control (mergers and acquisitions) increasingly funded its activities through the securities markets; shifting from capital transactions in cash to capital transactions in securities (Figure 8.4).

Figure 8.4. *Financing of Mergers and Acquisitions transactions, worldwide*



Source: taken from Zapotocky, 2002, p. 77

- Privatization also created additional supply of new publicly traded shares. Smith and Walter calculate that from 1990 to 1998, the amounts raised by privatization worldwide increased from 29.9 billion US dollar to 114.5 billion US dollar, an average annual average growth rate of 18%. More than half of these amounts raised originated from the European Union, whereas the share privatizations in the United States was negligible (Walter and Smith, 2000, p. 174).

After the liberalization of the New York Stock Exchange in 1975, abolishing fixed commissions (Dicken, 1998, p. 405), other countries with major financial centers aimed to at least replicate the following growth. Other major stock exchange liberalizations took place in Paris (1984) and London (1986). Over time a hierarchical structure was created with New York, London and Tokyo as the first tier stock markets to establish a presence (Dicken, 1998, p. 413), the major European countries, Hong Kong and Singapore as

second tier, and finally the other countries. Banks aiming to develop securities activities replicated this pattern with their presence. Banks in general sought to establish presences in at least the first tier major centers, being more selective about the second tier, and the third tier, depending on their strategy. The changing securities activities had the following characteristics:

- A move toward fully electronic trading. Physical presence at the exchange became less necessary.
- A high rate of information technology (IT) investments.
- Consolidation of the securities markets at a regional level.
- Within the securities markets, a shift took place from bonds to securities and derivatives.

The rise of the securities markets is particularly pronounced compared to banking loans or the size of the GDP. Given the natural predominance of a) higher stockmarket levels, b) more active corporate restructuring and c) less dependence on bank loans in the United States, two issues emerged: can different financial structures be distinguished, and did differences in financial structure drive economic growth. Changes in disintermediation and financial structure between 1980 and 2000 will now be discussed.

## 8.2. Industry

### 8.2.1. Disintermediation process

Disintermediation is the development of markets for a variety of negotiable securities, *replacing* loans as a means of borrowing.<sup>5</sup> A characteristic of disintermediation is that investors and borrowers bypass banks and transact business directly (Davis, 1995, p. 358). The replacement of loans can be substitution of loans at banks or, prior to the funding origination, the replacement of loans as one of the alternatives to fulfill the financing need, thereby bypassing the bank altogether.

Securitization is an important element in the process of disintermediation: debt instruments (loans and mortgages) are converted into negotiable securities that may be purchased by individual or institutional market participants (Davis, 1995, p. 358). Securitization occurs when an asset holder restructures its activities, to increase profitability, reduce mismatch between assets and/or liabilities or to adjust the overall size and capacities of its balance sheet (Smith and Walter, 1997, pp. 194-5). Securitization has

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<sup>5</sup> One view of disintermediation is taken by the FDIC, defining disintermediation as the “*withdrawal* of funds from interest-bearing accounts at banks [...] when rates on competing investments [...] offer the investor a higher return” (Federal Deposit Insurance Corporation, 1997, p. 214). This suggests that disintermediation a) is a funding related problem and b) per definition leads to a decline in total assets.

been mainly a development in the United States; Smith and Walter list four reasons why this has grown dramatically in the 1980s (Smith and Walter, 1997, p. 196):

- A general decline in long-term interest rates after 1981 and the return of a positively sloped yield curve increased the attractiveness of debt instruments with fixed interest rates in general.
- The credit quality of bank certificates of deposits had deteriorated in the early 1980s after the banks coped with large exposures to loans in problem sectors and LDC debt. This meant that high-grade companies could attract funding at lower rates than banks, making banking financing a high cost source of funds.
- The LDC debt burden led to a restriction of growth in assets to protect deteriorating capital ratios. The banks answer was to sell existing loans already on their books, and attract new funds. The issue of new capital strengthened the capital base, while issuance of new debt led to an overall lower cost of funds, due to better capital market conditions.
- The growth in volume, depth, and turnover in capital markets, combined with a widening variety of financial instruments, drew more loan activity away from banks because of lower rates, more suitable maturity structures and other special features.

Disintermediation and securitization imply an increasing role of non-bank competitors. Investment funds, mutual funds, insurance companies and financing companies have absorbed the capital flows redirected from banks.<sup>6,7</sup> Three claims with regard to disintermediation can be made:

- The importance of banks and other institutional investors have increased in importance between 1980 and 2000.
- The role of banks compared to direct competitors has declined between 1980 and 2000.
- The role of banks compared to other sources of funding has declined.

Figure 8.5 and Figure 8.6 illustrate where the changes in the importance of banks come from. In Figure 8.5, banking and institutional financial assets combined are presented as a percentage of GDP. In Figure 8.6, banking assets are shown as percentage of banking and

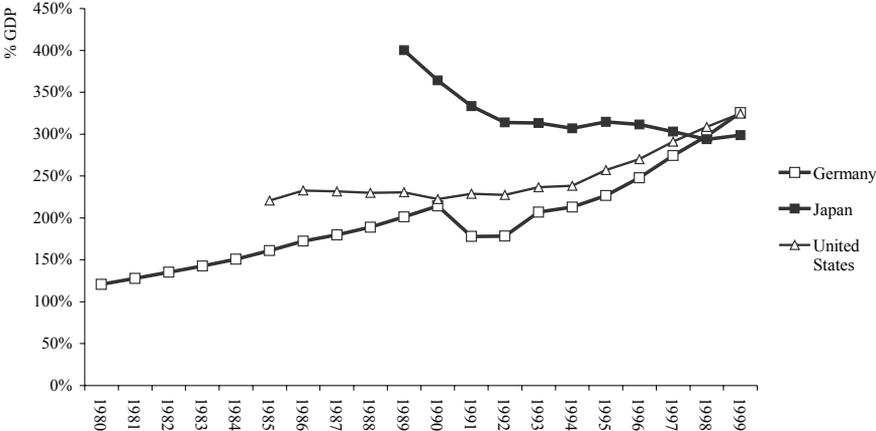
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<sup>6</sup> A more stronger view is taken by William Seidman, former chairman of the FDIC, who summarized the disintermediation process as “banks’ troubles began when they lost their big corporate customers to the commercial paper market early 1970s” in relation to the LDC debt crisis (Federal Deposit Insurance Corporation, 1997, p. 196).

<sup>7</sup> Institutional investors are also financial intermediaries, expected to generate lower costs and risks by pooling financial intermediation activities then trough individually organizing them in the open markets. They do not necessarily have to compete for the same services as a bank, but do compete for the same funds or funding. Also they have in common that they have to generate an adequate return as possible from private contributions on the capital markets to pass on the expected capital appreciation directly to the investor (mutual funds, investment funds), or to guarantee future payments (pension funds) or a combination of both (insurance funds).

institutional assets combined. In Germany, banks are the driving force. Although their share in combined financial assets has been slipping with almost 10% between 1980 and 2000, German banks still hold a 75% share. The increase in total financial assets is therefore instigated by banks, not so much other institutional investors. In the United States on the other hand, the share of banking assets in total financial assets has almost halved between 1985 and 1999, suggesting that other institutional investors have been accumulating assets more rapidly than banks. Finally, the share of banking assets has almost declined with 10% since 1989, but is still at a relatively high level in 1999, 66%. The rapid decline in the early nineties of total financial assets to GDP has however not been caused by banks, but by institutional investors.

Figure 8.5. Banking and institutional financial assets as percentage GDP

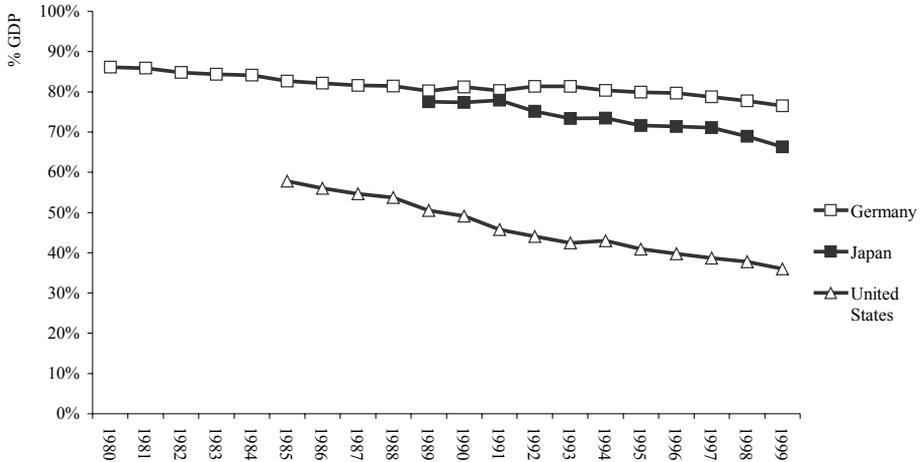


Source total banking assets: OECD, Bank profitability, 2002. Germany: all banks, United States: commercial banks, large commercial banks and saving banks. Japan: commercial banks, large commercial banks. Source institutional assets: total financial assets, institutional investor database, 2002. Source GDP: OECD Economic Outlook

Figure 8.6 illustrates the changes for banking industry in Germany, Japan and the United States. The combined financial assets of institutional investors and banks relative to GDP have steadily increased for the United States and Germany. The break in trend for Germany is the result of reunification with Eastern Germany.<sup>8</sup> Japanese financial assets relative to GDP have been decreasing systematically since the late 1980s. The appreciation of the Japanese Yen compared to other major currencies might be partly responsible, but the loan and stock market crisis has also diminished asset values, and declining GDP growth probably has forced Japanese consumers to adjust their expectations downward, preferring savings to other financial instruments that hardly results in growth of financial assets.

<sup>8</sup> The drop in ratio was caused by the unification: it raised GDP while West German banks acquired financial claims and liabilities of former Eastern Germany, which were financially underdeveloped.

Figure 8.6. Share of banking in combined institutional and banking assets



Source total banking assets: OECD, Bank profitability, 2002. Germany: all banks, United States: commercial banks, large commercial banks and saving banks. Japan: commercial banks, large commercial banks. Source institutional assets: institutional investor database, OECD.

In Table 8.3, the statistics for banking and institutional assets are also shown for other countries. If banking assets as a share of total financial assets is interpreted as a proxy for disintermediation, then disintermediation has been an issue for banks in the United States and the United Kingdom, although the banking industry itself has not been shrinking in absolute terms.<sup>9</sup> For continental European countries, total financial assets to GDP have been steadily rising, and banks have controlled a high portion of those financial assets, apparently successfully countering disintermediation threats. Exception has been Japan where the financial growth of both banking assets and institutional assets has been negative.

<sup>9</sup> This basically echoes Wheelock's analysis (1993), finding that while the number of United States commercial banks declined sharply between 1984 and 1992, other measures such as banks assets relative to GDP did not indicate a decreasing financial intermediation role. The other conclusions, based on a historic review, were that the diversification of banks across regions in the United States would enhance stability and profitability, and that before the legal separation of investment and commercial banks, banks were better diversified and that it appears that commercial banks underwrote higher-quality securities than investment banks, suggesting that banks would benefit from an increased variety of financial services (Wheelock, 1993, p. 20).

Table 8.3. *Total financial assets to GDP, and share of banks in total financial assets*

Institutional and banking financial assets as percentage of GDP, five year average								
Period	France	Germany	Japan	Netherlands	Spain	Switzerland	United Kingdom	United States
80-84	na	131.7	na	193.7	127.0	283.9	na	na
85-89	264.2	180.7	400.4	257.7	142.3	358.4	196.2	229.1
90-94	290.5	198.2	326.4	349.4	170.9	452.0	231.8	230.8
95-99	339.7	274.5	304.4	466.7	218.6	648.3	325.3	290.3

Banking assets as percentage of institutional and banking assets, five year average								
Period	France	Germany	Japan	Netherlands	Spain	Switzerland	United Kingdom	United States
80-84	na	85.3	na	57.8	96.1	98.4	na	na
85-89	82.4	81.6	77.5	54.6	93.9	92.0	45.2	54.5
90-94	78.4	80.9	75.4	61.5	87.1	83.8	43.6	44.9
95-99	71.2	78.5	69.9	63.0	76.0	84.5	41.3	38.6

na: Not Available. Source: OECD

Overall, European banks have maintained their financial intermediation role by internalizing the competitive threats of disintermediation (European Central Bank, 2000, p. 9):

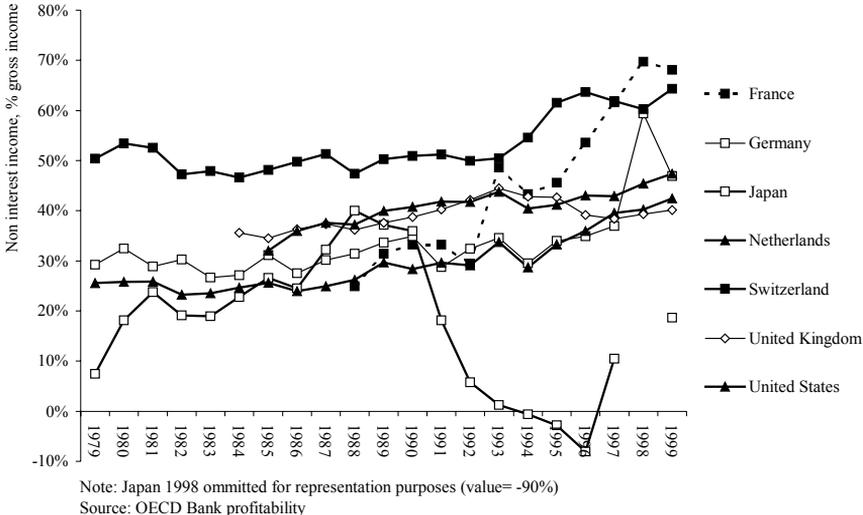
- Securitization has not bypassed the banking system, because banks have increasingly managed the securitization process, thus creating non-interest income.
- Banks have increased their product range.
- The role of provider of loans has remained intact over the years. For households, the majority of debt consists of mortgages and credit card financing, which is channelled to the banks. Despite the growth of capital markets between 1980 and 2000, this has not created more alternatives for financing to smaller and medium sized companies.
- For larger corporations, the major change for banks had already taken place in the 1970s with the introduction of commercial paper, and the issuance of corporate bonds. The direct access to the capital market has not meant that the role of banks has been bypassed as shown earlier.<sup>10</sup>

The effect on the income structure of banks has been twofold. The off-balance sheet activities (such as a letter of credit, a swap or loan commitments) have increased as banks

<sup>10</sup> First, the bank borrowing can be used as a signal for the capital markets of their creditworthiness. Second, bank credit can also be used as an alternative source of financing in the event of market downturns affecting access to capital markets. Third, market funding could be combined with the bank's services in the form of back up lines, syndicated loans, treasury management, etc. Fourth, large corporations may have a greater degree of flexibility to negotiate the terms and conditions of a bank loan rather than those of a bond issue (European Central Bank, 2000, p. 10).

diversified their product range. The other effect has been in the development of non-interest income, shown in Figure 8.7.

Figure 8.7. Non-interest income, as percentage gross income



From 1980 onwards, the increase in non-interest income has offset the decrease in interest income<sup>11</sup> to a large extent. Specifically for the EU countries, the European Central Bank investigated the changes in income structure for banks between 1993 and 1998. A finding was that non-interest income has increased in importance<sup>12</sup>, owing as much to the increase in non-interest income as to the fall in interest income. On average, the rise in non-interest income did not completely compensate the fall in interest income completely during the period investigated. Apparently, non-interest income has been especially vital as a "cushion", either reducing or compensating the fall in interest income to a large extent.<sup>13</sup>

<sup>11</sup> Diversification into non-interest generating activities shifts the balance towards non-interest income; Llewellyn (1999, p. 67) observed that banks can accelerate such a change in income structure by securitizing assets on the bank's balance sheet. This is called secondary securitization, securitization with non-bank companies is then called primary securitization.

<sup>12</sup> Fees and commission form the most important component of non-interest income, around 54% of total non-interest income in 1998. The second most importance source is income from financial operations (the result from buying and selling on own account, ranging from 19 to 22%). The relative distribution of components differs widely on a country basis. For example, the third component, income from securities (shares, variable yield securities and other participating interests) accounted for 24 to 35% of non-interest income in 1998 in countries like Sweden, Germany, Denmark, Austria and Spain, compared to 1% in the United Kingdom, indicating different levels of diversification through subsidiaries between those countries (European Central Bank, 2000, pp. 11-13).

<sup>13</sup> The European Central Bank finds an inverse correlation between interest and non-interest income, but notes that this should be treated with caution since the composition of non-interest income has not been stable, and banks might actually enforce such a negative correlation, for example by offering credit with very thin margins hoping that this will be followed by a stream of non-interest income (European Central Bank, 2000, p. 6).

### 8.2.2. Financial structure

There has been a great deal of research aiming to classify the different financial systems, usually amounting into an Anglo-American versus Continental European/Japanese classification. Each financial system has its unique traits, evolved over time to deal with country specific issues; a classification of financial systems might be interpreted broader than the scope of finance due to its socio-economic characteristics (Scholtens, 1996, p. 69). Demirgüç-Kunt and Levine (2001) examined the financial structure for a large set of countries over several decades. Classifying financial systems as underdeveloped, market-based or bank based, they found that:

- Banks and securities markets are larger, more active and more efficient in richer countries. Financial systems are on average more developed in richer countries.
- In high-income countries, stock markets become more active and efficient relative to banks. There is some tendency for financial systems to become more market oriented as they become richer.
- Legal and regulatory measures matter: countries with a Common Law tradition, strong protection of shareholder rights, good accounting regulations, low levels of corruption and no explicit insurance tend to be more market oriented. The opposite is true for French Civil Law tradition, where countries with poor protections of shareholder and creditor rights, high levels of corruption, poor accounting standards, restrictive regulation, and high inflation tend to have underdeveloped financial systems (Demirgüç-Kunt and Levine, 2001, p. 83).

Beck et al. (2001) studied the relationship between the degree to which a financial system is market- or bank based, and measures of economic development. This is done for 34 countries based on average data between 1980 and 1995. They conclude that financial structure is not useful to distinguish among financial systems: “countries do not grow faster, financial dependent industries do not expand at higher rates, new firms are not created more easily, firms’ access to external finance is not easier, and firms do not grow faster in either market- or bank-based financial systems.” (Beck et al., 2001, p. 233). The overall development of the financial sector, and legal system does however matter. Also, similar results were found by Levine (2002) for a sample of 48 countries for the 1980-95 period.

Schmidt et al. (1998) investigated whether financial systems of Germany, France and the United Kingdom changed between 1980 and 1994. They found neither a general trend towards disintermediation, or a transformation from bank-based to market-based, or a loss of importance of banks in the financial system for Germany and the United Kingdom. For France, a declining role of banks was observed. In other words, convergence to a market based financial system is not a general assumption.

For determining bank profitability, the difference between bank- and market based systems might also not be useful (Demirgüç-Kunt and Huizinga, 2001). Here too, financial development matters. The analysis suggests that banks have higher profits and margins in

underdeveloped financial systems. Greater bank development lowers bank profits and margins (Demirgüç-Kunt and Huizinga, 2001, p. 257). The implications for the internationalization of banks might have been the following:

- Since most Western economies have highly developed financial systems, shifts within the financial structure between 1980 and 2000 probably has not created significant differences in bank profitability or economic growth within this group of countries.
- Differences in financial development might have been an incentive for banks to internationalize to developing countries, but not to developed countries.
- Elements specifically attributed to bank-based or market based systems - such as long term versus short term relationships or equity participations - do not present specific additional internalization advantages which might be exploited through internationalization. What might be exploited, are new products, resulting from differences in financial development.

### **8.3. Financial issues**

#### 8.3.1. Monetary and exchange rate regimes

Two major events transformed the international monetary environment at the end of the 1970s for the next decades: coordinated policies to stabilize exchange rates, and the shift in monetary regimes to effectively control inflation.

A major shift in monetary regime occurred in 1979, when prices were rising again after a second oil price hike in a decade, triggered by the invasion of Iran in Iraq. Governments were, compared to a decade earlier, prepared to apply different economic policies. In the years before, price controls were used as a mechanism to keep inflation down, which turned out to be ineffective. They created allocative distortions in the economy, keeping prices and wages temporary low until the restrictions were lifted. A policy shift to managing macro economic measures, notably monetary growth in combination with fiscal restraint, was tried next.

To effectively combat inflation, monetary growth had to be rigorously restrained. Paul Volcker, chairman of the Federal Reserve bank, was determined not to witness a repetition of high inflation rates, and raised short term interest rates above 12% from October 1979 onwards, reaching 20% by the end of March the following year, to be repeated again in the third quarter of 1980.<sup>14</sup> This policy was also applied in the United Kingdom and (for a longer period) in West Germany, “accentuated by the election of right wing governments” (Channon, 1988, p. 167). For most countries, inflation subsequently fell and stayed on a relatively low level compared to the 1970s.

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<sup>14</sup> Short term rates are on a daily basis. Source: *Federal Funds Rate*. (n.d.). Retrieved January 2, 2003, from <http://www.federalreserve.gov/releases/h15/data/d/fedfund.txt>.

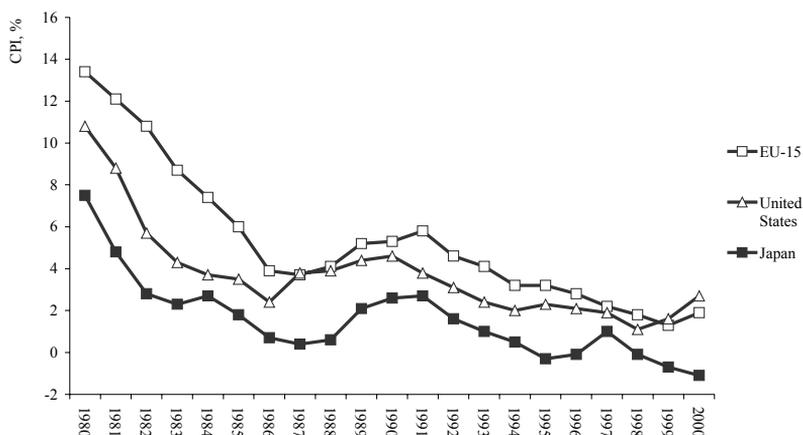
Table 8.4. *Major monetary and exchange rate events in 1980-2000*

Year	Monetary Event	Exchange rate event	Event	Effect on internationalization banks
1979		•	Start EMS	
1979	•		Tighter monetary policy Federal Reserve	Credit Crunch for United States banks, repatriation of repatriation foreign loans, start LDC loan crisis.
1985		•	G-5 central bank intervention to devalue the US dollar (“Plaza Accord”)	Relative attractiveness bank acquisitions United States increased
1987		•	G-7 finance ministers agreement to stabilize the US dollar exchange rate.	
1992		•	EMS crisis/realignment currencies	Increase value international activities
1996	•		Zero rate policy Bank of Japan	
1996	•		Independence Bank of England	
1998	•		Establishment European central bank	
1999		•	Irrevocably pegging of Eurocurrencies	Loss of foreign exchange business.

Source: adapted from Eichengreen (1996) and Braithwaite and Drahos (2000, p. 133).

The changing monetary regime and the economic slowdown had several long-term consequences. The first was that oil prices and other commodity prices fell dramatically. Compared to the earlier oil price hike, economies had readjusted themselves, decreasing its dependence on oil, by then mainly in use for transportation purposes. Lower economic growth reduced the need for oil products strongly, negatively affecting the income of oil producing countries. On the same note, commodity prices were hurt badly. This meant that the main source of income of developing countries, using this income as collateral for loans and interest payments, dried up. Banks and supranational agencies such as the IMF and World Bank would spend considerable amounts of capital in the 1980s to resolve this financial crisis stemming from this development.

Figure 8.8. Consumer Price Index, 1980-2000



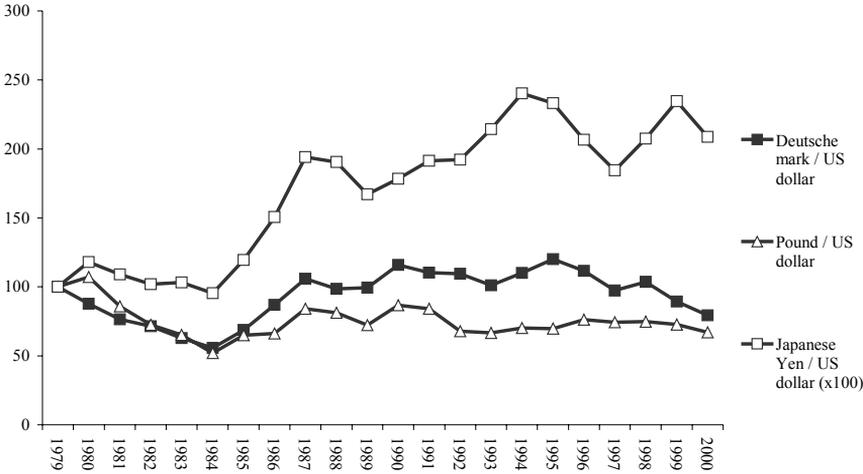
Source: European Commission, The EU economy: 2001 review, no 73, 2001, table 25. Annual percentage change of price deflator private final consumption expenditure. Aggregate EU-15: PPS weighted

Currencies were effectively floating after the collapse of the Smithsonian agreement in February 1973. The European countries soon aimed to create an institutional framework within which they could stabilize their currencies against one another. Their economies were more open to trade, and therefore more sensitive to exchange rate fluctuation than the United States. This process started with the Snake in 1972, continued with the European Monetary System (EMS) in 1979 creating the Exchange Rate Mechanism (ERM), culminating at the end of the decade into the European Monetary Union (EMU), creating a monetary union. Eichengreen (1996, pp. 167-168) argued that a complex interplay between existing commitments to coordinate exchange rates and rigidities in the labor market accelerated the European integration process in the mid-1980s. After readjustments in the ERM between 1979 and 1983, governments were committed to pegging their exchange rate to the ERM low inflation anchor (i.e. the deutsche mark).

While European countries sought an intra-regional solution to contain exchange rate fluctuations, the United States and Japan applied coordinated exchange rate interventions. The commitment to bring down inflation through raising interest rates was also accompanied with greater exchange rate flexibility. The ensuing higher interest rates between 1980 and 1982 created a positive interest rate differential with other currencies, appreciating the US dollar. The Reagan administration followed with increased spending and lower taxes. As the budget deficit widened, the US dollar continued to appreciate to an extent that differentials in interest rates did not explain. This prompted the Plaza Accord in 1985 to push the dollar down, to head off protectionist legislation as a result of the increasing economic losses for domestic producers. While the Plaza Accord drove the US dollar down through interventions from central banks, the subsequent Louvre Accord was

meant to stabilize the US dollar, having lost 40% of its value. Concerted interventions of this kind were not repeated with the same effect in the 1990s.

Figure 8.9. Exchange rates of major currencies against the US dollar



Note: Exchange rates at end-of-year value, rebased at end 1979 = 100. A higher (lower) value compared to a year earlier indicated an appreciation (depreciation) of the currency against the US dollar. Source: OECD.

An effect of the exchange rate for the internationalization of the banks between 1980 and 2000 might have been that acquisition of US assets for European banks became more attractive between 1984 and 1987/8. For Japanese banks, the appreciation of the Japanese Yen against the US dollar lasted until 1994, almost a decade where Japanese banks could buy cheaper United States banking assets. Jones (1993) suggested that the falling US dollar might have speeded investment decisions of British banks in the United States, but not necessarily the decision itself to invest in the United States.

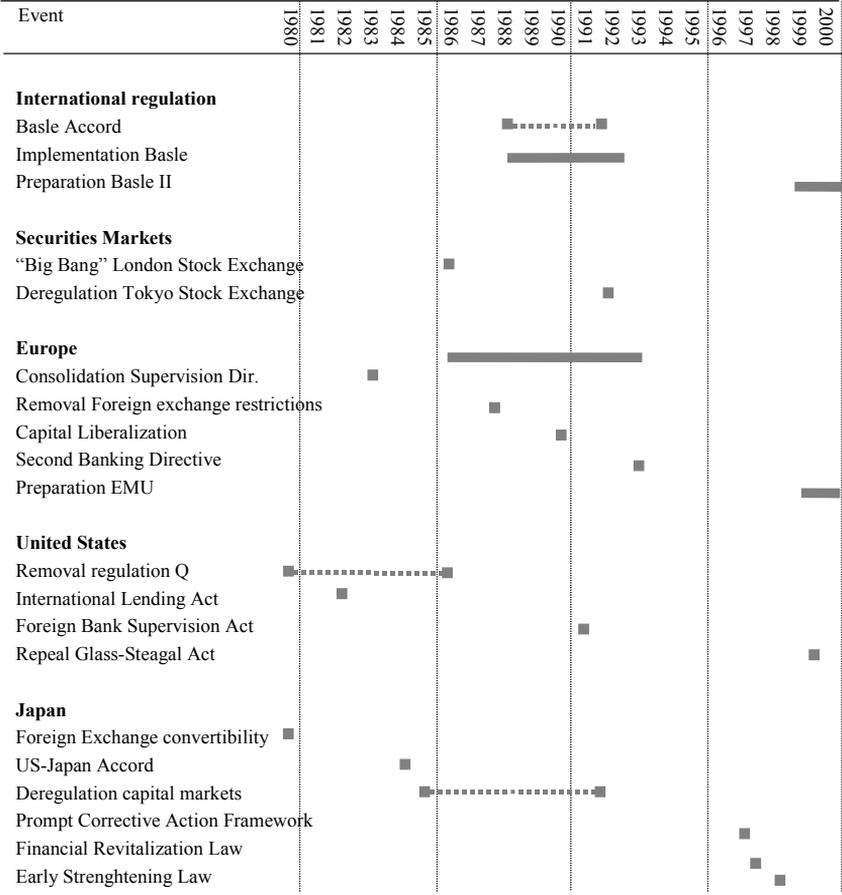
8.3.2. Regulation

Financial regulation after 1945 has differed for each country but the regulatory frameworks of the countries had three elements in common (Canals, 1997, pp. 305-6): separation of activities between commercial banks and investment banks, a deposit guarantee to protect the depositor should the bank fail and control over interest rates of the bank’s lending and deposit taking activities. This regulatory structure was applied by countries until the late 1970s, and has at least brought financial stability in most Western countries. Canals finds five motives for the regulatory frameworks to change since the late 1970s. First, liberalization of capital movements between countries exposed banks to competition from international capital markets and also increased the limits to foreign investments in the financial sector.

Second, the disintermediation process, making it possible for companies to turn directly to the capital markets for financing, decreased the (perceived) financial

intermediation role of banks. The separation between commercial banks, specialized in funding and lending, and investment banks, specialized in financial consultancy and capital market operations, favored the investment banks at the expense of commercial banks as a result of this process. The liberalization of capital flows also affected the disintermediation process on the funding side of banks, where investors became more active in finding better returns for their deposits.

Table 8.5. Regulatory events, 1980-2000



Third, financial innovation affected regulation. Initially, financial innovation was motivated by the need to cope with the high inflation rates of the 1970s and to sidestep the restrictions on certain operations imposed by the central banks. During the 1980s financial innovation received another growth incentive through the increasing application of information technologies. Fourth, information technologies have changed the way banking

business is performed. This has not only affected the organization of activities but also the geographic and time span, challenging the boundaries of regulation.

The fifth development has been increased competition. The number of financial organizations competing for the same clients has grown, caused by deregulation itself, the liberalization of capital flows, the lifting of the price controls, financial disintermediation and the entry of new competitors in the market.

Historically, the central banks have played an important role as regulators, their interest being the control of monetary policy and financial stability. Domestically, various regulators have been established, for banks and/or securities. From 1974 onwards, on a supranational level the Bank for International Settlements acted as a neutral international banking club on regulatory matters, whereas the EU commission prepared and monitored banking policy under the Single Market Act, to be enforced by domestic regulators.<sup>15</sup>

Table 8.5 lists major regulatory developments between 1980 and 2000, clustered per region and country. The table indicates that relatively many regulatory events were shaped in a short period: from the mid 1980s until the early 1990s. The capital adequacy regulation codified in the Basle Accord is regulation specifically designed for international active banks, as the subsequent discussion will show the implementation has especially influenced internationalization of Japanese banks, hastening their retreat from international banking. The following issues will be discussed in some more detail: capital adequacy regulation, regulation in the European Union, the United States and Japan.

### 8.3.3. Capital Adequacy Regulation

Supra-national regulation is difficult to enforce, especially if enforcement is on a voluntary basis. The implementation of the Basle Accord has been a notable success in that area. Internationalization of banks confronted central banks in the 1970s with a capacity problem and an information problem: regulators did not have powers over the international banking system, and with increasing complexity of cross border activities regulators had to base their oversight on poor information. Added to this, the problem of spillover, transmitting financial crises from one country to another through higher integrated capital markets became greater, demonstrated by the collapse of Herstatt Bank because of foreign exchange dealings and the failure of US wholesale bank Franklin. The central bankers from the ten largest economies formed in response to these crises the Basle Committee.<sup>16</sup> The initiative came from English regulators where foreign banks, especially United States banks, formed an important part of the domestic financial system. Two objectives had to be achieved: the maintenance of London as a major financial center, as well as the reduction of systemic risk (Braithwaite and Drahos, 2000, p. 104).

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<sup>15</sup> Another supranational institution is the International Monetary Fund. Its regulatory framework applied to the period before 1973, coordinating capital flows and exchange rates.

<sup>16</sup> Short for the Basle Committee on Banking Supervision, preceded by the Standing Committee on Banking Regulations and Supervisory Practices.

After first coordinating supervisory responsibilities for international banks in the 1975 Basle concordat, central banks devised the Basle ratios to solve two problems. The level of capital relative to loans had been falling steadily prior to 1988. That was worrying because capital is the cushion that protects depositors by absorbing losses when loans default (The Economist, 1992, p. 5). An ulterior problem to be solved was to eliminate the funding cost advantage of Japanese banks because they put up inadequate amounts of capital to back up their loans, seizing more than one-third of international lending in the 1980s (Wagster, 1996, p. 1321). Furthermore, in an effort to circumvent existing capital regulations, banks increased their level of involvement in contingent (as opposed to immediate) claims on the banks lowering the amount of capital to be reserved. Besides that, cross-country comparisons were difficult to make because many different elements were considered to be bank capital (Wagster, 1996, p. 1324).

In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basle Capital Accord. The Accord obliged banks to maintain a minimum capital standard, measured as a ratio of equity and quasi-equity funding to risk weighted assets, of eight percent by end 1988. The regulators intentions were to reinforce financial stability, establish a level playing field for banks from different countries, and third, in the case of some countries, to reduce explicit or implicit costs of government-provided deposit guarantees (Ediz, 1998).

Table 8.6. *Capital and reserves, % total assets*

Period	France	Germany	Spain	Switzer- land	United Kingdom	Nether- lands	United States	Japan
1981-85	2.56	2.69	a.	5.61	4.66	4.27	4.30	2.24
1986-90	3.33	3.07	a.	6.03	4.94	5.83	4.87	2.57
1991-95	4.30	3.21	5.59	6.02	4.76	6.09	6.70	3.66
1996-00	4.13	2.81	5.67	3.95	5.96	5.64	6.62	3.60

Note a: not included in sample.

Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with active international banks. Different capital requirements have had effects on bank behavior. As a result, banks have increasingly become better capitalized, especially if the average capitalization of banks in 1991-95 is compared to 1986-90. Commercial banks in the United Kingdom form the exception, although data shows that from 1993 capitalization has increased too. In general, stronger capitalized banks can be considered more safe, and also more profitable since the bank has lower funding costs due to its higher creditworthiness (The Economist, 1992, p. 6). An initial and undesirable effect might have been the shift from highly risk-weighted assets to low risk-weighted assets.<sup>17</sup> Banks adopted more conservative lending (and

<sup>17</sup> The criticism on the capital adequacy rules of the Basle Accord is broader, for example: the risk weights are too crude, the rule cannot vary to absorb shocks or reflect the financial structure of the country, no account is taken of

perhaps less diversified) lending policies. Such was the case when U.S. banks shifted from corporate lending to investments in government securities in the early 1990s. Ediz et al. (1998, p. 15) summarize research supporting such change in lending behavior caused by the Basle Accord system. Their own research for United Kingdom banks between 1989 and 1995 suggest a second impact of the Basle Accord: rather than substituting assets on the balance sheets, banks appear to have adjusted their capital requirements upwards primarily by directly attracting capital.<sup>18</sup>

The establishment of an international level playing field was especially hard felt in Japan<sup>19</sup> when the central bank of Japan adopted the Basle Accord guidelines, where an exception was made to include capital gains from investing in the (Japanese) stock market. Japanese banks invested more strongly than British or German banks in securities, generating large capital gains during the strong growth period of the Japanese stock market in the 1980s (Canals, 1997, pp. 258-265). Japanese accounting rules allowed unrealized capital gains in securities to be posted as profit generating resources that could be transferred to reserves, increasing the bank's net worth. When the Japanese stock market moved downward from 1990 onwards, due to tightening monetary policy triggering an economic recession, Japanese banks had to confront capital losses shrinking the net worth of the banks. This forced the banks to contract their lending activity and among others concentrate on the domestic market, withdrawing from international markets.

The combination of economic recession and capital losses posed further problems for achieving minimum capital requirements. First, Japanese banks already showed internationally the lowest capital ratios, their ratio being around three percent which was below the minimum required. The regulation however did not allow for the unrealized capital gains to be considered net worth. As a temporary measure, the Bank of Japan allowed up to 45% to be included as reserves, with the clear intention of reducing this percentage to zero. This too added to the cutback of lending activity.

Implementation of the capital adequacy rules in accordance with the Basle Accord meant that banks had to restructure their activities: "unable to increase the capital numerator, bankers have slashed the asset denominator", resulting in efforts to securitize and sell of loans, and divest loss making subsidiaries. In line with this effect the Institutional Investor reported in 1991 that many banks intended to refocus on their domestic markets, rationalizing their less profitable foreign operations. In the process,

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covariance between risk categories penalizing widely (risk) diversified banks, funding risk is not covered, market risk arising from security positions is not accounted for (Davis, 1995, pp. 125-126). These objections are (mostly) covered in the New Capital Adequacy Framework introduced in 1999.

<sup>18</sup> This is also reflected in the data sample, where the average capital ratio increased from 4.5% in 1991 to over 5% in 1994. Perhaps did this raise in capital ratio serve as a catalyst for expansion, when banks - in the process of acquiring external capital - raised more than they needed to do acquisitions.

<sup>19</sup> Stock market participants did not seem to share this view at the time. Wagster (1996) measured the wealth effects of shareholders of international banks from Canada, Germany, Japan, the Netherlands, Switzerland, the United Kingdom and the United States between 1985 and 1990 on the basis of major events concerning the Basle Accord. Japanese bank shareholders seemed to interpret the events in favour of Japanese banks, showing an abnormal cumulative return of 31.6% during the period, while German and Dutch banks were unfavourably treated with abnormal cumulative returns of -7.3% and -9.1% respectively.

more than twenty United States banks had withdrawn from Europe, while foreign banks also reduced their presence in the United States” (Fairlamb, 1991, p. 58).

The Basle Accord became counterproductive to some extent over time. The requirement to reserve 8 percent capital against all loans, provided an incentive to make loans to risky institutions, and not to high-grade companies where margins were already thin. This created a gap between real economic risk, as perceived by banks, and regulatory risk, as perceived by regulators. United States banks in particular had been running greater risk in the 1990s to remain competitive in their on- and off-balance-sheet activities. The crises in 1997-98 (Asia, Russia, LTCM) created a sense of urgency to change the capital adequacy framework (Fleming, 1999). In June 1999, the Committee issued a proposal for a New Capital Adequacy Framework to replace the 1988 Accord, aiming to implement the new framework in 2004.<sup>20</sup>

Basically, its aim was to improve the existing 1988 accord on a number of issues: the weighting approach of risk gave banks an incentive to shift from high quality to low quality loans, and internal, more sophisticated risk systems of banks deviated from the capital adequacy framework. The proposed capital framework consisted of three pillars: minimum capital requirements, which seek to refine the standardized rules set forth in the 1988 Accord; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts.<sup>21</sup>

#### 8.3.4. European regulation

The work of the Committee on Banking Regulations and Supervisory Practices of the BIS consisted of proposals which need not be followed by national authorities. On the other hand, directives in the European Union form part of EU law and should be implemented in the national legislations of the EU member states (Burgers, 1991, p. 46). The major directives of the 1992 program for financial services in the European Union can be divided into four categories: banking, investment services, collective investments and insurance. For banking, there had already been harmonization activities in several stages such as the First Banking Directive in 1977, requiring member states to establish systems for authorizing and supervising credit institutions (Chrystal et al., 1992; Burgers, 1991, p. 47). The 1983 Consolidation Supervision required that credit institutions be supervised on a consolidated basis; another provision mandated the exchange of information between supervising authorities while the 1986 Bank Accounts Directive assisted this by harmonizing accounting rules for credit institutions.

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<sup>20</sup> See for example Karadacag and Taylor (2000) for a review of the New Capital Adequacy Framework (Karadacag & Taylor, 2000), or the Centre for the Study of Financial Innovation (2002) for critiques on the proposed framework.

<sup>21</sup> Source: website BIS ([www.bis.org](http://www.bis.org)), consulted on December 20, 2002.

The Second Banking Coordinating Banking Directive has been the main directive for the 1992 program.<sup>22</sup> The Directive established "home country control and host country rules": jurisdiction over the supervision of the banks' solvency and liquidity was given to the bank's country of origin, regulation regarding the execution of monetary policy and other operation norms were transferred to country of destination (Canals, 1993, p. 16). In other words, credit institutions authorized in one member country could establish branches and provide banking services elsewhere in the EC. This common passport allowed home country authorization, but the credit institution must conform to all local laws.

Finally, the directive is supported by the Own Funds directive, establishing common definitions for the bank's capital base, and the Solvency Ratio Directive, where these definitions are used to establish minimum asset ratio's for all credit institutions.

#### 8.3.5. Regulation in Japan

At the beginning of the 1980s, the Japanese financial system can be characterized as a closed financial system.<sup>23</sup> Internationalization of financial markets did not grow substantially relative to economic growth. This can be traced to strict regulatory controls, discouraging financial transactions (Arora, 1995, p. 37). An important step towards liberalization was the revision of the Foreign Exchange Law in December 1980, practically allowing full convertibility of the Yen into foreign currencies and the abolishment of prior notification of cross border portfolio investment, both inward and outward. The new freedom, coupled with an attractive interest rate differential between the United States and Japan, led to a substantial increase in long term capital outflows in the 1980s (Arora, 1995, p. 37).

By 1984, the realization that the Japanese economy maintained high barriers to entry meant that Western governments pressured the Japanese for greater access to the domestic financial markets. The United States government was pressuring the Japanese government for these measures, arguing that liberalization would address the strong dollar problem by stimulating demand for yen denominated instruments and would help American banks to enter the Japanese market (Kanaya, 2000, p. 5). Financial liberalization in Japan was acknowledged in the U.S.- Japan Accord of May 1984, where Japan agreed to open its financial markets and promote the internationalization of the Yen (Arora, 1995, p. 37). The mid-1980s therefore witnessed acceleration in the pace of financial deregulation, consisting of (Kanaya, 2000, pp. 5-6):

- Relaxation of interest rate controls, starting with the liberalization of term deposit rates in 1985.

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<sup>22</sup> A debated and withdrawn issue was that the directive would give the commission influence in authorizing institutions from outside the European Community, on the basis of reciprocity.

<sup>23</sup> This section is based on Kanaya and Woo (2000).

- Capital market deregulation, including the lifting of the prohibition on short-term euro yen loans in 1984, the removal of restrictions on access to the corporate bond market, and the creation of the commercial paper market in 1987, enabling corporations to borrow directly from the market.
- Relaxation of restrictions on activities of previously segregated institutions, including the raising of different types of lending ceilings.

Japanese regulation developments in the 1990s have two major themes: the implementation of the Basle Accord, and regulation to cope with the banking crisis emerging from 1990 onwards. The Basle Accord was fully implemented in 1993. Japanese authorities required only banks with international operations to comply with the 8 percent capital adequacy requirement, but many domestic banks also chose to comply to 8% even though they had to comply with the domestic 4% requirement. Kanaya and Woo observe that “even though regulations permitted banks to use only 45% of these unrealised gains (amounting to 22 trillion yen) towards their tier 2 capital, these nevertheless accounted for about 25 percent of total bank capital [in 1993]” (Kanaya and Woo, 2000, p. 10).

From 1998 onwards, foreign banks began to play a role in the restructuring of the Japanese banking sector, taking over loan financing from Japanese banks. Foreign banks had played a small and decreasing role in the first half of the 1990s when credit by foreign banks fell from 2.7% in 1991 to 1.6% in 1995 of total credits in Japan. From 1995 onwards this percentage increased to 2.3 in 1998, while the total amounts of credit roughly remained the same.<sup>24</sup> Kanaya and Woo note that blue chip firms migrated loans from Japanese banks to foreign banks, especially for euro-yen loans (Kanaya and Woo, 2000, p. 31). Another development caused by the banking crises and the resulting changing regulatory environment was that foreign banks were allowed to acquire banks in Japan, previously prohibited. Merrill Lynch bought Yamaichi Securities in 1998, and the American investment firm Ripplewood acquired the nationalized Long Term Credit Bank.

#### 8.3.6. Regulation in the United States

In the past, major changes in United States banking legislation were direct responses to financial crises, such as the Federal Reserve Act of 1913 and the Banking Act of 1933. These acts helped shape a regulatory framework based on three pillars: deposit insurance, segregation of banking, insurance and securities activities, and control over the interest rates set by banks.

From 1980 onwards regulators had to deal with a number of issues.<sup>25</sup> For one, the trend towards deregulation placed more importance on capital adequacy. Prior to 1988,

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<sup>24</sup> Source: Kanaya & Woo, 2000, p. 44, Table 13. Source assets foreign banks in Japan: Website Bank of Japan, Principal Assets and Liabilities of Foreign Banks in Japan. [http://www.boj.or.jp/en/stat/stat\\_f.htm](http://www.boj.or.jp/en/stat/stat_f.htm), consulted on September 9 2003.

<sup>25</sup> The Federal Deposit Insurance Corporation lists five major developments: regulatory competition, capital adequacy, formal regulatory forbearance, brokered deposits and expanded powers. Formal regulatory forbearance refers to activities preventing bank monitoring and lending to be too lenient, especially for agricultural or energy

different guidelines were set for groups of banks based on their asset size. The 17 largest banks, mostly internationally active, were monitored individually and had no mandated capital requirements, in the expectation that their capital adequacy ratios would improve in time. The LDC debt crisis from 1981 onwards created great anxiety about the condition of the largest banks. Although regulators at first did not respond to this pressure, the International Lending Act of 1983 stipulated that all banking institutions maintained adequate capital levels, and failure to do so was made an unsound and unsafe practice for different types of domestic banks. The adoption of the Basle ratios led to further convergence of capital standards in 1991 (Federal Deposit Insurance Corporation, 1997, p. 116).

Regulation and foreign bank activity have traditionally been intertwined in the United States. Prior to 1980 United States regulation stimulated American banks to undertake foreign activities. Regulation Q introduced interest rate caps, helped to ensure the growth of the Eurodollar market outside of New York, as multinational corporations and other preferred to place funds earned overseas in London, rather than return them to New York. The United States government also imposed controls on the flow of capital overseas, effectuated from the early 1960s through the interest equalization tax, the Voluntary Foreign Credit Restraint Program and restrictions on direct foreign investment (Channon, 1977, p. 153).

In the early 1970s foreign banks in the United States operated under a larger degree of freedom than their American competitors. Under the Bank Holding Company Act foreign banks had not been defined as "banks". Even if they offered the full range of commercial banking services, they had not been forced to limit their operations to only one state but had been free to negotiate with individual state legislators of the states that allowed them in. In 1974, 40 states still barred foreign banks (The Banker, 1974, p. 341).

The activities of foreign banks in the United States attracted the attention of Congress, perceiving that foreign banks enjoyed a competitive advantage over the domestic banks. As mentioned earlier, foreign banks could undertake activities in more than one state, while this was denied to domestic banks. Also, domestic banks had to maintain reserves at the Federal Reserve System, while foreign banks did not have to. After four years, the International Banking Act (IBA) was approved in 1978, creating a regulatory structure for agencies and branches, with the aim to eliminate competitive advantages of foreign banks (State of New York Banking Department, 1999). The Act consisted of:

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biased banks, offering an assisting program for banks which were then required to submit a restructuring plan, and annual progress reports (Federal Deposit Insurance Corporation, 1997, p. 117-119). Brokered deposits were commercial deposits (CD), with denominations not exceeding 100,000 US dollar and being insured by the FDIC and denominations for the institutional market exceeding that amount. First brought to light by the Penn Square bank failure where funding in CD prior to its failure had soared, concern was expressed that CD were brokered in amounts up to 100,000 US dollar, singling out institutions that were in trouble to earn higher fees. In 1984 the FDIC proposed that such a deposit insurance be granted per institution, finding considerable resistance from the brokers. Although the proposal was dropped in 1985, limitations were effectuated in 1989 (FIRREA) and 1991(FDICIA) (Federal Deposit Insurance Corporation, 1997, pp. 119-122).

- limiting interstate deposit taking activities,
- imposing reserve requirements for monetary policy purposes,
- requiring federal deposit insurance for foreign branches engaged in retail deposit taking activities,
- imposing the non-banking prohibitions of the Bank Holding Company Act and
- allowing foreign banks to directly own Edge Act corporations.<sup>26</sup>

Also the IBA allowed a foreign bank wishing to open a United States office to choose between a federal or state licensed one, just as for domestic banks. The federal branches are licensed and supervised by the Office of the Comptroller of the Currency, residing under the Treasury Department. The multitude of regulatory instances is complemented by the Federal Reserve, who regulates the activities of the foreign banks, but behind state and federal regulators.

Foreign banks were in 1991 again the subject of regulation with the passage of the Foreign Bank Supervision Enhancement Act (FBSEA). Direct reaction for drafting this regulation were the fraud scandals of two banks, the Bank of Credit and Commerce International (BCCI), a Middle-East bank chartered in Luxembourg, and Banca Nazionale Del Lavoro, an Italian bank. The FBSEA gave the Federal Reserve Board a more direct role in the supervision of foreign banks, mandating annual on-site examinations of all foreign branches. Also, the FBSEA imposed that the Federal Reserve Board approved the establishment of any new organizational activity by a foreign bank (State of New York Banking Department, 1999).

A major influence in the consolidation in the United States banking industry was the April 1998 acquisition of Citicorp by insurer Travelers for 82.5 billion US dollar, driven by the prospect of cross selling retail financial services.<sup>27</sup> The newly formed company was acclaimed to be the world's largest financial services firm and received regulatory approval for the merger, providing that the United States Congress would drop its restrictions against banking and insurance combination, shaped by the Glass Steagall Act. This was achieved in the Gramm-Leach-Bliley Act in 1999. The Act also had far-reaching consequences for foreign banks operating in the United States. Prior to the Act in 1999, a consequence of the separation of investment, banking and insurance activities was

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<sup>26</sup> One of the first vehicles that the US commercial banks used to participate in the international capital markets was the Edge Act corporation (EAC). The act was effective since 1919, but became a vehicle for international expansion with the implementation of Federal Reserve Regulation K. The new regulation allowed the use of special Edge Act corporations to engage in transactions in equity and loan financing of non-banking foreign corporations and to hold equity positions in overseas banks. Until the strategy of establishing direct overseas presence was developed, the EAC was the only means of participating in international operations. Even after having set up establishment overseas, the EAC remained the principal method for holding shares in foreign banks. This is because Federal Reserve Regulation M limits to 25 percent of the investing bank's capital and surplus the amount that it may invest in the equity of foreign commercial and investment banks. The result is an organizational divide between financial participations overseas and direct investments overseas (Channon, 1977, p. 153-156).

<sup>27</sup> Corrigan, T. (1998, April 9). USA: Pair looks at options on banking side - synergies. *Financial Times*.

that entrants (from Europe) had to choose which activity the bank would undertake. This theoretically limited the application of the universal banking model, and its potential profitability in one of the largest banking markets. Domestic mergers and acquisitions could have far reaching consequences for foreign bank activities in the United States. When the ING was formed, a Dutch bank and insurance company, it had both insurance and banking activities in the United States. ING was given leeway to operate with a banking license in the United States until the group decided itself to give up its banking license (Wolffe and Waters, 1998). The opposite was also true, domestic mergers were influenced by United States regulation. Merger talks between Dutch insurer Nationale Nederlanden (forerunner of ING) and ABN (forerunner of ABN Amro) were discontinued because if the merger would have taken place, either the substantial activities of insurance or banking in the United States would have to be divested, which neither party agreed to.

### 8.3.7. Financial Crises

Financial crises have been a recurring theme as well as a major influence on internationalization activities of banks, as the case studies in chapters 11-18 will demonstrate. Major crises in the 1980s and the 1990s were the international debt crisis (1981-1989), the currency crises in Europe (1992-1993), the "Tequila" crises in Latin America (1994-1995) and the crises in South East Asian countries (1997-1998). The IMF (1998, pp. 74-75) identifies four types of financial crises: foreign debt crisis, currency crises, bank crisis and systemic crises. A foreign debt crisis arises when a country cannot service its (corporate or sovereign) foreign debt. A currency crisis occurs when a speculative attack on the currency results in a devaluation of the currency or forces authorities to defend its currency by increasing international reserves or raising interest rates. A banking crisis refers to a situation where actual or potential bank runs or defaults force banks to suspend internal convertibility of their liabilities, to prevent this government may intervene by providing assistance on a large scale (IMF, 1998, p. 75). Banking crisis can grow into a systemic crisis, spilling over to other sectors in the economy, because banks play a key role in payment and settlement systems where a failure to meet obligations could trigger domino effects. Most financial contracts the bank intermediates in are intertemporal; when uncertainty arises about the credibility of the financial commitment of the bank market expectations may shift substantially leading to large asset price fluctuations (Bandt and Hartmann, 2000, p. 13-14).

Frydl (1999) reviewed several studies of banking crises and found that consensus did not exist on the dating, length and costs of the crises. He concluded that there is a stronger link between growth shortfall in the crisis period and the length of the crisis, than between the length of the crisis and the resolution costs. The IMF study (1998) identified between 1975 and 1997 158 currency crises and 54 banking crises for 50 countries. Currency crises had a relatively higher occurrence in first period (1975-1986) than in the second period (1987-1997) while for banks an opposite result was found.

Table 8.7. *International monetary, securities and banking crises and their effect on internationalization*

	Monetary and securities crisis	Banking crises	Individual failures	Crises	Effect on internationalization banks
1981		●		Polish crisis	Withdrawal emerging market loans European banks
1982-89	●	●		International debt crisis	Withdrawal emerging market loans for most major banks, increasing role international monetary institutions, creation of Basle Accord in 1988
1983			●	Failure Continental Illinois Bank, Banco Ambrosiano	
1987	●			Stock market crash	Large provisioning
1987-92	●			Banking crises in Finland, Norway and Sweden	Regional effect
1989	●			Stock market crash	Large provisioning
1989		●		Savings and Loans crisis	Consolidation and liberalization US banking market, refocusing large US banks on home market
1990	●	●		Japanese banking crises	Withdrawal Japanese banks from internationalization activities
1991			●	Failure BCCI	Increased international regulation
1994-95	●			Mexican crisis	Large provisioning
1994	●			Bond market crisis	
1995			●	Failure Barings	Expansion internationalization ING group
1996	●			Brazilian crisis	
1996			●	Failure Sumitomo bank	
1997-98	●	●		Asian banking crises	
1998	●			Long Term Capital Management	Speeding up proposal for Basle II.
1998	●			Russian crisis	Withdrawal derivatives/investment banking activities
2000	●			TMT stock market crash	Decrease of capital market activities (IPO's)

Source: adapted from Van Eerden (forthcoming)

De Bordo et al. (2001) calculated growth shortfall in the crisis periods and found that financial crises are followed by economic downturns lasting on average 2-3 years and

costing 5-10% of GDP.<sup>28</sup> Compared to earlier historic periods, the longevity or severity of financial crises since 1973 has not been different, but the frequency of crises has doubled. An important reason for this higher frequency has been that crises increasingly occurred in pairs, combining banking crises as well as currency crises (*twin crises*). For 1975-1997 the IMF study estimated that the combination of currency and banking crises were the most persistent and have the largest average recovery time, also being responsible for the largest cumulative losses. The average cumulative loss relative to trend is between 4 and 7% of GDP for currency crises, increasing to 12% for banking crises and 15% for twin crises (IMF, 1998, p. 79; see also Kaminsky and Reinhart, 1998, cited in Kaminsky, 1999). Table 8.7 shows the monetary, securities and banking crises between 1980 and 2000 with international consequences.

The crises have had a major impact on the internationalization of banks, and the international regulatory design. Crises present both risks and opportunities. For internationally active banks, a risk might be that deteriorating economic conditions cause an increase in bad loans and provisioning. The devaluation of foreign currencies changes balance sheet and income statement, and can worsen earnings and risk profile. Worse, counter-parties of the internationally active bank may default, creating losses. This might lead banks active in foreign countries with crises to retreat from foreign activities, selling off activities, to restore domestic financial health (if losses are incurred there). Finally, crises might also lead to the nationalization of banking activities in foreign countries.

Crises also present opportunities. Foreign banks are put for sale after crisis, creating entry opportunities in previously closed financial markets. Also, the retreat of other foreign banks increases the market share of incumbent banks. Importantly, customers in countries with crises can move their activities to (foreign) “blue chip” banks with high reputation.

An important case study is the LDC debt crisis in the 1980s, clearly demonstrating the risks of international banking, and the importance of controlling it. The crisis not only forced restructuring of American and European banks, it was also an impetus for the creation of a capital adequacy framework. The Less Developed Countries (LDC) debt crisis surfaced in 1982 when the Mexican government announced that it was unable to service an 80 billion US dollar debt. The situation worsened and by the end of 1983, 27 countries owing USD 239 billion had rescheduled or were in the process of doing so.

American banks had been active in Latin America since the 1950s, attracted by higher growth rates in the LDC countries, generating corporate investments and financial services. The sharp rise in crude oil price with the oil crisis in 1973-74 began almost a decade of inflation and serious balance of payments problems for developing countries, coping with higher costs of oil and imported goods. These deficits were financed through loans from the international capital market, where the Eurodollar market increased strongly through the expanding deposit base of oil producing countries. These loans were usually dollar denominated and had interest payments tied to the LIBOR rate.

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<sup>28</sup> The crisis duration is calculated as the number of years before GDP growth returns to the trend growth. The costs associated with the crisis is then calculated by cumulating the difference between pre-crisis trend growth and actual growth (De Bordo et al., 2001, p. 55).

Table 8.8. *Loan exposure top five United States banks to Mexico and Brazil, end 1982*

Bank	Exposure in Brazil	Exposure in Mexico	Total	Bank capital	Exposure (percentage capital)
Citicorp	4,402	3,270	7,672	5,989	128%
BankAmerica	2,299	2,500	4,799	4,799	100%
Chase Manhattan	2,402	1,688	4,090	4,221	97%
JP Morgan	1,687	1,081	2,768	3,107	89%
Manufacturers Hanover	2,014	1,729	3,743	2,592	144%
Top nine US banks	12,804	10,268	23,072	20,708	111%
All United States banks (as percentage total)	59%	42%	50%		
Total BIS reporting banks (as percentage total)	21%	17%	19%		

Note: Amounts in million US dollar. Source: table taken from United Nations Centre on Transnational Corporations, 1991, Table 10, p. 36

The second oil crisis of 1979-80 changed this institutional setting, when the Federal Reserve raised interest rates. Debt service cost grew progressively because the LIBOR rate was closely tied to US interest rates, but also because the US Dollar began to appreciate against other currencies, raising costs for dollar denominated debt further. A slowdown in economic growth and drop in commodity prices left exports stagnant and service commitments hard to meet. The announcement of Mexican and other Latin American governments to defer payments and following rescheduling of debt forced American banks' provisions up from 25% to 34% of net income in 1982. Starting in 1987, banks began to realize that a large portion of the LDC loans were not to be repaid. Loan provisions in the United Kingdom and the United States soared to respectively 84% and 120% of net income.

The role international active banks played during the lending and the following debt restructuring process has been researched by the United Nations Centre on Transnational Corporations for six countries<sup>29</sup>, examining the role of the largest 25 organizers of syndicated loans.<sup>30</sup> Banks over lent to major debtors during the lending boom, and for

<sup>29</sup> Three "price competitive" developing markets (Argentina, Colombia, Philippines) where increased price competition by banks to place syndicated credits was coupled with lending volumes during the lending peak, and three "riskier" markets (Bolivia, Peru, Uruguay) where price competition did not exist or was not coupled to lending volumes (United Nations Centre on Transnational Corporations, 1991, pp. 1-2).

<sup>30</sup> Banks are categorized in three groups: leaders (five large United States banks that dominated the loan syndications), challengers (ten relatively smaller banks, mainly non-United States, which actively competed with the leaders in the organisation of loan syndication), and followers (ten large non-United States banks which, though active in organizing loan syndication, were less active than the challengers). (United Nations Centre on

different reasons. Increased competition meant that banks tended to forgo a risk premium and assume excessive exposure, a form of disaster myopia.<sup>31</sup> Short term profit orientation led banks to shift from more creditworthy clients to riskier clients such as non-guaranteed private sector clients, where “those borrowers suddenly found [the leading banks] to persuade them to take on huge credits which they had not necessarily contemplated borrowing or, at least, not in such large volumes. The [banks] thus tended to depend on income more from special deals with riskier clients...” (United Nations Centre on Transnational Corporations, 1991, p. 3). Although applicable to a situation ten years later, The Economist commented on the state of world banking that “[for a while] lending outstripped economic growth in many countries because banks assumed that loan growth was synonymous with high profits” (The Economist, 1992, p. 3).

During the resulting debt restructuring process, banks exercised much control and influence over the process, forming a cohesive bloc at the beginning (United Nations Centre on Transnational Corporations, 1991, p. 3). The much higher exposure of United States banks than other banks, and the natural concern of United States officials to safeguard the domestic financial system, also meant a similar interest of United States government as the banks in the restructuring process.

While provisions might help banks, the austerity policies introduced by the United States and the IMF in exchange for financial assistance did little to reduce the outstanding LDC problem debt for the Latin American countries between 1983 and 1989.<sup>32</sup> Restructuring plans combined the requirement for domestic restructuring with financial assistance, expecting that the resulting economic growth would help cover the debt and interest owed. The creation of a plan by Nicholas Brady, US secretary of the treasury, in 1989 finally solved the debt problem by acknowledging that troubled debtors could not fully service their debt and restore growth at the same time. Approximately 32% of the 191

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Transnational Corporations, 1991, p. 1). The banks are listed in the following table, an asterisk indicates if the bank is also in the sample of this study.

Leaders	Challengers	Followers
Citicorp*	Lloyds*	National Westminster*
Chase Manhattan*	Bank of Montreal	Deutsche Bank*
BankAmerica Corp*	Bank of Tokyo*	Royal Bank of Canada
J.P. Morgan*	Bankers Trust	Westdeutsche Landesbank*
Manufacturers Hanover*	Chemical Bank*	Dresdner Bank*
	Canadian Imperial Bank of Commerce	Barclays Bank*
	Toronto Dominion Bank	Midland Bank*
	Commerzbank*	Crédit Lyonnais*
	Bank of Nova Scotia	Industrial Bank of Japan*
	Long Term Credit Bank of Japan	Banque Nationale de Paris*

<sup>31</sup> A failure in risk estimations or creditworthiness evaluation that is converted into a systematic tendency (United Nations Centre on Transnational Corporations, 1991, p. 2).

<sup>32</sup> Virtually all costs of associated with the international debt crisis were transferred to the debtors, at least during the first phase from 1982 to 1984 (United Nations Centre on Transnational Corporations, 1991, p. 4).

billion US dollar in outstanding loans was written off, while the remaining debt was rescheduled converting loans in other financial instruments. In exchange developing countries had to agree to introduce economic reforms. The resolve of the LDC debt crisis forced provisions once again in 1989.

## **8.4. Clients, arenas, products**

### **8.4.1. Financial innovation, products**

Technology is an important enabler for product innovation. As noted in chapter one, banks produce services: their financial products are mostly transparent and cannot be patented<sup>33</sup>, which means that any new product can be easily imitated (Podolski, p. 110). The main core products of the banks, deposit taking and extending loans, can be assumed to be mature products, especially in the Western economies after the 1970s. The floating exchange rates environment that existed after the suspension of the US dollar convertibility in the Bretton Wood system presented banks with further opportunities in the foreign exchange markets. More opportunities led to more risk. Banks began to devise hedging instruments, developing markets for future contracts, swaps and currency options (Braithwaite and Drahos, 2000, p. 102).

The foreign exchange markets grew dramatically; by 1991 the daily net turnover in foreign exchange (including derivative products like futures, options and swaps) was estimated at 900 billion US dollar, close to the total foreign-currency reserves of all IMF members. Almost 25% of the foreign exchange business was done in London, New York 16% and Tokyo 11%, with most of the rest spread among Frankfurt, Singapore, Hong Kong, Zurich and Paris. Less than 5% related to underlying trade flows, the demands of companies and individuals that sell or buy in foreign currency. Another 10-15% represented capital movements from institutional investors. The remaining share consisted of dealing that banks and investment banks did among themselves (The Economist, 1992).

The market changed during the 1990s, reducing the number of participants in the foreign exchange market. The already thin margins, increasing sophistication of corporate clients increasingly managing foreign exchange deals themselves, the prospect of the EMU reducing currencies reduced the number of players further. In 2000 the three biggest foreign exchange banks - Citigroup, Chase Manhattan and Deutsche Bank - commanded 28.9% of overall revenues, while a further 13 banks such as JP Morgan, Bank of America, HSBC, Credit Suisse and UBS, had a market share of a further 31.4% (Swann, 2000).

Other opportunities occurred through the growth of the off-shore currency markets. The Eurocurrency market grew into the world's largest capital market. International banks became key operators, both as lenders and as borrowers. The markets became a crucial source for multinationals, and governments. The combination of floating currencies and

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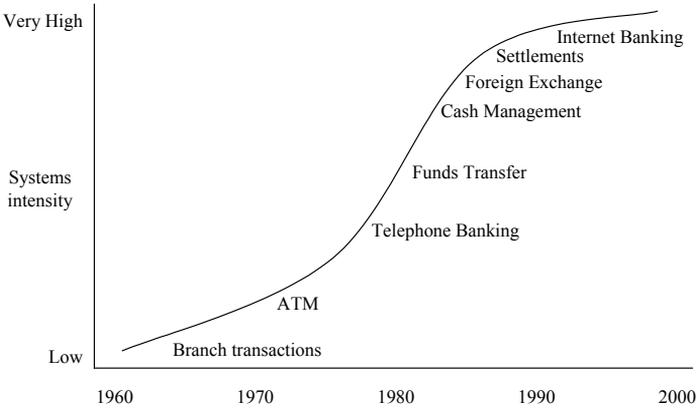
<sup>33</sup> Non-transparent products also exist, but only because of disclosure restrictions and/or the use of opaque financial instruments such as OTC's.

the sheer size of the markets brought new risk. Currency speculators had found a new source to fund their activities. Participants trading tangible goods realized that their trade could be wiped out by currency fluctuations. Their desires for risk protection fuelled a new form of service, that of risk protection through the creation of derivative financial instruments. Some forms of these derivatives became tradable on the exchanges, creating derivatives markets (Braithwaite and Drahos, 2000, p. 102).

8.4.2. Technology/distribution channels

In 1997, Carrington et al. studying the role of technology with British banks, stated that "technology is transforming retail banking and creating value in the economy but [...] it is benefiting consumers rather than the providers. By increasing market efficiency, technology is [...] reducing industry profit and shareholder return." (Carrington et al, 1997, p. 49). Of the service industries, banks use technology most intensively (Morris, 1987, p. 260) because of the labor intensive nature of the industry. Technology is a change process: "it makes possible new structures, new and organizational and geographical arrangement of economic activities, new products and new processes, while not making particular outcomes inevitable" (Dicken, 1998, p. 145). Two technologies have helped overcome the frictions of space and time relevant to the internationalization of firms: transport systems, transferring materials and people from place to place, and communication systems, transmitting information from place to place in different forms (Dicken, 1998, p. 151). A catalyst enhancing worldwide communication was the development of satellite technology, in essence making communication costs increasingly insensitive to distance.

Figure 8.10. *Technological developments within banking*



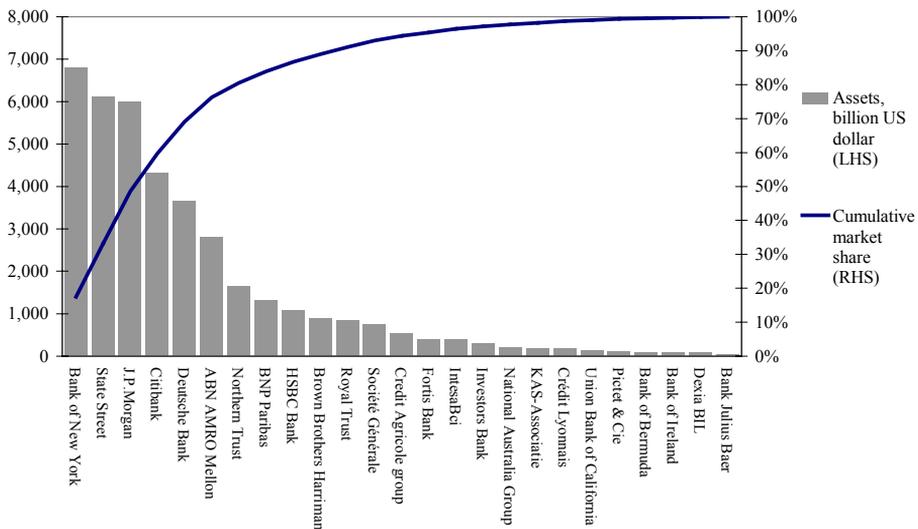
Source: adapted from Carrington et. al, 1996, p. 80

Information technology emerged from the late 1950s, converging communications technology and computer (Dicken, 1998, p. 150). From the outset, a main goal was

rationalization of existing processes. In the United Kingdom, banks began to invest heavily in computers in the late 1950s and the early 1960s as a response to a projected increase in workload. This was anticipated to follow from an increase in wage payments from retail clients. Growth in demand for bank services led initially to a rapid rise in bank personnel which were becoming increasingly costly. Computers were then implemented to handle routine transactions and increase the capacity of the branches. In the mid 1970s, most branches were connected to a central computer (Channon, 1977). The first automatic teller machine (ATM) was installed by Barclays in 1968, and in 1969 Chemical Bank installed the first ATM in the United States.

Between 1980 and 2000, information technology (IT) has changed most banking markets. It enabled outsourcing, especially in high volume and low margin activities. A clear example of this are the custody activities of banks. The increase in securities and transactions raised the IT costs of maintaining custodial activities, while margins fell. Banks increasingly retained the fund management itself but outsourced the administering and settlement of securities to other banks. The establishment of settlement protocols (SWIFT) aided this process of concentration.

Figure 8.11. Concentration in worldwide custodial activities



Note: Assets per June 30 2000. Source: www.globalcustody.net

Also, an increase of scale and of operations took place in the securities markets. The amount of transactions handled increased dramatically. Information systems also allowed the frequency of quotations of publicly traded shares to increase to real time, increasing liquidity. The speed of securities activities rose dramatically. On the one hand

did information technology help reduce the settlement risk<sup>34</sup>, on the other hand did it help increase the volume of transactions dramatically.

Another major development has been insourcing. Home banking, cash management and internet banking have in common that the bank provides the client with technology to perform parts of the production process of the bank which were previously proprietary. In the case of cash management, banks sought to keep or retain fee generating activities that firms, for retail clients the main advantage were cost and efficiency savings.

From the mid 1990s onwards, internet was added as an additional distribution channel. It basically provided a cheaper distribution channel, with the potential to reduce barriers to entry into the banking industry. By 2000, internet proved successful in providing trading platforms for securities, and the offering of commoditized financial services. It is also an enabling technology for insourcing and outsourcing of activities.

Due to the high interrelatedness of banks through the payments and settlements as one of their core activities, the creation of common technology standards or cost sharing were important issues to consider. Sometimes were new organizations set up to handle specific activities.<sup>35</sup>

The effect of information technology on internationalization activities has been twofold. First, it enabled as well as forced the restructuring of activities of banks. Processing and transaction related activities could be centralized. For administration purposes, banks would have to focus on finding skilled personnel as one of the main location decisions. Ireland attracted a number of back office activities in the 1990s, although its significance as financial center or banking market is minor. Smaller branches and representative offices, especially located in dense banking regions, could be closed and clients served from regional centers. For example, Dutch clients could also be served from Brussels or London. Also, the activities could simply be closed and trading activities could be conducted electronically elsewhere, still represented in the foreign country by for example an electronic chair at the stock exchange.

The higher degree of information and communication technology also allowed a greater degree of control of foreign activities. Country specific differences aside, banks could in theory monitor and consolidate their foreign activities with higher frequency. This would suggest that monitoring costs were lowered, raising internalization advantages of international activities. Viewed from this angle, information technology might have been an enabler for asset seeking strategies.

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<sup>34</sup> For securities, the Securities Industry Association, a self-regulatory body of the securities industry, has over the year steadily decreased the settlement risk by reducing the time between the transaction, and the actual payment. Eventually the standard moved to T+3 (Trade-date-plus-three-days settlement periods), and goals were set for T+1 in 2004. These however were postponed after September 11 2001. Other financial protocols and requirements are Fix (financial information messaging) and ISO 15022 (as international messaging standard) For foreign exchange transactions, instantaneous settlement was introduced in 2002 when Continuous Linked Settlement (CLS) was created by a consortium of banks.

<sup>35</sup> For example Mastercard, VISA for credit cards, Euroclear for Settlements, and Depository Trust Company for Funds Transfer



## 9 Positioning of the sample

This chapter explains how the bank sample has been constructed and what its characteristics are (9.1), examining the asset distribution within the sample in more detail (9.2). The question of representativeness of the sample is addressed, comparing the characteristics of the banks in the sample to a broader group (9.3). Next a financial overview of the bank sample between 1980 and 2000 is presented (9.4), concentrating on the analysis of a number of key indicators. Income will be first analyzed consisting of interest income and non-interest income. Costs, represented by the cost to income ratio, are then discussed. As a specific characteristic for banks, loan provisions deserve close attention. Finally, the resulting profitability and developments in banks' capital strength are discussed.

### 9.1. About the sample

The sample consists of the five largest banks measured by total assets in the Netherlands, Germany, France, United Kingdom, United States, Switzerland, Spain and Japan, as determined in the benchmark year 1995. These banks have been involved in internationalization activities between 1980 and 2000. In the case of both the Netherlands and Switzerland initially only three banks were included for the benchmark year 1995, due to high concentration of banking activities in these countries.

One bank was added to the Dutch sample: Fortis, the Belgian/Dutch bank whose administrative headquarters are in Belgium but has extensive Dutch operations.<sup>1</sup> For the United Kingdom, HSBC has been included as a United Kingdom bank in 1995. The bank relocated to the United Kingdom from 1992 after the acquisition of Midland bank. Therefore, HSBC has been included from 1992 onwards in the sample. This leads to an initial list of 37 banks for the benchmark year 1995, whose key characteristics are listed in Table 9.4. Including predecessors, the total sample for 1980-2000 consists of 44 banks.

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<sup>1</sup> For Fortis, Belgian/Dutch corporate structure creates a problem to determine what region is home or foreign. This is solved in the database by denoting Benelux as home. Similarly, HSBC is the only bank not disclosing information for the home country, instead reporting Europe as 'home region'.

The banks in the sample have several characteristics in common. First, most banks have not only been among the largest banks in their countries in 1995, but also between 1980 and 2000. All banks combined have taken up a major share of the assets, capital and profits of the world's 100 largest banks, a topic discussed in 9.3. Also, between 1980 and 2000 all banks have been engaged in international banking activities.

In this study, internationalization patterns are not differentiated by banking type because most banks in the sample are universal banks, providing a broad range of commercial banking services. European banks have historically provided the widest range of financial services, while United States banks have historically offered a more limited range of financial services, converging over time to universal banks as regulation changed. A limited number of (mostly European) banks also have become part of, merged with, or came to own insurers. In the study, the bank activities of the bank-insurers are considered. Table 9.1 lists the most noteworthy combinations of banks and insurers.

Table 9.1. *Combinations of insurers and banks in sample between 1980 and 2000*

Year	Country	Activity
1988	United Kingdom	Acquisition of insurer Abbey Life by Lloyds Bank
1989-90	Netherlands/Belgium	Formation of Fortis through merger of Dutch bank VSB and insurer AMEV with Belgian insurer Groupe AG and bank ASLK
1990	Netherlands	Acquisition of insurer Interpolis by Rabobank.
1991	Netherlands	Formation ING Group through merger NMB Postbank with insurer Nationale Nederlanden.
1997	Switzerland	Acquisition of insurer Winterthur by Credit Suisse
1998	United States	Formation Citigroup by merger Citicorp and insurer Travelers group.
2000	Germany	Acquisition Dresdner Bank by insurer Allianz

Finally, most banks in the sample had publicly traded bank shares between 1980 and 2000. Banks who did not have publicly traded bank shares either were nationalized, owned by government institutions or have had a co-operative status. Two banks have been nationalized (Paribas, Société Générale in 1982) and re-privatized (Paribas in 1986, Société Générale in 1987). Crédit Lyonnais was effectively nationalized between 1992 and 2000). Furthermore, three banks have a co-operative structure and have had no publicly traded shares. The Rabobank and Crédit Agricole share co-operative ownership, and are mainly owned by the local associated banks, while West Deutsche Landesbank is owned by the state government. The discussion of financial systems in chapter 2 indicates that German, French, Japanese and Swiss banks also had higher concentration of ownership than English or American banks, because of the characteristics of the financial systems the banks are part of (bank oriented and government directed versus market oriented financial systems).

Mergers and acquisitions determine the dynamics of the sample; the number of banks decreased from 34 banks in 1980 to 29 banks in 2000. In Table 9.2, the changes per

country are tabulated; the changes (caused by mergers, acquisitions and additions to the sample) are accounted for in Table 9.3. Key figures such as total assets, staff and capital are presented in Table 9.4. The composition of the sample is relatively stable between 1980 and 1990; the major changes in the sample have taken place between 1990 and 2000. Also, the majority of mergers and acquisitions affecting the size of the sample have taken place within the same country. However, cross border mergers have increased between 1980 and 2000. Besides earlier mentioned mergers of HSBC and Fortis, other important cross border acquisitions were the acquisition of Belgian BBL by ING in 1997 and HSBC's acquisition of French CCF in 2000.<sup>2</sup>

In a number of cases there were reverse takeovers where the name of the acquired bank was kept but strategic control in hands of the acquiring bank: the merger of UBS and SBC (1998), Nationsbank and Bank of America (1996), Chemical Banking and Chase Manhattan (1995).

Table 9.2. Number of banks in sample between 1980-2000

Country	1980	1985	1990	1995	2000
France	5	5	5	5	4
Germany	6	6	6	6	5
Spain	na	na	3	4	2
Switzerland	3	3	3	3	2
United Kingdom	5	5	5	5	5
Netherlands	4	4	4	4	4
United States	6	6	6	5	3
Japan	5	5	5	5	4
Total sample	34	34	37	37	29

Note. na: not available

For the sample, the mergers and acquisitions in 2000 posed a data continuity problem. In the last year of the sample period, Royal Bank of Scotland acquired National Westminster, Dai-Ichi Kangyo merged with IBJ and Fuji into Mizuho, Sumitomo merged with Mitsui to form the Sumitomo Mitsui Banking Corporation, and J.P. Morgan was acquired by Chase Manhattan. For these banks, except J.P. Morgan, separate annual accounts were still published after the merger activities in 2000, so these data have been used to complete the sample for the year 2000.

<sup>2</sup> Cross border mergers tend to be a Northern European phenomenon. The most extensive cross border merger was probably Nordea formed between 1997 and 2000, merging Norwegian Christiana Bank, Swedish Merita Banken and Danish UniBank, the latter two results of earlier domestic mergers. Source: *About Nordea*. (n.d.). Retrieved December 28, 2003, from [http://www.nordea.com/eng/group/group\\_2.asp?navi=group](http://www.nordea.com/eng/group/group_2.asp?navi=group).

Table 9.3. *Mergers and acquisitions affecting sample size between 1980 and 2000*

Year	Merger/acquisition/other activity	Change in size sample	Effect on sample
1990	Creation of Fortis	+1	Addition of one bank
1990	Merger NMB-Postbank into ING Group	0	Termination NMB-Postbank, creation ING Group
1990	Merger ABN and Amro into ABN Amro	-1	Termination ABN, Amro, creation ABN Amro
1990	Addition BCH, Santander and BBV to sample	+3	Initiation of coverage Spanish banks in sample
1991	Creation of Argentaria, addition to sample	+1	Addition of one bank
1991	Merger Manufacturers Hanover and Chemical Banking	-1	Termination Manufacturers Hanover
1992	Relocation HSBC from HongKong to United Kingdom with acquisition Midland bank.	-1	Termination Midland bank
1992	Relocation HSBC from HongKong to United Kingdom with acquisition Midland bank.	+1	Addition HSBC to sample
1995	Merger Chemical Banking and Chase Manhattan	-1	Termination Chemical Banking
1995	Merger Tokyo bank and Mitsubishi bank	-1	Termination Tokyo, Mitsubishi, creation Tokyo-Mitsubishi.
1996	Merger of Nationsbank and Bank of America	0	Nationsbank not in sample, but composition and activities BankAmerica altered significantly.
1998	Merger of Bayerische Hypobank, Vereinsbank	-1	Termination Bayerische Hypobank, Vereinsbank, creation HypoVereinsbank.
1998	Merger of SBC and UBS	-1	Termination SBC
1999	Acquisition of BCH by Santander	-1	Termination BCH, name change BSCH
1999	Acquisition of Paribas by BNP	-1	Termination Paribas, name change BNP Paribas
1999	Acquisition of Argentaria by BBV	-1	Termination Argentaria, name change BBVA
2000	Acquisition of J.P. Morgan by Chase Manhattan	-1	Termination J.P. Morgan, name change Chase Manhattan into J.P. MorganChase
2000	Acquisition of National Westminster by Royal Bank of Scotland	0	National Westminster continues to report separately for 2000.
2000	Merger IBJ, Dai-Ichi Kangyo, Fuji Bank into Mizuho Bank	0	IBK, Dai-Ichi Kangyo continue to report separately for fiscal year 2000.
2000	Merger Mitsui, Sumitomo into Sumitomo Mitsui Banking Corporation	0	Sumitomo continues to report separately for fiscal year 2000.

Table 9.4. Key indicators banks in benchmark year 1995

Country	Bank	Total assets, mln US dollar	Capital and reserves, % total assets	Profit before tax, % capital and reserves	Costs, % total income	Staff
France	Crédit Agricole	381,386	5.35	11.88	63.12	74,380
	BNP	320,954	5.94	3.27	74.96	53,600
	Crédit Lyonnais	334,911	2.27	5.51	83.36	59,018
	Paribas	268,618	4.63	-0.64	82.30	25,841
Germany	Société Générale	322,194	3.42	10.27	74.10	45,374
	Bayerische Hypobank	207,229	3.06	14.85	59.23	16,239
	Commerzbank	280,527	3.05	9.69	70.36	25,826
	Deutsche Bank	500,898	3.89	12.71	71.56	74,119
	Dresdner Bank	336,273	2.85	14.50	74.09	46,890
	Bayerische Vereinsbank	247,472	2.89	12.97	64.31	22,188
Spain	Westdeutsche Landesbank	294,826	2.98	8.73	74.91	9,670
	Argentaria	106,641	5.05	12.89	52.78	16,715
	BBV	115,429	5.38	19.10	60.02	34,178
	BCH	91,597	4.48	5.10	71.18	29,369
Switzerland	Santander	134,453	5.21	17.03	67.11	42,023
	Credit Suisse	358,536	4.21	12.12	63.14	34,310
	SBC	250,569	4.89	9.68	73.55	27,236
United Kingdom	UBS	336,193	6.17	8.44	69.19	29,071
	Barclays	261,681	4.37	27.91	70.17	92,400
	HSBC	351,457	6.80	23.31	55.69	101,070
	Lloyds TSB	204,213	4.78	25.79	65.99	91,044
	National Westminster Standard Chartered	287,541 60,348	6.74 5.15	7.75 32.98	69.07 59.20	72,500 26,953
Netherlands	ABN-Amro	338,785	6.13	11.47	67.48	63,694
	Fortis	174,571	6.19	13.16	74.18	30,388
	ING bank	153,217	6.49	10.93	70.87	28,015
	Rabobank	181,956	6.18	10.99	67.07	37,437
United States	Bank of America	232,446	8.70	22.58	61.51	79,900
	Chase Manhattan	121,063	7.37	20.70	67.47	33,618
	Chemical Banking	182,926	6.51	24.89	59.15	39,078
	Citicorp	269,000	7.28	28.52	59.44	85,300
	JP Morgan	184,879	5.65	18.24	67.72	15,613
Japan	Dai Ichi Kangyo	519,193	3.70	8.37	46.61	18,069
	IBJ	383,301	3.25	-8.02	45.01	5,362
	Mitsubishi Bank	514,187	4.53	3.76	60.03	14,977
	Sumitomo Bank	528,217	3.46	1.44	83.30	18,104
	Bank of Tokyo	250,102	5.23	5.28	47.38	17,538

Source. Annual reports, the Banker top 1000 1995, issue July 1996

## 9.2. Distribution within sample

Asset growth and distribution on a country level are presented in Table 9.5. Total reported assets increased from 2,260 billion US dollar in 1980 to 13,550 billion US dollar in 2000. Total assets increased with an 11.7% annualized growth rate from 1980 to 1990 leveling off to 7.0% between 1990 and 2000, generating an annual average asset growth of 9.3% over the total period. The difference in asset growth might indicate:

- *Change in currency.* Fluctuations in the currencies have increased or decreased relative positions in US dollar terms. For example, the surge in the Japanese Yen substantially increased the size of Japanese banks in dollar terms.<sup>3</sup>
- *Saturation.* Due to their large size, it may have become more difficult to maintain high levels of asset growth.
- *Change in monetary regime.* Total assets are positively correlated to the level of money supply, whose growth has been more restricted in the 1990s than the 1980s.
- *Change in management focus:* The focus of a bank may have shifted from asset growth as a management goal to other goals such as profitability and capitalization.
- *Change in regulation.* The implementation of the capital adequacy rules from 1988 onwards provided a regulatory framework for new management drivers. For example, when banks evaluated granting new loans, it also became important to consider the effect on capital reserves, effectively lowering asset growth. Clearly, change in regulation and change in management focus are intertwined.

Table 9.5. *Distribution of assets in sample*

	1980			1990			2000		
	Sum of total assets	% Sample	N	Sum of total assets	% Sample	N	Sum of total assets	% Sample	N
France	452,493	20.5	5	1,295,341	19.3	5	1,743,338	12.8	4
Germany	348,658	15.8	6	995,102	14.8	6	2,791,265	20.5	5
Spain	na	na	na	194,630	2.9	3	600,240	4.4	2
Switzerland	121,990	5.5	3	494,405	7.4	3	1,268,023	9.3	2
United Kingdom	315,480	14.3	5	757,639	11.3	5	1,774,937	13.1	5
Netherlands	162,845	7.4	4	481,777	7.2	4	1,559,380	11.5	4
United States	442,337	20.0	6	653,430	9.7	6	1,909,146	14.1	3
Japan	368,055	16.6	5	1,843,810	27.5	5	1,937,306	14.3	4
Total	2,211,857	100.0	34	6,716,134	100.0	37	13,583,635	100.0	29

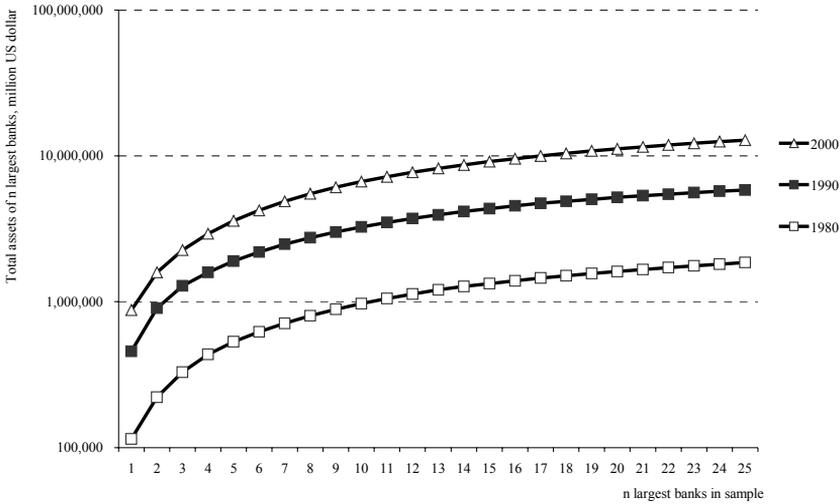
Note: Total assets in million US dollar. N is the number of banks in the sample for the specified country  
na: Spanish banks are not included in the sample prior to 1980, see chapter 10

If the distribution of assets in the sample per country for 2000 is compared to 1980, then the asset share of French banks has decreased, as have United States banks and to a lesser extent banks in the United Kingdom. German banks have shown the largest increase, followed by Swiss and Dutch banks. Japanese banks have maintained roughly the same asset share in 1980 and 2000, but dominated the sample in 1990 with 27.5%.

Within the sample, the distribution of asset size has also changed over time. Comparing the cumulative asset distribution for different years in Figure 9.1 it is not surprising that the total asset distribution has shifted upwards.

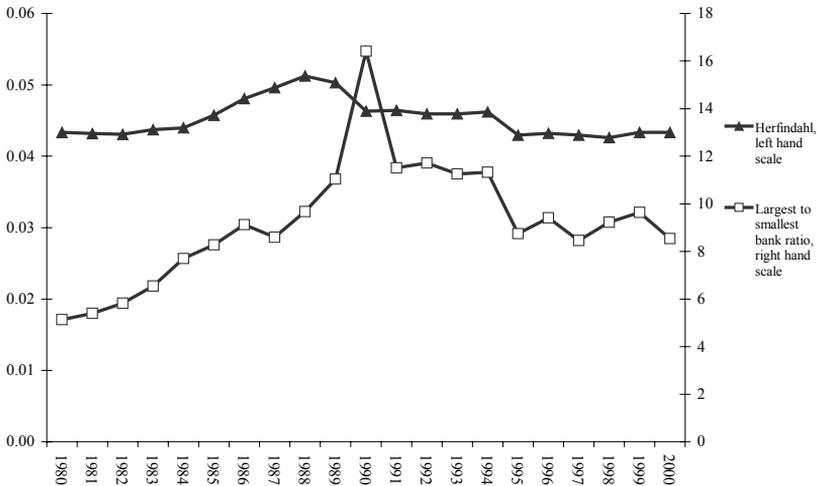
<sup>3</sup> Cf. the introductions to the yearly Banker Top 500 or 1000 listings, where currency fluctuations are a recurring theme in explaining fluctuations in the ranking of banks.

Figure 9.1. Cumulative asset distribution within sample



The steepness of the cumulative asset distribution has also changed between 1980 and 2000 (Figure 9.2). Comparing the total assets of the largest bank to the smallest bank, this ratio has fluctuated over the years, increasing from 5 in 1980 to 16 in 1990 due to the strong asset growth of Japanese banks in US dollars. From 1990, Japanese banks' asset growth stalled while other banks in the sample increased their asset growth, reducing the ratio to 9 in 2000.

Figure 9.2. Concentration measures in sample



The fluctuations of total assets of the largest banks compared to the smallest bank in the sample between 1980 and 2000 have not led to substantial changes for the concentration within the sample. For the Hirschmann-Herfindahl index (HHI), values between 0.04 and 0.05 are calculated, indicating a relatively stable distribution of changes in assets between the banks.<sup>4</sup> The reciprocal of the HHI represents the number of banks if the market were made up of equal sized firms (Ferguson, 1988, p. 26). Here, the reciprocal of the HHI would suggest a sample of 25 to 31 equally sized banks, approaching the actual size number of the sample. In other words, concentration of bank assets has remained low within the sample during the observed period<sup>5</sup> although from 1995 a steady increase is observable, partly explained by the decreasing number of banks in the sample (Table 9.3).

Another measure of concentration is the yearly rankings of asset size compiled by "The Banker" (Table 9.6). The banks in the sample on average rank relatively high, since they have been selected on their size in the country. The average rank has dropped from 22 in 1980 to 30 in 1990, increasing to 17 in 2000. The diversity in rankings has changed over time too, 1990 being the most pronounced year. In that year one bank ranked lowest in comparison to the other years shown<sup>6</sup>, in line with the earlier observation that the ratio of largest to smallest bank peaked in 1990 due to the strong growth of Japanese banks.

Table 9.6. *The Banker rankings of banks in the sample*

Year	Average rank bank in sample	Lowest rank bank in sample	Highest rank bank in sample	% Banks in sample inside top 25
1980	22	53	1	57
1985	27	64	1	48
1990	30	84	1	45
1995	22	65	1	60
2000	17	55	1	77

Source: The Banker top 1000, 500, 300. Various issues. Rankings based on asset size, end of year in US dollar.

For individual banks the trends have been more pronounced. A few banks managed to maintain their high rankings in the top 25 between 1980 and 2000, such as Crédit Agricole or Citicorp. A number of Japanese banks crowding the top ranking in the latter

<sup>4</sup> Naturally, it does not indicate anything about the dynamics of asset growth. A simultaneous declining and growing bank in terms of assets might still yield the same concentration measure although economic power might have shifted substantially.

<sup>5</sup> This index will be close to zero when a large number of banks with equal size operate in the market, and close to 1 when there is a monopoly (Ferguson, 1988, p. 26).

<sup>6</sup> On a yearly basis, lower rankings than this are included in the sample. The lowest ranking was found for the Nederlandsche Middenstandsbank (NMB), one of the forerunners of the ING group, who ranked 105th in 1984.

part of the 1980s and early 1990s have kept their rankings through domestic mergers, while most new entrants in the 1990s are the product of mergers.

### 9.3. Representativeness of sample

The number of banks is relatively small, but represent a large portion of the country's assets, profits and capital. These figures are presented in Table 9.7 where these key-indicators are compared to the top 100 banks and top 1,000 banks as compiled by The Banker.<sup>7</sup>

Table 9.7. *Bank sample compared to Banker Top 100 and Top 1,000, billion US dollar.*

	Assets			Capital			Profit before tax		
	1980	1990	2000	1980	1990	2000	1980	1990	2000
Sample	2,208.3	6,472.3	14,914.0	83.0	255.5	580.7	14.2	31.5	128.5
Top 100	4,200.2	13,065.2	26,577.4	147.9	535.1	1,133.1	24.3	69.9	224.5
Top 1000		19,900.0	36,700.0		828.5	1,784.8		113.3	309.7
Sample, % Top 100	52.6	49.5	56.1	56.1	47.8	51.2	58.3	45.1	57.2
Sample, % Top 1000		32.5	40.6		30.8	32.5		27.8	41.5

Source: The Banker July issues 2001, 1991, 1981. Totals Top 1000 for assets, capital, profit before tax are listed in the Banker July 2001 issue, p. 158

Table 9.7 shows that the sample dominates the 100 largest banks in terms of total assets, capital and profits before tax, averaging between 48 and 54% for the reported periods, compared to the top 100 banks. Exception is the share of profits in 1990, although this measure is bound to be more volatile than assets or capital. Total assets of the sample as a share of the Top 100 largest banks increased with 5.7% from 48.1% in 1990 to 53.8% in 2000, while the asset increase of the sample as a share of the 1000 largest banks was 7.4% in the same period. This suggests that the Top 100 as a whole has increasingly grown in size at a higher pace than the Top 1000. On the other hand, the capital share increase of the sample compared to the Top 100 and Top 1000 between 1990 and 2000 is much more subdued, 3.0% for the share in the Top 100 and 1.5% for the share in the Top 1000.

The banks in the sample have accumulated a more than average share of assets for 1990 and 2000, if the share of assets is compared to the share of capital or profits. This suggests that they have been relatively less capitalized than the other banks. Also, the share of assets of the bank sample in the top 100 changed at a lesser pace between 1980 and 2000 than the asset share of top 100 banks in the 1000 largest banks. This is demonstrated by Figure 9.3, where the concentration ratios for different numbers are presented. As can

<sup>7</sup> The rankings for 1990 and 2000 are based on capital, while the ranking for 1980 is based on assets (less contra accounts). Although ranking by assets or capital yields different results for the ranking itself, it has no consequences for the inclusion of banks in the sample, a side effect of choosing large banks (a large amount of assets implies a large amount of capital and vice versa).

be deduced from the figure, mid-sized banks must have grown at a relatively faster pace, although not that much, increasing the concentration ratio of the 20 largest banks with about 5% between 1980 and 2000.

Figure 9.3. Total assets of *N* largest banks, as percentage of assets Top 100 banks

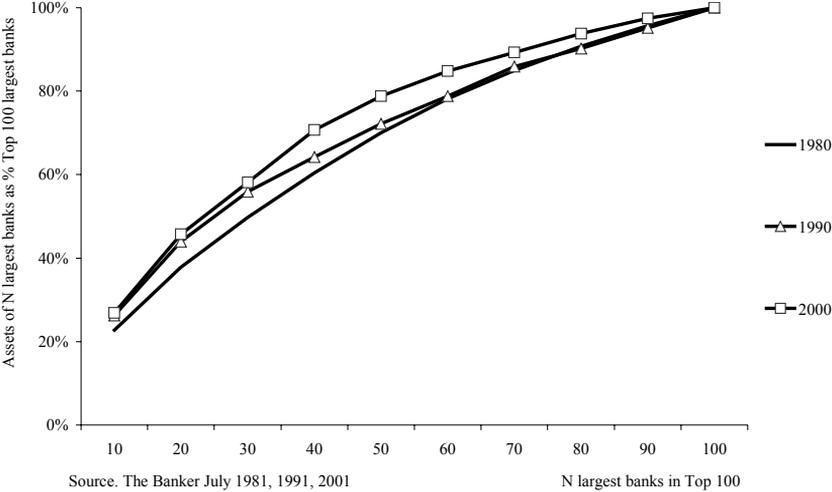


Table 9.8 shows that the relatively large domination is due to both the choice of countries in the sample and the selection of banks within the countries. The countries in the sample are all wealthy economies with developed financial infrastructures and large accumulation of assets. For the Netherlands and Switzerland, the selected banks cover the complete presence of the country’s banks in the top 100, while for the United Kingdom, Germany and France 86-100% is covered in 1980, leveling off to 71-74% in 2000. This reflects the strong growth of banks outside the sample, for example the Landesbanken in Germany, Credit Mutuel and Groupe Caisse d’Epargne in France, and Abbey National in the United Kingdom.

Table 9.8. *Share total assets of banks in Top 100 per country*

Country	1980			1990			2000		
	Total assets Top 100, bln US dollar	Total assets bank sample in Top 100	Share sample in Top 100, %	Total assets Top 100, bln US dollar	Total assets bank sample in Top 100	Share sample in Top 100, %	Total assets Top 100, bln US dollar	Total assets bank sample in Top 100	Share sample in Top 100, %
	Japan	1,016.6	367.4	36.1	4,740.0	1,759.2	37.1	5,367.3	2,892.1
United States	653.8	435.8	66.7	1,230.8	646.0	52.5	4,122.1	2,259.7	54.8
France	528.5	454.5	86.0	1,518.8	1,266.8	83.4	2,441.3	1,743.3	71.4
Germany	502.7	349.4	69.5	1,233.6	993.5	80.5	3,759.5	2,786.3	74.1
United Kingdom	315.5	315.5	100.0	914.4	714.9	78.2	2,563.4	1,842.9	71.9
Italy	266.8			646.0			783.3		
Canada	193.0			380.2			825.7		
Netherlands	163.5	163.5	100.0	454.8	454.8	100.0	1,203.9	1,203.9	100.0
Belgium	127.6			75.4			718.0	313.5	43.7
Switzerland	122.2	122.2	100.0	445.1	445.1	100.0	1,267.9	1,267.9	100.0
Sweden	58.7			143.7			530.4		
Australia	55.5			198.1			465.8		
Brazil	52.2			69.0			119.3		
Spain	43.0			301.7	192.0	63.7	604.2	604.2	100.0
Singapore	17.4			-			137.8		
China	-			263.7			1,434.1		
Denmark	-			118.1			233.4		
Other countries	83.2			331.7			0.0		
Total top 100	4,200.2	2,208.3	52.6	13,065.2	6,472.3	49.5	26,577.4	14,914.0	56.1
Total top 1000	na			19,900.0	6,472.3	32.5	36,700.0	14,914.0	40.6

Note: Country order based on asset size in 1980. -: not in Top 100. na: not available  
Source: calculated from the Banker, July issues 1981, 1991, 2001

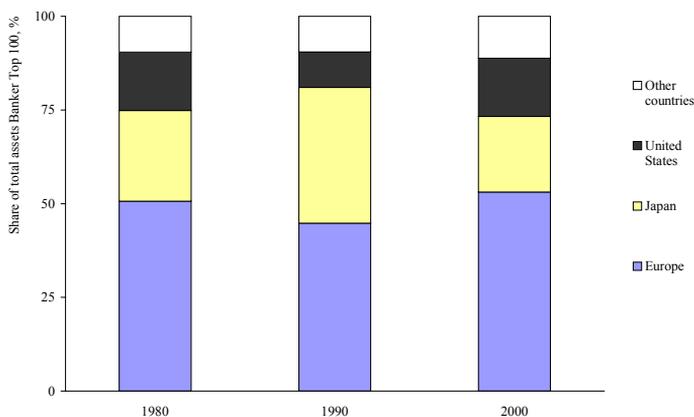
An exception is Japan where the coverage has risen between 1980 and 2000. Table 9.9 shows that the number of Japanese banks in the Top 100 has decreased from 24 in 1980 to 18 in 2000, indicating that the increase is partly a survivor bias, also demonstrated by the change in asset distribution between regions presented in Figure 9.4. The years 1980 and 2000 are similar, whereas 1990 differs with respect to Japanese assets.

Table 9.9. *Number of banks in sample compared to Top 100*

	1980			1990			2000		
	nr banks in Top 100	nr banks in sample	% sample of Top 100	nr banks in Top 100	nr banks in sample	% sample of Top 100	nr banks in Top 100	nr banks in sample	% sample of Top 100
United States	14	6	42.9	15	6	40.0	20	3	15.0
United Kingdom	6	5	83.3	7	4	57.1	8	5	62.5
Japan	24	5	20.8	24	5	20.8	18	4	22.2
Germany	11	6	54.5	8	6	75.0	9	5	55.6
France	8	5	62.5	7	5	71.4	7	4	57.1
Netherlands	4	4	100.0	4	4	100.0	4	4	100.0
Switzerland	3	3	100.0	3	3	100.0	2	2	100.0
Spain	1	0		5	3	60.0	2	2	100.0
Other countries	29	0		27	0		30	0	
Total	100	34		100	36		100	29	
In sample, not in Top 100		0			2				
Total sample		35			38			29	

Note: The banks in 1990 that are in the sample but outside the Top 100 are Standard Chartered and Fortis (ASLK-CGER)

Figure 9.4. *Geographic asset distribution Top 100 banks*



Summarizing, a sample based on the five largest banks for eight countries with the benchmark year 1995 has led to a group of banks with relatively stable characteristics. The choice of size as a selection criterion implies that the banks, in terms of assets, capital or profitability, form a large part of the largest 100 or largest 1000 banks in the world. There is no indication that they have a relatively higher share of profitability or capital though. Based on asset size, the concentration in the sample has remained stable and low between 1980 and 2000. There have however been shifts in relative sizes: for example, the Japanese banks dominated the sample in 1990.

#### 9.4. Overview financial developments sample

After the introduction of the sample, characteristics of the sample are examined that can play a role in the patterns of internationalization (Part II) or the effectiveness (Part III). First, summary statistics of the sample are presented (9.4.1), where also the influence of exchange rate movements is considered, and the ratio of bank assets to GDP is calculated to assess the relative size of the banks in the sample. Next, the drivers of profitability and capital strength are analyzed. Change in income structure is discussed (9.4.2), the development of costs between 1980 and 2000 (9.4.3), and the major provisioning events are reviewed (9.4.4). Finally, profitability for the sample is considered (9.4.5), as well as the changes in banks' capitalization (9.4.6).

##### 9.4.1. Key figures, asset growth and asset size

The banks in the sample reported total assets of 2,211 billion US dollar in 1980; the asset size of the sample increased assets fivefold to 13,585 billion US dollar in 2000. The average bank in the sample showed a compounded annual growth rate of 10.4% during that period; average gross income showed similar growth rates of 11%. Growth in the

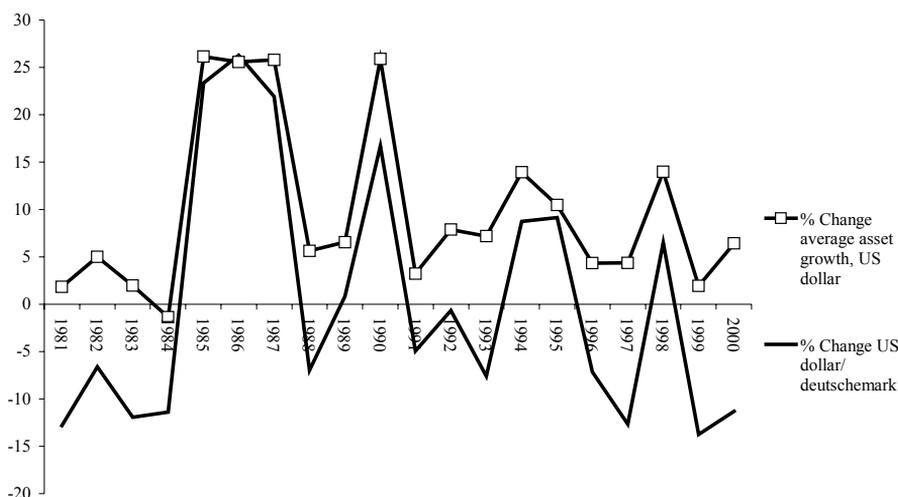
number of employees on the other hand was lower between 1980 and 2000. The average number of bank employees increased by 1.6% per year between 1980 and 1990. Between 1990 and 2000 this rate of increase picked up to 6.0% on a yearly basis.

Table 9.10. *Basic statistics for the bank sample*

	Total sample				N	Average bank in sample			
	Assets, mln US dollar	Capital, mln US dollar	Income, mln US dollar	Staff, number		Assets, mln US dollar	Capital, mln US dollar	Income, mln US dollar	Staff, number
1980	2,211,857	79,946	63,020	1,197,667	34	65,055	2,351	1,854	35,226
1985	3,000,886	104,156	92,945	1,281,961	34	88,261	3,063	2,734	37,705
1990	6,716,134	274,836	197,020	1,472,773	37	181,517	7,428	5,325	39,805
1995	10,087,788	476,007	296,041	1,534,484	37	272,643	12,865	8,001	41,473
2000	13,583,635	661,131	437,494	2,078,646	29	468,401	22,798	15,086	71,677

The growth rates of both average gross income and total assets have been particularly strong between 1984 and 1987.<sup>8</sup> This has partly been the result of exchange rate movements of the US Dollar, illustrated in Figure 9.5 where the yearly average asset growth is compared with the yearly change of the US dollar / deutschemark exchange rate, assuming the German currency to represent continental Europe.

Figure 9.5. *Total average assets and yearly growth rate*



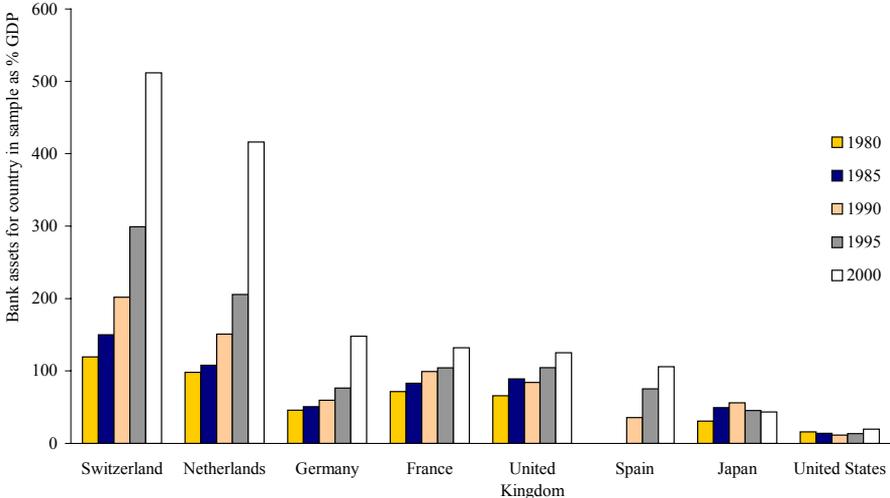
Note: a positive (negative) % change of US dollar/deutschemark indicates a depreciation (appreciation) of the US dollar against the deutschemark. Source: OECD. Exchange rates at end-of-year value.

<sup>8</sup> See Figure 8.9 in Chapter 8 for exchange rate movements of the deutschemark and Japanese yen against the US dollar.

The figure shows that asset growth has been consistently higher than the exchange rate movements. The parallel movement of asset growth and exchange rate indicate that translating total assets reported in local currencies to US dollars produced a major currency translation effect, boosting year on year growth rates in US dollars.

Banks have been selected in the sample based on their size. To assess the magnitude of large banks, total assets can be compared to GDP. This ratio serves as a proxy for the relative importance of banking intermediation to the economy.<sup>9</sup> Based on the ratios in Figure 9.6, a tentative conclusion might be that disintermediation is not visible in our sample, perhaps the opposite. From 1980 to 2000 banking assets in the sample as a ratio to GDP have been stable in Japan and the United States. An increase is visible in the other countries, implying that asset growth was larger than GDP growth.

Figure 9.6. Assets bank in sample as a ratio of GDP



Source. GDP figures OECD

The ratio of bank assets to GDP is the highest for banks in the sample located in countries with smaller economies, Switzerland and the Netherlands, confirming that small home market as an incentive to internationalize might be relevant to investigate in Part 3. For most countries, the ratio of bank assets to GDP also suggests that banks in the sample have accumulated assets at a rapid pace.

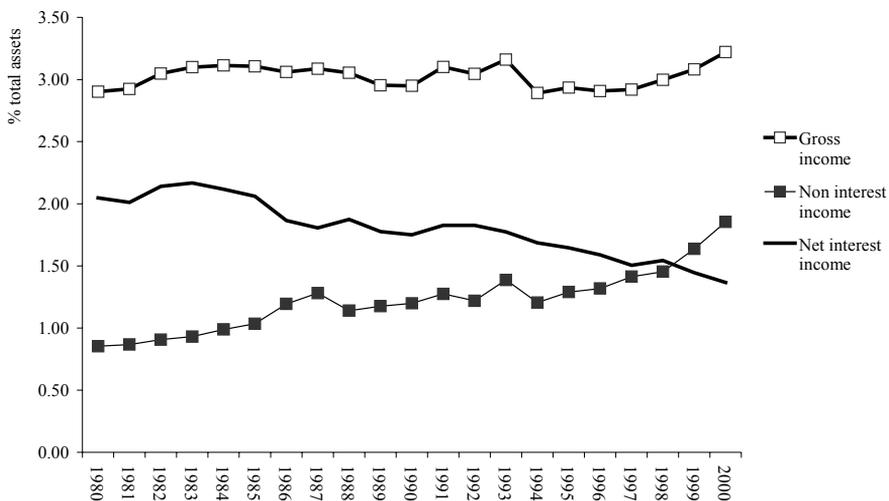
<sup>9</sup> Cf. Demirgüç-Kunt and Levine (2001). This ratio can be interpreted as a combination of two ratios; 1) the ratio of banking assets in the sample to total financial assets in that country and 2) the ratio of total financial assets to GDP of that country. The first ratio signifies the relative market power of the banks in the country, whereas the second ratio represents the relative financial development of the country, analogous to Goldsmith (1969).

### 9.4.2. Change in income structure

The income structure of banks, consisting of net interest income (spread between funding and loans) and non-interest income (fees and commissions), has changed between 1980 and 2000 for the sample: net interest margin has declined for banks, especially in the 1990s, while non interest income steadily increased between 1980 and 2000. Gross income, i.e. net interest income and non interest income combined, has increased slightly over the two decades.

In other words, the shift from interest income to non-interest income on average has not led to a structurally higher gross income over the whole period. This corroborates the earlier finding that growth rates of gross income and total assets were closely aligned. Between 1980 and 1983, gross income increased from 2.8% to 3.2% mainly due to an increase in non-interest income. After 1987 hat a volatile period set in with gross income showing results between 2.8% and 3.3%, receding to 3.3% once more in the latter half of the 1990s.

Figure 9.7. *Net interest income, non interest income and gross income for banks in sample*



Note: Gross income, non interest income, net interest income weighted by total assets in US dollar

Table 9.11 presents the sources of income for banks per country, and per five year period. Banks in the United States have enjoyed the highest net interest income as a percentage of average assets.<sup>10</sup> In fact, net interest income of American banks steadily increased from the early 1980s for almost a decade.

<sup>10</sup> That is, net interest income in local currency as a ratio of the average of begin of year assets and end of year assets in local currency.

Table 9.11. *Key indicators income structure of banks in sample, per country*

		France	Germany	Spain	Switzer- land	United Kingdom	Nether- lands	United States	Japan
Gross income, % total assets	1981-85	3.18	2.42	na	2.40	4.51	2.88	3.81	1.56
	1986-90	3.14	2.43	na	2.60	4.97	2.85	5.26	1.48
	1991-95	2.89	2.32	3.84	3.16	4.46	3.31	5.70	1.62
	1996-00	2.66	2.00	3.99	3.06	4.07	3.09	5.32	1.79
Net interest income, % total assets	1981-85	2.33	1.62	na	0.89	3.06	2.17	2.63	1.18
	1986-90	1.96	1.54	na	1.00	3.08	2.00	2.99	0.85
	1991-95	1.77	1.41	2.51	1.08	2.46	2.17	3.07	1.05
	1996-00	1.24	0.91	2.35	0.70	2.24	1.75	2.58	1.01
Non interest income, % total assets	1981-85	0.83	0.81	na	1.51	1.45	0.71	1.18	0.36
	1986-90	1.13	0.90	na	1.60	1.88	0.85	2.27	0.63
	1991-95	1.11	0.91	1.33	2.08	2.00	1.14	2.63	0.57
	1996-00	1.42	1.09	1.65	2.36	1.83	1.34	2.73	0.77
Non interest income, % gross income	1981-85	25.91	31.95	na	62.92	32.11	25.19	30.66	24.44
	1986-90	36.26	35.11	na	61.46	37.78	30.06	43.42	42.81
	1991-95	39.81	40.83	34.36	65.65	44.86	33.51	46.96	32.46
	1996-00	54.00	51.95	40.45	76.24	45.22	43.02	53.55	42.08

Note: averages weighted by total assets in US dollar, except non interest income as % gross income, weighted by gross income in US dollar. na: not available.

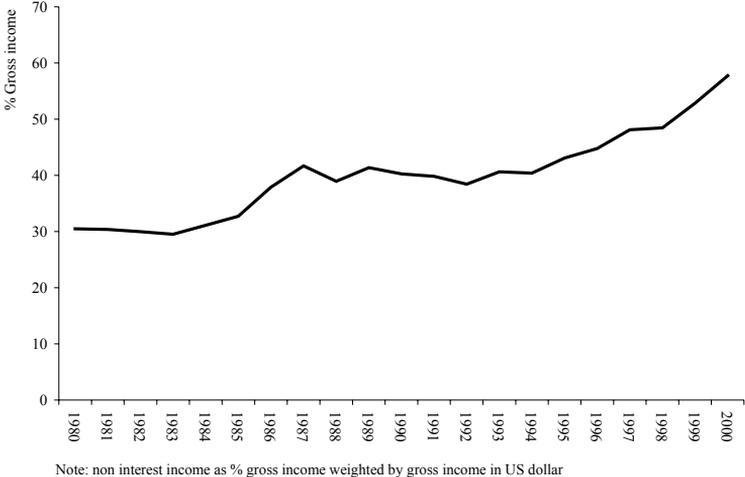
On the other hand, net interest margin earned in the United Kingdom has been constantly decreasing, starting out as one of the most attractive earning possibilities in 1980. The trend for German and Dutch banks has developed quite similarly over the period, showing a real but modest decline since 1995. Japan on the other hand has shown the lowest income potential throughout the period. For all banks, the net interest margin in 1996-2000 was lower than in 1981-85. The table also shows that the relative decrease in net interest margin varied among countries.

If banks had exploited differences in net interest margin, then Japanese banks would have felt the greatest urge to exploit differences by undertaking activities outside Japan. The choice of host country might be of lesser importance since benefits could be gained in each country. German and Dutch banks would have an incentive to set up activities in the United Kingdom and the United States. Bank setting up activities in Japan cannot have been motivated by interest income differentials; and banks in the United Kingdom stood only to gain from activities in the United States, after 1990. Finally, if banks in the United States had set up foreign activities, they must have been motivated by other incentives than the exploitation of net interest margin.

The shift from interest income to non-interest income is in general viewed as banks' response to disintermediation (Figure 9.8), where the line represents the percentage of non-interest income to gross income. For the largest banks the shift from interest income to non-interest income has gradually moved from 30% on average in 1980 to almost 55% in 2000. This structural change of business model eased somewhat between 1990 and 1994. During this period non-interest income decreased slightly; economic recessions in 1991 in

the United States and 1994 in Germany slowed down growth of capital market activities while net interest margins were upheld. This temporarily increased the relative importance of interest income. After 1994 the trend towards an income structure with relatively more fee income was reinstated.

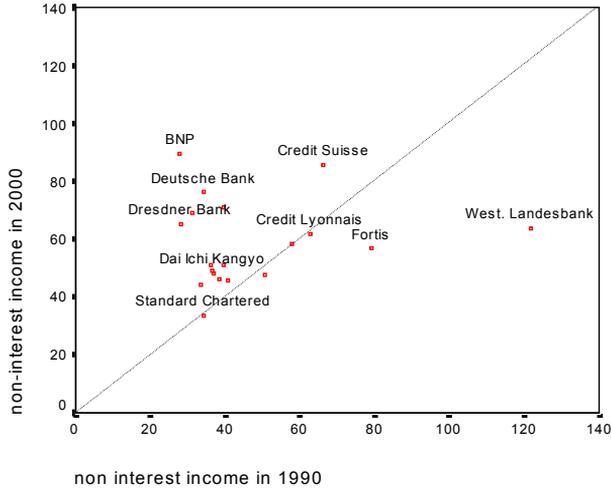
Figure 9.8. *Non interest income, percentage of gross income*



A large number of banks changed the ratio of interest income to non interest income. To illustrate this, the ratio of non-interest income as a percentage of gross income is displayed in Figure 9.9 for 1990 (horizontal axis) and compared to 2000 (vertical axis). Markers on the diagonal line would indicate banks whose ratios have not changed between 1990 and 2000.

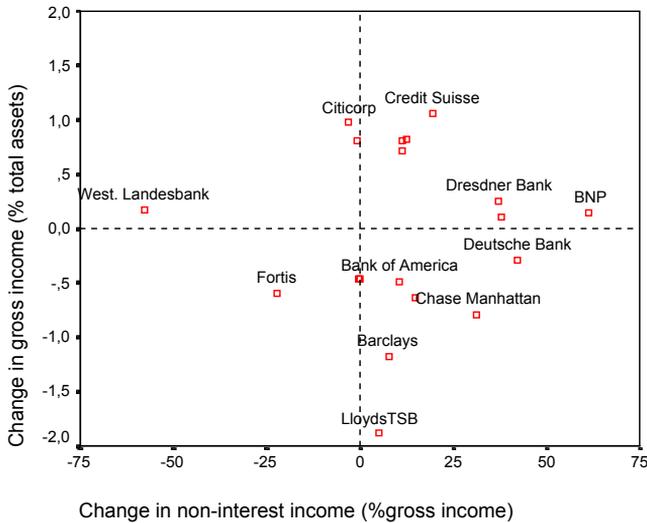
Two banks are below the diagonal line, indicating a relative decrease of non-interest income. In the case of Fortis, the acquisition of Belgian Generale Bank in 1998 increased its dependency on interest margin considerably. Westdeutsche Landesbank is an outlier; it reported negative net interest income in 1990, raising the share of non-interest income in gross income over 100%. An opposite change of profile is shown by BNP, whose acquisition of Paribas in 1998 raised its dependency on non-interest income considerably. Similar explanations can be given for Deutsche Bank (acquisition of investment bank Morgan Grenfell in the United Kingdom and investment bank Bankers Trust in the United States) and Dresdner (acquisition of British investment bank Kleinwort Benson).

Figure 9.9. *Non-interest income as % gross income in 2000 versus 1990*



The number of banks who have increased their non interest to gross income ratio and also raised gross income equals the number of banks who increased their non interest to gross income ratio but did not increase gross income ratio. There is no visible relationship between change in gross income and change in the share of non-interest income; this is illustrated in Figure 9.10 where the change in non-interest income as a percentage of gross income between 1990 and 2000 on the horizontal axis is compared to the change in gross income as a percentage of assets between 1990 and 2000.

Figure 9.10. *Change in gross income and share of net interest income between 1990 and 2000*

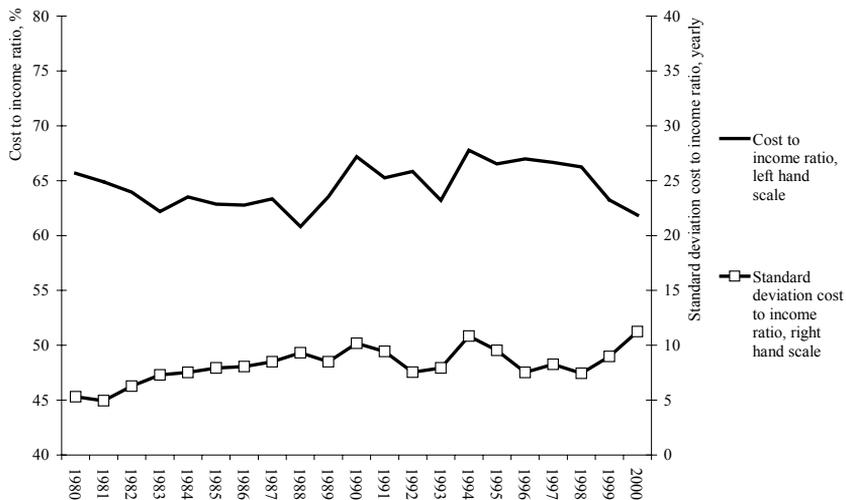


For banks on or near the vertical zero-axis the relative importance of non-interest income stayed the same between 1990 and 2000. However, they have managed to increase income (Citicorp) or decrease income (Commerzbank, Lloyds TSB) suggesting major changes. For example, a change in the kind of clients the banks do business with might have changed, or the geographic composition of business has changed. For banks on or near the horizontal zero-axis, the business mix changed between 1990 and 2000, but this has not increased gross income. Banks on or near that axis are Chase Manhattan, Dresdner Bank and BNP. Apparently, the acquisition of non-interest activities in either 1998 (Paribas by BNP) or 1995 (Kleinwort Benson by Dresdner) has had no material effect on the level of gross income. A drawback of this analysis is that the business mix might have changed strongly, perhaps even lowering gross income. If this were to be compensated by higher efficiency advantages, lowering the costs, then a causal relationship could be pinpointed at.

#### 9.4.3. Costs

Profitability is influenced by the operational costs bank incur, the provisions they have to make on their loans and the development of the bank's capital. The operating expenses of a bank can be summarized as a ratio of operating expenses to gross income, yielding the cost to income (CI) ratio.<sup>11</sup>

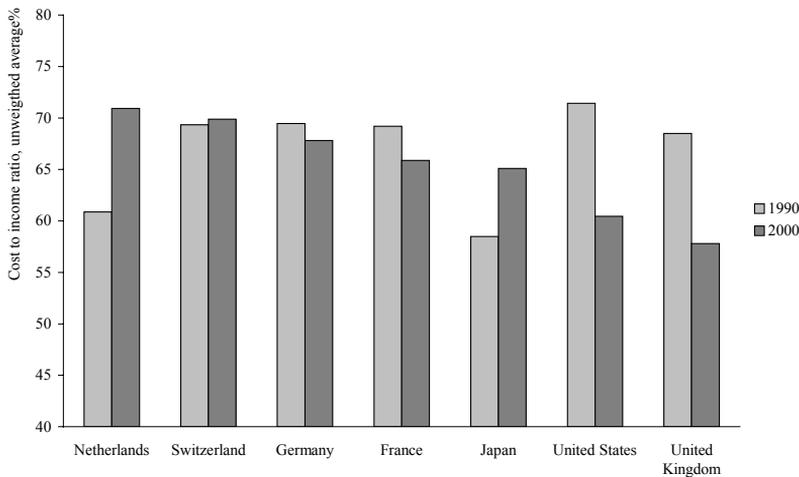
Figure 9.11. Cost to income ratio



<sup>11</sup> The rationale of looking at the cost to income ratio is the use of the ratio as a key measure of bank efficiency (Dijcke, 2001, p. 299). A change in the CI ratio heavily determines the change in profit before tax. A problem with the cost to income ratio is that it does not account for the fact that some product mixes cost more to produce than others (Dijcke, 2001, p. 324). Changes in the CI ratio should be related to either gross income and/or the composition of gross income, as noted earlier.

The swings in CI ratio are not uniformly distributed among banks: on a yearly basis there is no relationship between the change in CI ratio and the dispersion of CI ratio among banks, measured by the yearly standard deviation of CI ratios of the banks in the sample. If the CI ratio changes and the standard deviation decreases, then the change might apply to a large group of banks pointing to general market events that influence all banks in the same way. Between 1990 and 1992, and 1994 and 1996 were such periods observable. In both periods, the CI ratio decreased. Generally, a lowering of the CI ratio tends to be accompanied with an increase in the standard deviation, suggesting that a minority of the banks cause the major changes in CI ratio shifts. From a country perspective, the cost to income ratio has varied between countries as well as between periods (Figure 9.12).

Figure 9.12. Average cost to income ratios, per country



British banks and American banks showed a strong decrease in CI ratio between 1990 and 2000, Dutch and Japanese banks on the other hand showed the strongest increase. Based on this sample, banks from the same country tend to show similar CI ratios, probably due to different institutional settings.<sup>12</sup> Significant differences in CI ratios between the United Kingdom, United States, Japan and the other European countries are found, whereas no significant differences between the United States and the United Kingdom are observed.

<sup>12</sup> Using ANOVA comparing CI ratios for five year periods per country. Between 1986-90, the CI ratio of Japanese and Swiss banks was significantly lower than other banks, the main differences are found between the United Kingdom, Japan, the United States and other European countries. A decade later, between 1996-2000, Japanese banks still showed lower CI ratios with p values < .05 compared to other banks, as did banks in the United Kingdom. Although the banks in the United States also reported lower CI ratios compared to most countries, the mean only differed significantly from Dutch and Japanese banks.

Figure 9.13. Cost income ratios for banks in sample in 2000

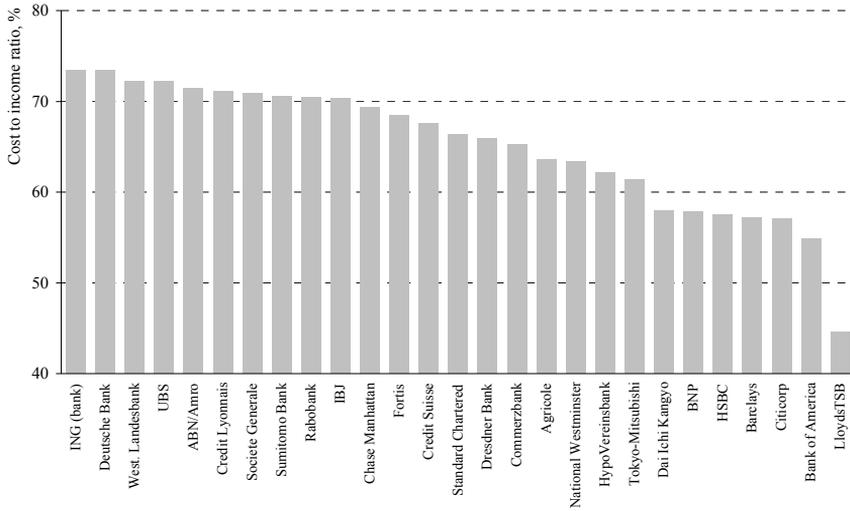
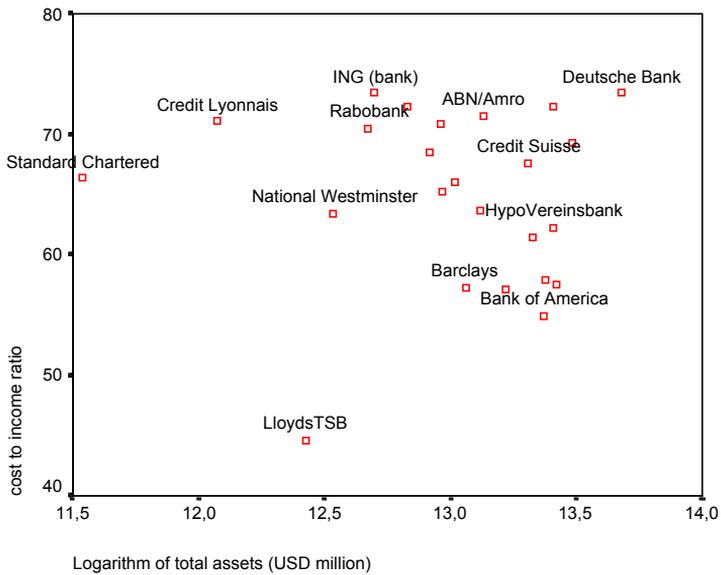


Figure 9.14. Relationship between asset size and cost income ratio in 2000



The CI ratio as a measure of bank efficiency can also be used to determine whether there is a possible relationship between asset size and efficiency. The existence of economies of scale suggests that aggregate costs are lowered when the right amount of asset size is chosen (Van Dijcke, 2001, p. 299). This relationship is not traceable in the sample between 1990 and 2000, Figure 9.14 illustrates this for the year 2000.<sup>13</sup>

The composition of the sample might result in a non-relationship between the CI ratio and asset size: if efficiencies occur through scale enlargement it probably takes place with smaller banks, which are not part of the sample. Also, the relative weakness of UBS in 1997 and Bankers Trust in 1998 preceded the emergence of the two largest banks at the time (Danthine, 2000). The creation of Japanese Mizuho in 2000 would be another example of banks with weak financial positions merging into larger banks. In other words the findings agree with the research about the relationship between bank size and efficiency, and the limited evidence to support it.<sup>14</sup> Similarly, no relationships have been found in this sample when the level of CI is related to the level off gross income to assets and/or the composition of income.

#### 9.4.4. Provisions

Swings in provisions are more pronounced. Figure 9.15 represents total provisions as a percentage of net income<sup>15</sup>, resulting when operating expenses are deducted from gross income, and as a percentage of total assets.

Provisions did rise in 1981 from 26 to 30% of net income because of the debt crisis in Eastern Europe. The increase in provisioning is especially visible for German and French banks, which were also the main stakeholders. The announcement by Mexican and other Latin American governments to defer payments and following rescheduling of debt forced provisions up from 29% to 42% of net income in 1982. In 1987, the banks in the sample began to realize that a large portion of the LDC loans was not to be repaid, and provisions soared to over 80% of net income. The resolve of the LDC debt crisis forced provisions up in 1989, to almost 65% of net income. For 1987 and 1989, the provision peaks are observable when expressed both as a ratio of total assets and net income. 1998 is different in this respect. As a percentage of assets, provisions do not differ substantially from the long-term average. However, absence of change in gross income, a slightly higher CI ratio, and a modest rise in provisions to assets caused a substantial rise in provisions to net income.

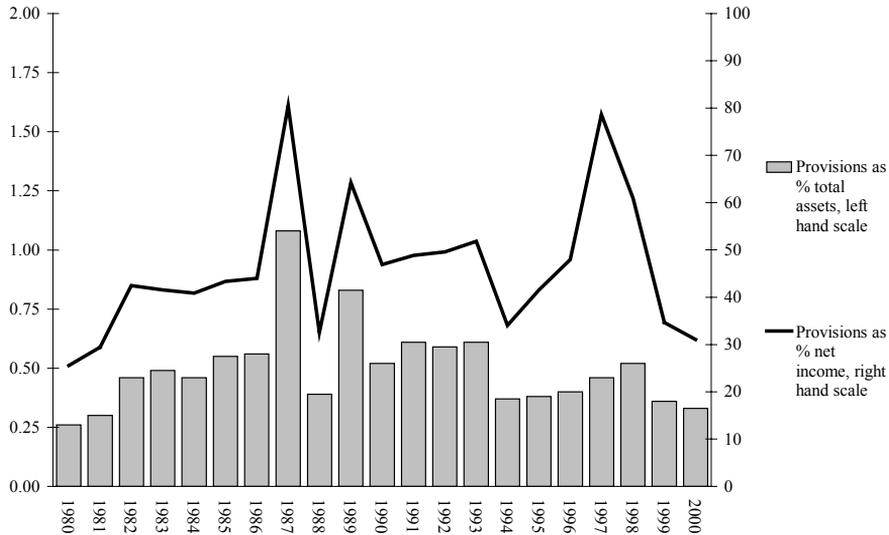
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<sup>13</sup> Relationship between CI ratio and asset size have also been tested with proxies for country and/or proxies for the year, neither of which added any explanatory power. Finally, the relationship has been examined on a bank level to see whether there are interaction effects. As might be expected by chance, one bank showed a significant relationship between CI ratio and asset size. This is contrary to Majahan et al. (1996) who found that for American banks, internationalized banks showed different cost structures than domestic banks, suggesting that internationalizing banks are able to better exploit economies of scale.

<sup>14</sup> See Dijcke (2001, pp. 300-306) for an overview of bank efficiency research.

<sup>15</sup> Total provisioning: loan provisioning + extra ordinary provisioning charges

Figure 9.15. Provisions



With hindsight for 1987 and 1998, provisions probably have been "overdone". In both years the provision levels the year after were extremely low, suggesting a "big dip" strategy: bank management realized that extra provisions were unavoidable, and probably included other possible negative events for the near future in the provision amount.<sup>16</sup> On a bank level, provisions have not been uniformly as high for all banks. On a yearly basis the standard deviation is the highest for the three top provision years (1987, 1989, 1998), indicating that while these crises have raised provisions for all banks, they have increased provisions dramatically for some banks. This is demonstrated in Table 9.12. The highest provision rates for 1998 do not reflect the average increase due to the LTCM/Russia crises but are country specific: the domestic banking problems in Japan.

Table 9.12. Top five highest provisioning in 1987, 1989 and 1998

Rank	1987		1989		1998	
1	Manufacturers Hanover	3.04	Lloyds	4.08	Dai Ichi Kangyo	1.81
2	Lloyds	2.83	J.P. Morgan	2.29	IBJ	1.32
3	Midland	2.57	Manufacturers Hanover	2.20	Tokyo-Mitsubishi	1.23
4	Chase Manhattan	2.41	Midland	2.05	Sumitomo Bank	1.19
5	Standard Chartered	2.19	Chase Manhattan	1.61	Standard Chartered	0.91
Average sample		1.17			0.86	0.49

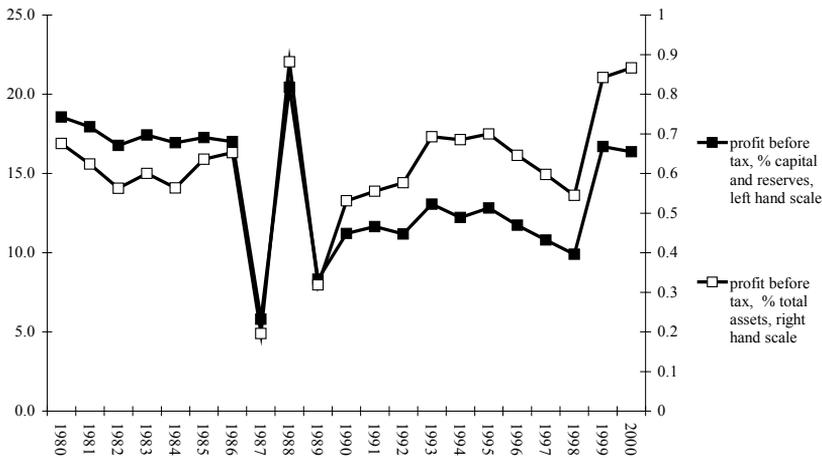
Source: annual reports. Between brackets provisions as a percentage of total assets.

<sup>16</sup> All things being equal, the year after the provisioning would show a strong profitability rebound: not only are provisions lower the year after, but the capital basis is probably also reduced, lowering the denominator in the ratio.

### 9.4.5. Profitability

Profitability is calculated as profits before tax as a ratio of capital and reserves, or as a ratio of total assets. A number of elements are familiar: the low extremes of 1987, 1989 and 1998 can be traced back to provisioning. Differences in the two profitability indicators point to relative changes in the capital/assets ratio, displayed in Figure 9.17. For the total sample, profitability has been high between 1981 and 1986 (17-18%), followed by a transitional period in 1987-89. From 1990 onwards profitability has been relatively stable, averaging 11-13%, following by a decline under 10% in 1998 and an uplifting in 1999-2000.

Figure 9.16. Profitability of largest banks, 1980-2000



Note: profit before taxes are weighted by total assets, capital and reserves in US dollar

If the highest and lowest periods of profitability are compared, then the French and Japanese banks stand out. The French banks achieved the highest profitability in 1981-85, and the lowest in 1991-95. Even more pronounced are Japanese banks, reporting the highest profitability between 1986 and 1995, followed by a period of negative profitability. For both groups of banks, periods of relatively high profitability were followed by relatively low profitability.

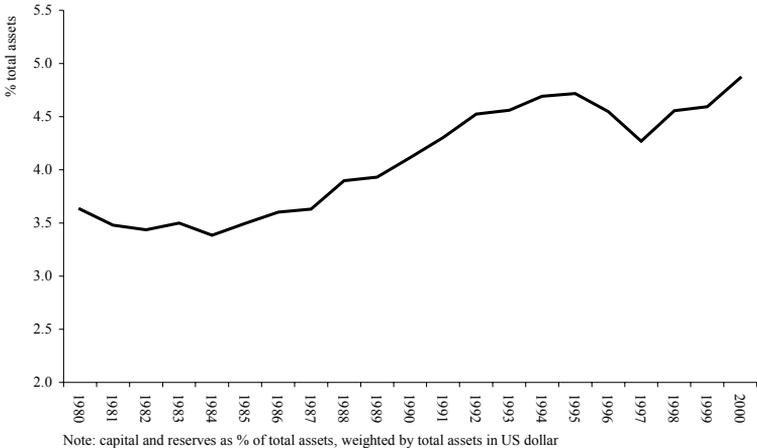
### 9.4.6. Capitalization

The difference in profitability for the period up to 1986 and from 1989 onwards can also be related to a change in capitalization: when capital increases at a different pace than profits, then this affects the profitability ratio. Capitalization of the banks was under pressure in the early eighties, to rise over five percent in 1995. Deterioration in 1996 and 1997 is probably due to a combination of temporary higher asset growth and more sophisticated capital management. Temporary asset growth can be the result of acquiring

assets at a higher market value than the one the bank is valued at, on average decreasing capital.

A changing approach to bank capital management resulted from the growing focus on bank solvency at the end of the 1980s, leading to the Basle accord where standards were introduced how to measure capital and to calculate risk based capital. Also, a distinction was introduced between core capital (tier one, the basis provided by shareholders and retained profits) and secondary capital (reserves, preferential securities). In the latter half of the 1990s new financial instruments were introduced, designed to serve as tier two capital, shifting (rather expensive) capital away from tier one to tier two. Here only tier one capital is shown.

Figure 9.17. Capitalization



9.5. Summary

- The banks in the sample grew considerably in size between 1980 and 2000. They have especially increased in size in Switzerland and the Netherlands if compared to GDP, while their share has remained stable in countries like Japan or the United States. Gross income showed on average the same growth rates as assets; employee growth was for the whole period lower than asset or income growth, moderately picking up in the 1990s. This suggests an increase in scale and productivity for the whole period, and for the 1990s a shift to relatively more labor intensive activities in the sample such as retail banking.
- Average gross income as a percentage of assets has been relatively stable during the whole period, with structural differences in levels between countries. The composition

of income has changed considerably for most banks, shifting from interest income to non-interest income.

- Costs showed no change on average between 1980 and 2000. On a country basis, there are significant trends observable: American and English banks have reduced their costs considerably, especially since the 1990s, while Dutch, Japanese and Swiss banks have increased their costs considerably since the 1990s.
- Provisions have had a major impact on profitability. From 1982 onwards, general provisioning levels were raised peaking in 1987 and 1989 as the result of the LDC debt crisis. In the 1990s Japanese banks stand out with high provisioning levels. The 1998 Russia LTCM crisis raises provisioning levels once again, but also shows some learning effects: due to less concentrated exposures compared to the 1980s, no individual bank stands out.
- Profitability, i.e. profit before tax as a percentage of capital and reserves, on average moved between 15 and 20% between 1980 and 2000, with strong swings in 1987-1989 due to high levels of provisioning not only affecting profits but also capital strength. The average bank increased its capital strength between 1984 and 1994.

# 10 Internationalization developments

This chapter introduces and applies the Transnationality Index (TNI) as the measure in this study to capture the internationalization of banks in the sample. Trends are then analyzed and internationalization of banks is examined from different angles: the changes in internationalization between 1980 and 2000 analyzed, as well as differences in internationalization between countries.

## 10.1. Key internationalization indicators

The aim of this study is to measure and to analyze the level of internationalization of the banks in the sample. There are different approaches to measure a banks' degree of internationalization, and estimating the degree of internationalization of a firm or bank is to some extent arbitrary. An initial approach could be to construct a single item indicator; Sullivan (1994) reviewed 17 studies which all applied a single item indicator to measure the degree of internationalization, i.e. foreign sales to total sales. However the use of a single item indicator increases the potential error of measurement, because it is for example more prone to external shocks. An alternate approach is to combine several indicators into one index. Depending on the choice of indicators, this might provide a better approximation of the degree of internationalization, but the choice of indicators may be restricted on data availability rather than theoretical induction (Sullivan, 1994).

This study applies three single item indicators, which are combined in a composite index to analyze the degree of internationalization of a bank, the Transnationality Index (TNI). The TNI is one of the most cited indicators for internationalization (cf. UNCTAD, 1998; Van Tulder et al., 2001, p. 47). The index is expressed as a percentage and calculated as an unweighted average of 1) foreign assets to total assets ratio, 2) foreign gross income to total gross income ratio and 3) foreign employment to total employment ratio.<sup>1</sup> The collection of data poses some challenges however; appendices A and B review problems encountered with the data collection and how this has been solved.

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<sup>1</sup> See Van den Berghe (2003, pp. 129 - 135) for a review of research on the use of these internationalization indicators.

The general appeal of the TNI is that the degree of internationalization is presented in one scale, which by definition moves between 0 and 100. Also an internationalization index that incorporates income, staff and assets captures a richer picture of the bank's foreign activities than that which would be captured by income, staff and assets separately (cf. Sullivan, 1994, p. 338). Another attractive characteristic is that the TNI dampens the effect of finance companies or off shore funding constructions if a ratio were only based on foreign assets relative to total assets. A substantial amount of assets can a priori be expected to be located in tax havens or countries with lenient fiscal regimes. Such reported assets would be accompanied by low number of employees. Combining both employees and assets in the TNI would then create a more balanced view. The same argument also applies to investment banking activities that are concentrated in financial centers outside the home country; these activities tend to generate a relatively high degree of income with fewer employees.

A disadvantage of the TNI might be that the construction of such an index cannot take account of the effects of technological change. Changes in technology can for example raise productivity and increase the assets or income per employee; if these changes are distributed evenly over the total bank organization then its effect on the TNI is probably limited. If the ratio of foreign assets per foreign employee increases in the same amount as the ratio of domestic assets per domestic employee, then technological change has no effect on the TNI. From the mid 1990s however technological advances have had other geographic distribution effects. For example, the development of "internet" banks like ING Direct implies that the share of foreign assets and foreign income increases while staff and operations working for the internet bank basically remain at home. This might potentially depress the true extent of internationalization measured by the TNI.

Table 10.1 presents the key internationalization indicators for selected years between 1980 and 2000. The average bank in the sample has operated roughly one-third of its banking activities outside the home country between 1980 and 2000. The average TNI was 29% in 1980, remaining stable in the 1980s, rising to 39% in 2000. These percentages are consistent with the ones reported in the annual listings of the Banker from 1992 onwards. Other comparisons however are not available, the degree of internationalization for non-financial firms has been better documented. For the top 100 trans national (non-financial) corporations, as compiled for the UNCTAD World Investment Report, the average degree of internationalization moved between the 50-55% range between 1995 and 1998. Another measure of internationalization is the one compiled by the SCOPE project, where the degree of internationalization is determined for the 200 largest (non financial) firms worldwide. For the year 1995 an average TNI is reported of 29.7 agreeing with the banks' TNI to some extent; this however might simply be a coincidence.

Table 10.1. *Key statistics of internationalization indicators of total sample, selected years*

Statistic	year	Foreign/total assets	Foreign/total gross income	Foreign/total employees	TNI
Average <sup>a</sup>	1980	34.82	47.65	20.95	28.96
	1985	35.10	40.29	20.41	28.60
	1990	32.50	32.29	23.16	28.34
	1995	36.09	33.48	26.71	31.93
	2000	40.26	40.94	42.23	39.85
Weighted Average <sup>b</sup>	1980	21.97	55.61	27.40	34.99
	1985	24.64	43.83	28.18	32.65
	1990	31.31	32.94	27.28	30.51
	1995	38.76	34.56	31.16	34.82
	2000	40.29	39.09	42.17	40.51
Median <sup>c</sup>	1980	8.57	55.70	26.78	28.97
	1985	32.02	42.37	12.66	30.46
	1990	31.66	37.00	26.97	29.30
	1995	35.50	31.19	29.07	30.18
	2000	32.08	33.15	34.70	34.85

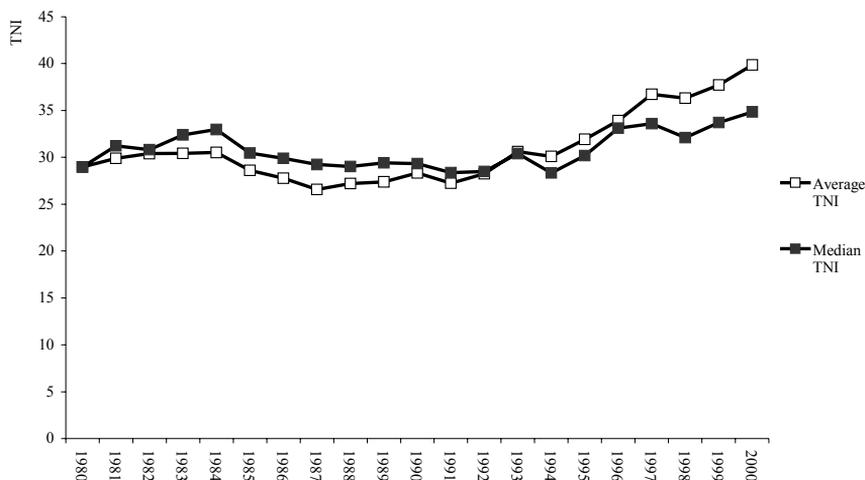
Note a: Indicators 1,2,3 and TNI are calculated as arithmetic average; the sum divided by the number of cases.

Note b: Indicators 1,2,3 are calculated as weighted averages. For example, foreign/total assets for one bank is weighted by the share of total assets of a bank in total assets of the sample, and then aggregated for all banks. For the TNI, the average of the weighted averages of indicators 1,2,3 is then calculated.

Note c: Indicators 1,2,3 and TNI are median values, i.e. the value above and below which half the cases fall.

For the bank sample, the decrease in the 1980s is mainly due to the decrease of foreign gross income. This decrease can largely be ascribed to English and American banks, on the one hand reducing their activities in LDC loans and selling off related activities outside the home country, on the other hand increasing the share of domestic activities. Figure 10.1 shows the trend in more detail, displaying average and median values for TNI.

Figure 10.1. Average TNI development between 1980 and 2000 (in %)



Initially in 1983-84, TNI was at its highest, declining until 1991. From that period, TNI increased again, reaching higher levels (both for median and average TNI) than in 1980. Between 1980 and 1993, median TNI was higher than average TNI, indicating that there were relative many banks with a low degree of internationalization. On the other hand, between 1994 and 2000 average TNI was higher than median TNI, suggesting a concentration of banks with relatively high TNI's.

The country averages for TNI can also provide useful information; if banks in a country are considered as separate groups, then the development of internationalization activities of banks has differed between countries. In other words, there is a certain country-of-origin effect observable in banking.<sup>2</sup> At the beginning of the 1980s, American and British banks showed the highest degree of internationalization. In the 1980s, the degree of internationalization decreased systematically for American banks, while this applied to British banks from the mid 1980s.

The ascent of Japanese banks in the late 1980s in the international banking arena also filled a relative void created by American and British banks in the 1980s. The

<sup>2</sup> Country averages have shown structural differences. For example, for TNI data from 1990 to 2000 the variability of the country means is tested with ANOVA, and the Bonferroni procedure has been applied to determine which country means are different. The average TNI from banks in Germany differ significantly (with p values < .05) from all other countries in the sample. Average TNI in the United Kingdom differs significantly from French, German, American and Japanese average TNI, but not from Dutch and Swiss. Finally, Japanese average TNI differs significantly from average TNI in the United Kingdom. Although the sample is small and these statistics should thus be treated with caution, it is an indication that country of origin matters in internationalization.

internationalization activities of Japanese banks increased until the early 1990s, their descent followed from the mid 1990s.

Table 10.2. *Average TNI values per country*

Country	1980		1985		1990		1995		2000	
	TNI	N								
France	19.73	5	24.93	5	26.75	5	30.53	5	31.38	4
Germany	8.45	6	8.95	6	12.17	6	23.20	6	39.04	5
Spain					20.39	3	21.34	4	57.72	2
Switzerland	31.95	3	31.69	3	41.30	3	42.78	3	67.39	2
United Kingdom	44.22	5	46.05	5	37.98	5	44.31	5	40.77	5
Netherlands	18.34	4	21.61	4	23.23	4	29.75	4	47.61	4
United States	49.06	6	39.77	6	31.77	6	32.88	5	27.24	3
Japan	28.05	5	28.13	5	33.14	5	34.20	5	27.20	4
Average	28.96	34	28.60	34	28.34	37	31.93	37	39.85	29

Note: the TNI is calculated as arithmetic average; i.e. the sum divided by the number of cases.

Continental European banks showed the strongest increase in degree of internationalization between 1980 and 2000; the largest banks from the Netherlands, Germany, Spain, France and Switzerland steadily increased internationalization in the 1980s, which accelerated in the mid 1990s. From 1994 onwards, the TNI increased steadily, mainly propelled by German, Dutch, French and Swiss banks. On average the TNI for British banks has increased in the 1990s; however the increase is caused by the addition of HSBC in the sample in 1992. The bank had a higher TNI than Lloyds, National Westminster and Barclays, but also increased its TNI throughout the 1990s while the other British banks did not. American banks tended to show decreasing TNI's at the end of the 1990s when domestic mergers in the United States raised the relative weight of domestic activities between 1990 and 2000. In other words, in the 1980s the reduction of TNI for American banks was caused by divestment of foreign activities, while domestic acquisitions in the 1990s reduced the average TNI of American banks.

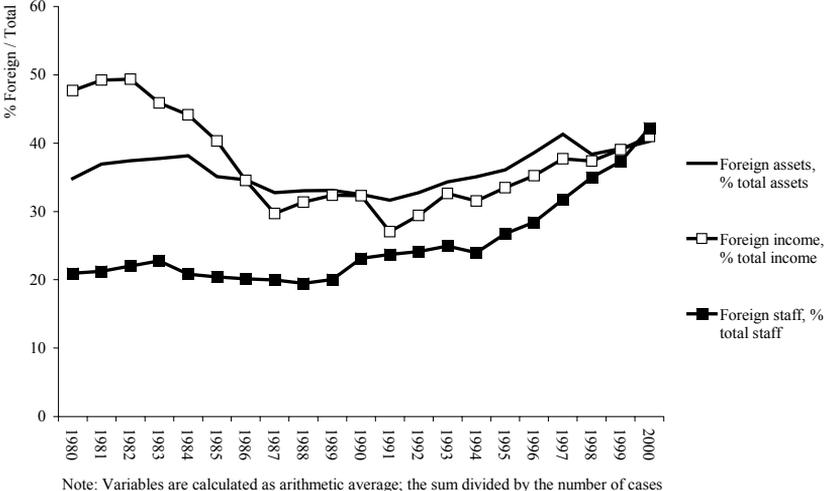
## 10.2. Ratio's

The individual components of TNI (foreign assets ratio, foreign income ratio, foreign staff ratio) provide additional information; they are presented in Figure 10.2. Foreign income was relatively high in the early 1980s, decreasing between 1983 and 1989, steadily increasing again since 1991. Foreign assets showed a similar pattern, but with less volatile changes than foreign income, especially in the 1980s. On the other hand, the ratio of foreign employees was relatively stable in the 1980s, but steadily increased in the 1990s.

The different trends of the underlying indicators illustrate that the combination of income, staff and assets captures a richer picture of the bank's foreign activities (Sullivan,

1994, p. 338). The three indicators suggest that internationalization up to the early 1980s was income driven, while the internationalization activities in the 1990s were both asset driven and employee driven. In other words, setting up and acquiring investment banking and corporate finance activities in the 1980s, while the major component of internationalization activities of bank in the 1990s consisted of acquiring retail banks.

Figure 10.2. Average development key internationalization indicators



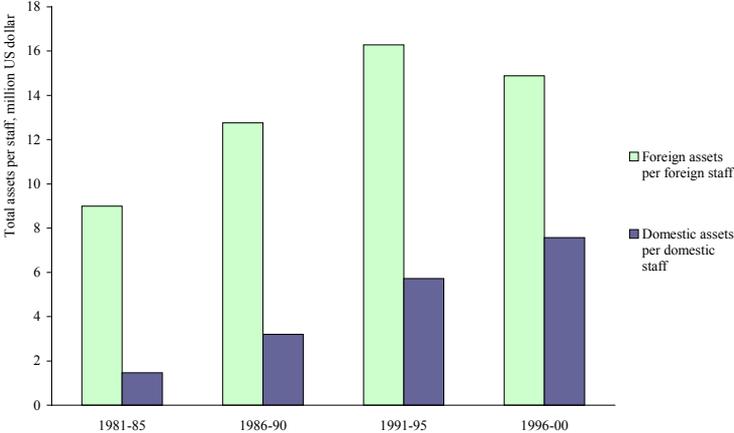
In Figure 10.3, average assets per employee and average foreign assets per foreign employee are displayed. Both indicate an increase in scale, but the relationship has shifted over the period. Foreign employees undertook activities with four times the average assets in 1981-85, this proportion decreased to one and a half times average assets between 1986 and 2000. For the whole sample, there appears to be a convergence of the three ratio's (foreign assets ratio, foreign income ratio, foreign staff ratio) in the 1990s.

Figure 10.3 confirms the earlier suggested change in change in composition of internationalization activities. From 1980 to 1990, a number of banks set up foreign activities in either financial centers concentrating activities there such as brokerage or corporate finance. Large loans (to foreign countries of foreign firms) were concentrated in those centers, leading to high assets to employee ratios. Besides that, assets were also located in centers outside the home country for fiscal reasons, needing few employees administering large assets. This has been especially the case for German banks, leading to a relative high ratio of assets to employees.

In the 1990s new activities were also developed; acquisitions in retail banking took place in a more rapid pace than in the earlier decade, creating more labor intensive activities for the banking organizations abroad which lowered the average foreign to assets ratio. Overall, the developments of the three indicators to construct the TNI suggest that the composition of internationalization activities at the end of the 1990s has become more

stable (in terms of relationship between foreign assets, income and staff) than in the early 1980s.

Figure 10.3. *Total assets per employee and foreign assets per foreign employee*



**10.3. Changes in TNI**

The degree of internationalization varies significantly between banks, as can be deduced from Figure 10.4. Changes in TNI for banks between 1990 and 2000 are presented in Figure 10.5. If the TNI of banks in 2000 is compared to 1990 (Figure 10.5), a large numbers of banks have increased their internationalization activities. The bank with the largest degree of internationalization in 2000 as well as 1990 is English bank Standard Chartered, Bank of America has the lowest degree of internationalization. Banks in continental Europe such as Deutsche Bank, ABN Amro, UBS and Credit Suisse have increased their foreign activities the most during this period. One bank in continental Europe has reduced its foreign activities, Crédit Lyonnais, as part of a restructuring strategy. Apart from Europe, Japanese banks have also reduced their foreign activities as a share of total activities.

Figure 10.4. *TNI levels in 2000*

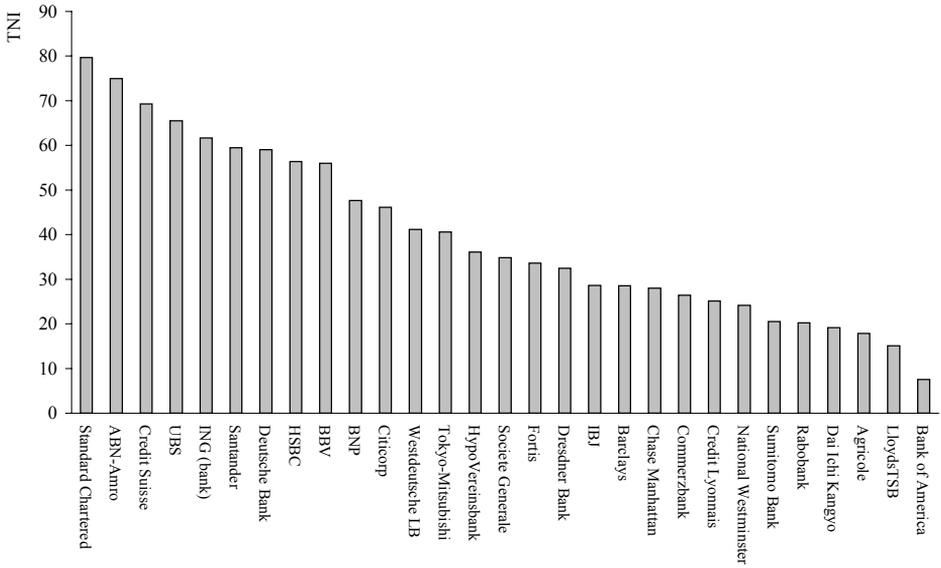
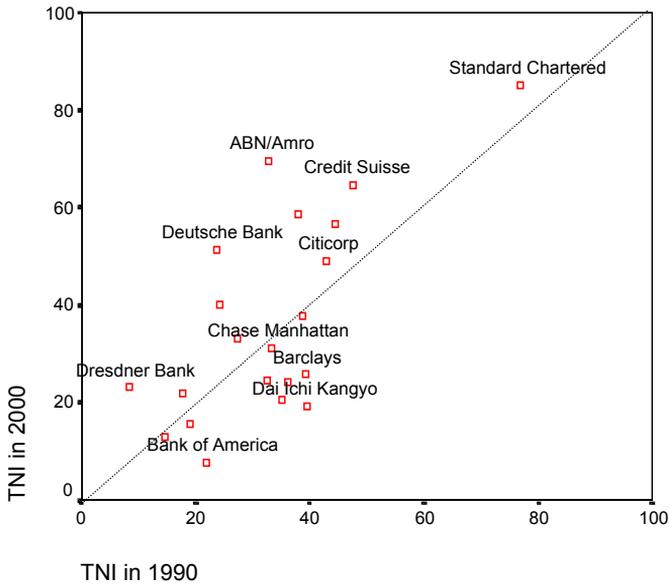


Figure 10.5. *Degree of internationalization in 2000 compared to 1990, measured by TNI.*



A drawback of comparing TNI in 2000 to 1990 is that it hides dynamic developments during the period itself. An alternative presentation of the development in

TNI is presented in Table 10.3 where changes in TNI are compared here to five years earlier.

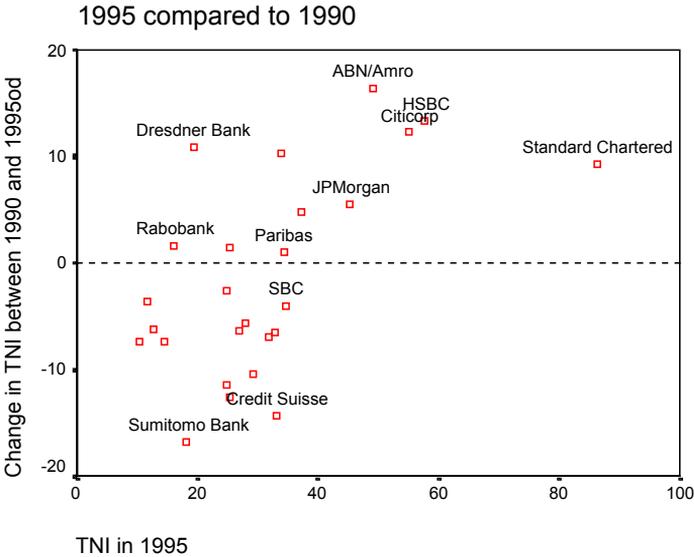
Table 10.3. Change in TNI compared to 5 years earlier

Period	< -25%	-25 to -10%	-10 to 0%	0 to 10%	10 to 25%	> 25%	Total
1985 compared to 1980		4	8	18	2	1	33
1990 compared to 1985	1	4	12	13	3		33
1995 compared to 1990		2	9	15	8		34
2000 compared to 1995		3	7	8	4	5	27

Note: the number of observations varies as the result of mergers and/or acquisitions. For example, Paribas did exist in 1995 but was merged with BNP in 1999, so a comparison between 2000 and 1995 is not possible.

For the 5-year periods displayed, over two third of the observations show changes in TNI ranging between -10% and +10%. The period 1990 versus 1985 stands out, where 17 out of 33 banks reported a negative change in TNI. The effect of these changes for the total level of TNI is demonstrated for selected periods in Figure 10.6 and Figure 10.7, showing the changes in TNI (on the vertical axis) and the resulting TNI (on the horizontal axis) for 1995 versus 1990 and 2000 versus 1995.

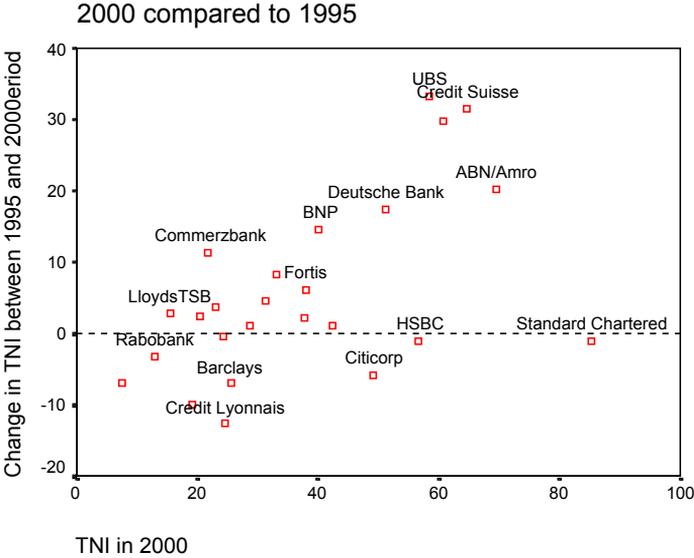
Figure 10.6. Change in TNI between 1990 and 1995 versus level of TNI in 1995



For the comparison of 1995 to 1990, all negative changes in TNI have led to overall levels of TNI in 1995 lower than 40%. Whether this 40% signifies something relevant

remains to be examined.<sup>3</sup> When the TNI change was positive, the dispersion in resulting TNI levels also became greater. German Dresdner bank basically set up most of its internationalization activities in that period, while internationally active banks like ABN Amro and HSBC increased the international activities by more than 10%. An outlier here is once again English bank Standard Chartered, showing the highest degree of internationalization without expanding its foreign activities. As one of the last remaining British overseas banks, it historically has enjoyed such high levels of TNI.

Figure 10.7. Change in TNI between 2000 and 1995 versus level of TNI in 2000



From 1995 to 2000 there are far more positive changes in TNI than from 1990 to 1995. Two Swiss banks show the largest change in internationalization, UBS and Credit Suisse. Major growth acquirers in the previous period like ABN Amro repeated the high levels of increase for 1995 to 2000. A few American banks (Citicorp, Bank of America) tended to exhibit negative changes, albeit from different perspectives. Citicorp remained highly engaged in international activities, broadly balancing foreign and domestic growth of activities, while the foreign activities of Bank of America decreased in importance through the domestic merger with Nationsbank and active divestitures in 1998.

More than in the previous period, there seems to be a positive relationship between change in TNI and resulting level of TNI: banks with already higher levels of TNI tend to expand their foreign activities most between 1995 and 2000. For 1995 to 2000 this seems

<sup>3</sup> For example, the 40% TNI level could be interpreted as a threshold below which stakeholders in the bank find the risks of internationalization manageable or the returns satisfying.

to be a tendency for the whole sample, for 1990 to 1995 this is only valid for TNI levels above 40%.

In conclusion, dissection of (changes in) TNI for five-year periods suggests that between 1990 and 1995 the decline in TNI was a broadly experienced phenomenon by many banks, while the largest increases in TNI took place between 1995 and 2000. Also (a non-statistically significant) positive relationship between change in TNI and resulting level in TNI is visible, confirming average trends seen in Figure 10.1. An explanation for this might be that some kind of experience curve exists: organization with TNI's above a certain level are better equipped to absorb more foreign activities.



# 11 Internationalization of Dutch Banks

Dutch banks consistently engaged in international activities between 1980 and 2000. Expansion through subsidiaries, representative offices and branches was the main strategy, steadily increasing TNI between 1980 and 1989. In 1990, when regulators no longer prohibited mergers between banks and insurers, Dutch banks changed their strategy and engaged in domestic mergers to create large universal banks or financial conglomerates with large and stable market shares in the Netherlands.

Table 11.1. *Incentives for internationalization Dutch banks*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: difference in net interest margin incentive to internationalize to the United States and the United Kingdom</li> <li>• Economic structure: High degree of financial assets to GDP, and relatively small GDP compared to large economies, Comparable with Switzerland</li> <li>• Regulation: Gradual relaxation separation activities in 1980s, consolidation insurers and banks. Between 1980 and 2000 no specific regulation for foreign banks; acquisitions by foreign banks tend to be poorly performing Dutch banks</li> <li>• Client: outward flow of FDI</li> <li>• Perception of the market. 1988-: European market as measurement scale. 1989-91: from banking market to financial services market, mergers banks and insurers</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: All banks part of banking clubs in 1970s. Dutch banks in the 1980s were generally less involved in LDC debt crisis. ABN Amro and ING followed similar strategies in the 1990s</li> <li>• Market power and concentration: From 1980s banking market has been divided four largest banks. Between 1989-1991: the high concentration broadened to insurance sector</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Foreign banks: limited role, occasionally acquiring (failing) banks</li> <li>• Economies: Cost-to-income ratio's have historically been among the highest, even after scale enlargement, efficiency decreased with large acquisitions in the 1990s.</li> <li>• Cost of capital: Relatively lower funding costs, due to stable financial domestic home base</li> <li>• Shareholder return: relatively low stock market valuations compared to other countries until the mid-1990s</li> </ul>

Over the next decade, they acquired large foreign financial institutions in the 1990s, transforming banks like ING group and ABN Amro into organizations that had more than 60% of their activities abroad in 2000.

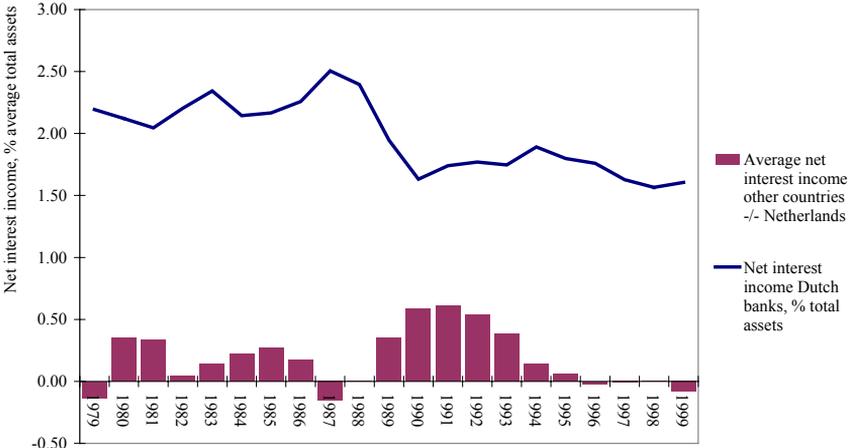
Table 11.1 summarizes the incentives for Dutch banks, which will be discussed in further detail (11.1).<sup>1</sup> The incentives have been discussed in chapter 3, where a framework was presented to cluster incentives for the banks to internationalize into *Extrinsic*, *Sector intrinsic* and *Bank intrinsic* incentives. Next, the banking strategies of ABN Amro, ING Group, Rabobank, Fortis and its forerunners are reviewed (11.3), and commonalities and differences in strategies are discussed (11.4).

### 11.1. Incentives

#### *Spreads, profitability*

For Dutch banks, difference in net interest margins between foreign and domestic markets has been an incentive. Figure 11.1 shows the net interest margin of Dutch banks, and the difference between net interest margins banks outside the Netherlands earned and Dutch banks. A positive difference indicates that Dutch banks theoretically stood to gain by funding and extending loans outside the Netherlands, regulation permitting.<sup>2</sup>

Figure 11.1. *Net interest income and net interest income differential between Dutch and foreign countries*



Source: calculated from OECD Bank profitability. Other countries: Unweighted average commercial banks in United States, Japan, United Kingdom, France, Germany, Spain and Switzerland.

<sup>1</sup> The incentives have been discussed in chapter three, where a framework was presented to cluster incentives to internationalize into extrinsic, sector intrinsic and firm intrinsic incentives.

<sup>2</sup> Theoretically, because one has also add a risk premium for additional country risk and the translation risk of foreign exchange.

Gross income has been persistently lower for Dutch banks since the early 1980s<sup>3</sup>. This is mainly due to the lower degree of non-interest income and can be interpreted as a) modest sized securities markets in the Netherlands, indicating a relatively high amount of bank intermediation consistent with a bank oriented system, b) a low degree of financial innovation, banks not being able to introduce new financial products to clients, and c) a tendency for Dutch banks to engage relatively more in asset gathering than other banks. In other words, both net interest margin as non-interest income were incentives for Dutch banks to internationalize.

### *Regulation*

Van Eerden (2001) characterized the regulatory development of the Dutch financial sector as a period of manifest deregulation from 1980 to 1992, followed by a search for new relations between regulators, insurance companies and banks since then. The main regulator was the Dutch Central Bank (DNB), with delegated powers from the Ministry of Finance, monitoring the development of the industry structure, and guarding the solvency of the individual banks.<sup>4</sup> Initially, objectives of monetary stability supervision prevailed over those of financial sector efficiency in the policy of the DNB (Prast, 2003). In 1981, a generic separation between banks and insurers was upheld, while it was allowed that the two types of institutions sell each others products. Rising interest rates and a collapsing housing market created a crises for the mortgage banks. Acquisitions of mortgage banks by insurers and banks were then allowed by the Ministry of Finance, allowing a softening of the industry policy strictly upheld in the 1970s. In the 1980s, tax issues became of great importance in the regulatory debate, when DNB tried to curb insurance intermediation by banks for their own account, leading to an unequal treatment of banks and insurers (Van Eerden, 2001, p. 374).

In 1987, the ministry of finance advocated a gradual liberalization of the financial services industry. The pace of liberalization up to 1990 was regularly slowed down by insistence of the banks (De Leeuw, 1996, p. 71). Banks and insurers wanted, if liberalization were to take place, a preparation period followed by a complete liberalization. Although there was initially a strong political opposition to liberalization, the European internal market created a momentum for change, especially with the development of the EU Second Banking directive, the Life Insurance directive and the internal market for the financial services industry in 1993. These developments motivated by the ministry of finance to change structure policy, and help to convince political parties that this was the road to take (Van Eerden, 2001, p. 374).

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<sup>3</sup> See Appendix D on page 569.

<sup>4</sup> Regulatory responsibilities for the banking sector are delegated to the Dutch Central Bank (DNB) by the ministry of finance. Through legislation, namely the WTK law (Wet Toezicht Kredietwezen), the way to supervise and the instruments to regulate are determined. Within the WTK the role for industry policy (*structuurbeleid*) is defined, formulating a strategy to organize the industry structure of banks, and more specifically the relationship between banks and non-banks. Furthermore, the Dutch Central bank can draw up memorandums, giving its binding interpretation of the *structuurbeleid* and thereby its view on how the Dutch banking industry should be organized.

Table 11.2. *Chronology regulatory regime Netherlands*

Year	Regulatory event	Effect on internationalization	Effect on entry foreign banks
1978	new WTK law prohibited, unless approved by DNB: <ul style="list-style-type: none"> <li>• financial participation &gt;5% in any firm</li> <li>• acquisition assets and liabilities</li> <li>• mergers or acquisitions</li> <li>• diminished shareholder influence if more than 5%</li> <li>• Ministry of Finance, not DNB final right of approval</li> </ul>	Stable home market	None, domestic and foreign banks under one regulatory regime.
1989	Privatization Postbank	None	None
1990	Memorandum "structuurbeleid" <ul style="list-style-type: none"> <li>• as of 1/1/'90 separation banking and insurance activities no longer prohibited</li> <li>• combination under holding company possible, full fledged legal merger prohibited</li> </ul>	Consolidation in home market complete for next decade	
1992	New WTK		European passport implemented
1998	New Bank Act <ul style="list-style-type: none"> <li>• Right for the government to give directions to DNB abolished (Prast, 2003)</li> </ul>		

The financial sector changed considerably when ABN and Amro announced their merger intentions in 1990. Although the DNB had been taken by surprise and had the power to refuse its approval to the merger, the argument that the merger would strengthen the bank's international competitive position especially convinced the DNB to approve the merger (Prast, 2003). Since 1990, all institutional barriers between banks and insurance companies have been removed, and in 1992 supervision of bank-insurance conglomerates were formalized. From 1999, the regulatory regime itself changed, combining the regulatory powers of banks, insurers and securities markets into one organization, motivated by the trend that beside the bank-insurer combinations, financial services also grew in complexity. The new financial products increasingly combined bank, insurance, and securities characteristics, increasing the need for integral monitoring (Docters van Leeuwen, 2001). In Table 11.2 major regulatory changes between 1980 and 2000 are presented.

The Dutch authorities have not developed a separate set of rules for foreign banks entering the Dutch banking market prior to the implementation of the European directives. Foreign banks were subjected to the same rules such as minimum capital, internal organization, and supervision. The entry of foreign banks was mainly stimulated when

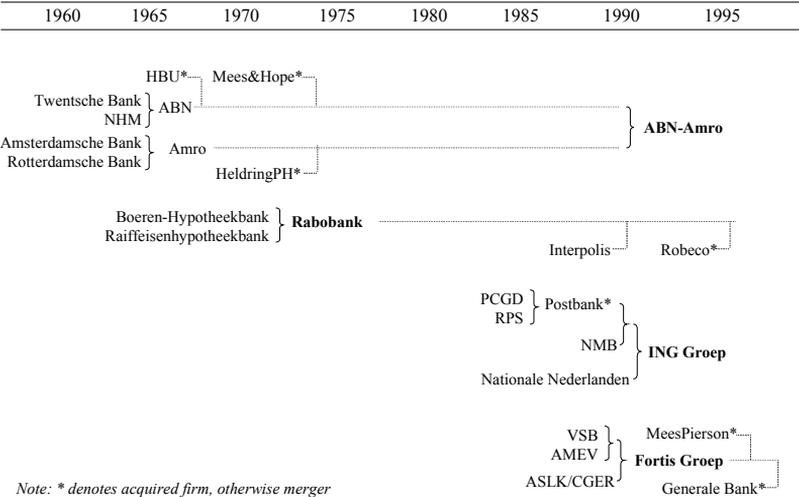
Dutch domestic banks were in dire straits, and needed to be bailed out. This was the case with the takeover of Slavenburg bank by Cr dit Lyonnais in 1987, the acquisition of Cr dit Lyonnais subsidiaries by Belgian Generale Bank in 1998, or the acquisition of a small bank by Dresdner Bank in 2000.

Summarizing, regulation in the Netherlands has not been a force in directing Dutch banks to an internationalization strategy. But on the other hand, it provided up to 1990 a protective environment for the banks to conduct their business (as in most other European countries), and perhaps a competitive advantage over a longer period by allowing mergers between insurers and banks at an early stage.

*Market power and concentration*

High concentration ratios were spurred by three periods of increased consolidation. The Dutch banking sector experienced a merger and consolidation from 1964 to 1974, followed by a further minor consolidation early 1980s to rescue failing (smaller sized) mortgage banks. From 1989 to 1992 a second large consolidation wave took place in the advent of unprecedented expansion of Dutch banks outside the Netherlands. How did changes in industry structure from 1980 onwards influence internationalization of Dutch banks strategies?

Figure 11.1. Main Dutch banks, domestic mergers and acquisitions



On average the Dutch banking sector was fairly stable between after 1974, at the end of the first consolidation wave, and 1989, when the second period of mergers and acquisitions after the Second World War took place. The mergers, creating ABN bank and Amro bank in 1964 and Rabobank in 1972, were domestically orientated and partly intended to capture the potential of the retail savings market. Competition for household

accounts was traditionally dominated by independent savings banks, the state owned savings institutions (Rijkspostspaarbanc and Postgiro) and co-operative agricultural banks. Retail savings caught the attention of Dutch commercial banks as a funding source for medium term loans, when increasing economies of scale in the Dutch industry led to larger financing needs, while at the same time the traditional source of funds for commercial banks, deposits by business clients and wealthy private clients, steadily declined in relative terms.

The merger of the Rabobank in 1972 was the last major merger until 1989.<sup>5</sup> In the years between, the major Dutch banks acquired (specialized) smaller Dutch banks; both ABN and Amro acquired merchant banks. ABN also steadily acquired smaller local banks throughout the country, incorporating them in its network. In 1982, most mortgage banks were acquired after a real estate crisis.

The announcement that merger talks between Amro bank and Belgian Generale bank failed marked the beginning of the second domestic consolidation wave. The failed cross-border bank deal forced banks to reconsider relative positions in the Dutch banking market (Laurie, 1990). In November 1989 the merger between the medium sized Nederlandsche Middenstandsbanc (NMB) and the partly privatized Postbanc was announced, followed by the news in December that Rabobanc and insurer Interpolis were discussing the possibilities of a bank-insurance merger. A merger between an insurer and bank was possible from January 1990 onwards, allowing banks to merge with insurance companies under a holding company structure. Insurer Amev acted upon it speedily by merging with medium sized savings bank VSB in January, initiating a larger cross border merger with Belgian insurer Groupe AG in April. Insurers were eager merger partners. Just as a number of banking areas, the ten largest insurers held 80% of the market, with margins under pressure under the threat of proposed changes to their tax treatment (Laurie, 1990).

In March 1990 ABN and Amro announced a full-scale merger, prompting anxious remarks about the accumulation of market power within one bank. The chairman of the Dutch stock exchange warned that ABN Amro, with their fully owned subsidiaries, would command a market share of almost 33% in securities trading, stifling any competition (Bakker, 1991). Some time later Rabobanc revealed that it was seeking a strategic alliance with the largest European bank, Cr dit Agricole, after taking a stake in Spain's Banco Popular. Rabobanc also announced a close relationship with Dutch asset manager Robeco.

Insurer Nationale Nederlanden and the freshly merged NMB Postbanc group announced in November 1990 that they intend to merge too. The size of the NMB Postbanc/Nationale Nederlanden made it a controversial one. The financial merger conditions caused some uproar, but the revolt was also triggered by the announcement that

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<sup>5</sup> The change in focus of the commercial banks does not go unnoticed by the co-operative banks, which are being threatened on their natural territory. They too broaden their product range and move towards a universal banking strategy. In an effort to bundle overhead costs and develop common products, the two largest co-operative banks in the Netherlands, Raiffeisen hypotheekbanc and Boerenleenbanc merge in 1972 into Rabobanc (De Vries et al., 1999, p. 349).

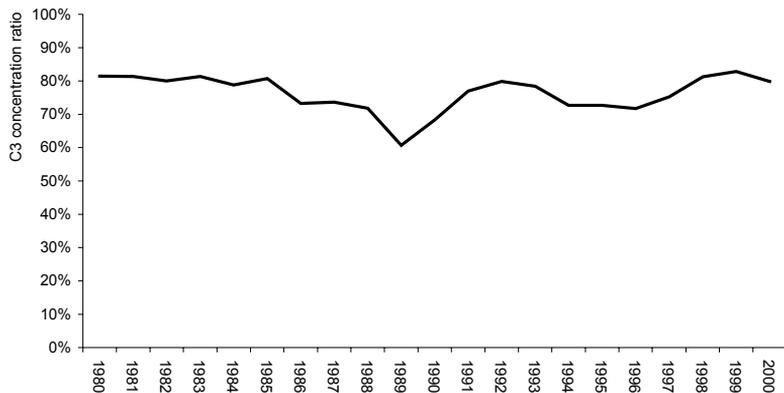
the to be merged group would offer both banking and insurance products, threatening to cut out the insurance intermediaries. To save the day the merger partners abandoned this part of the strategy.

The reshuffling on the Dutch banking map was a drastic departure from the relatively protected and static positions a few years earlier, where large banks relied to a great extent on their oligopolistic competitive advantages. ABN had a broad international coverage, NMB was considered strong in finance for small and medium sized companies, Postbank had its giro system with half the Dutch population as its customers, and Amro maintained a strong position in securities (Bakker, 1991).

The mergers in the second consolidation wave were purely domestic, just as in the 1960s and 1970s. The relatively low price earnings ratios of Dutch banks made a share for-share-merger with a foreign partner unattractive and with Dutch partners attractive.<sup>6</sup> Also, diversification of banking activities, started in the 1960s, was taken to new heights. Banks broadened their activities to include insurance related activities, developing a bank-assurance strategy. Three large mergers were between bank and insurance while ABN, the merger partner of Amro, contemplated one (Bakker, 1991).

Another feature of the Dutch banking market is that it has been highly concentrated. Concentration in the Dutch banking market has remained consistently high since the early 1980s (Figure 11.2); distribution of market shares has been very uneven, pointing to a highly concentrated banking market.

Figure 11.2. Concentration ratios Dutch banking market



Note: assets three largest banks as % total banking assets. Source largest three banks: The Banker Top 1000, 500, issues 1981-2001. Source total banking assets: broadest measure banking assets in OECD Bank profitability database ("All banks").

<sup>6</sup> The search for partners was also visible in the industrial sectors; the difference was that banks were better capitalized compared to industrial firms. Dutch multinationals such as KLM, Philips, DSM or DAF were experiencing economic slowdown and intensifying competition. They faced the difficulty of finding suitable partner to build up strong distribution positions and market shares, before competition would further intensify in a deregulated Europe.

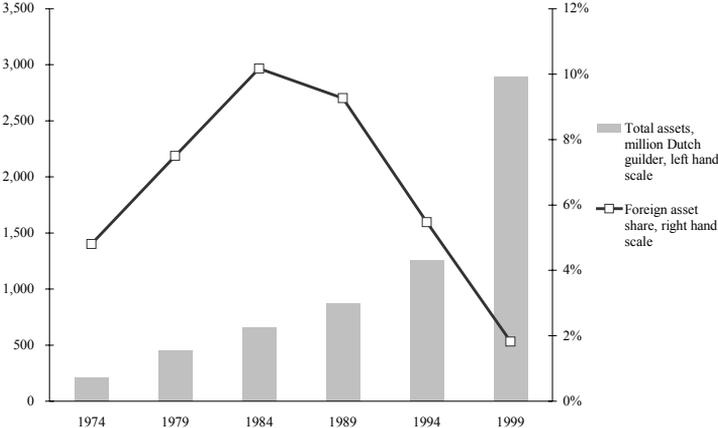
The high degree of bank concentration also exists on a product level. In the early 1990s, only one of the four major banking product markets, mortgages, had opportunities for other competitors than the largest banks. By 1998 ABN Amro acquired Bouwfonds, a large Dutch mortgage bank, and filled this remaining void.

**11.2. Foreign banks**

Have foreign banks influenced the internationalization activities of Dutch banks? While they may have introduced or induced financial innovation, they have played a minor role in the Dutch financial system in terms of assets, staff or income. Any influence may have taken place in terms of perceived threat (relative market position).

High concentration did not imply that the main Dutch banks did not have to compete with a range of foreign owned banks. In comparison with other European countries, a lenient supervisory environment formed the basis for 50 foreign banks with established branches. This number stayed relatively stable over time, although underlying dynamics caused large shifts between foreign banks. Figure 11.3 shows reported assets of foreign banks in relation to total assets reported in the Netherlands.

Figure 11.3. Foreign banking share in the Netherlands



In 1984, foreign market share topped 10% (measured in assets), falling to 2% in 1999. From 1989, the falling asset share of foreign banks was not so much caused by the relatively high asset growth of domestic banks but more by the negative growth figures for foreign banks as a group - the banks have been retreating from the Dutch banking market since the 1990s for the following reasons:

- Foreign mergers and acquisitions created overlap in Dutch branches and offices.
- Foreign presence became more regionally oriented: the Benelux countries could be served from Brussels, eliminating the need for an Amsterdam branch.

- Rationalization of internationalization strategies, focusing on major financial centers.
- The need to have a physical presence in the Netherlands diminished, for example because of electronic trading.

From 1970 onwards, most middle-sized banks in the Netherlands were either partly or fully owned by foreign banks.<sup>7</sup> While some create a niche for themselves in providing services to larger corporations, other banks stand out: the French, American, Japanese and German. Banks from other countries in the sample, such as Switzerland, Spain, and United Kingdom have not built set up or acquired sizeable subsidiaries in the Netherlands (Table 11.3).

Table 11.3: Asset share foreign banks in the Netherlands, percentage

Region	Country	1974	1979	1984	1989	1994	1999
Europe	France	0.7	0.8	2.8	4.2	2.8	-
	Germany	0.6	0.5	0.7	0.8	0.5	0.7
	Belgium	0.1	0.1	0.1	0.1	0.2	0.4
	United Kingdom	0.1	0.1	0.8	0.8	-	-
North America	United States	2.2	4.6	2.3	-	-	-
Asia	Japan	0.5	1.1	2.6	2.9	1.6	0.3
	Indonesia	0.4	0.4	0.8	0.3	0.3	0.1
Total		4.8	7.5	10.1	9.2	5.4	1.6

Note -: Zero or negligible.

Source: NIBE Bankenboekje, various issues

French banks have historically been committed to the Dutch market. The most eye-catching is the acquisition of Slavenburg bank in 1981 by *Crédit Lyonnais*. Slavenburg bank, the ninth largest bank in 1979 with assets worth 10 billion guilders and the sixth largest banking employer with staff of 2,500 got itself into serious difficulties, some managers being accused of aiding clients in tax-evasion (Blanden, 1984). The bank came up for sale, and changed ownership as *Crédit Lyonnais* pursued its own aggressive growth strategy and sought a foothold in the Netherlands. The Dutch branch never became a success, leading the way for the end of *Crédit Lyonnais*' international strategy by overenthusiastically financing fraudulent corporate raiders.<sup>8</sup>

A few major American banks showed interest in the Dutch market since the 1950s. Amro and Morgan Guaranty were equal partners in Amsterdam based Bank Morgan Labouchere. In 1984 Morgan Guaranty transformed Bank Morgan Labouchere into a

<sup>7</sup> Edi Cohen (1986). See also NIBE Bankenboekje, various issues.

<sup>8</sup> Dutch banks have not always been this lenient to a new entrant in the market. For example, they protected their home market when National Westminster acquired van Lanschot Bankiers, a medium sized commercial bank. When the stake was up for sale, a consortium of Dutch banks each took a participation in Van Lanschot.

wholly owned subsidiary. JP Morgan felt the squeeze of a highly concentrated market and opted out after a few years, selling its Dutch operation to Dutch insurer Aegon.

Chase Manhattan formulated its internationalization strategy in the late 1950s, when it aimed to broaden its scope of activities as well as geographical breadth in Europe. The main driver at that stage was to extend services to its United States customers abroad, the Netherlands being one of the countries targeted. In 1967 Chase bought a 17.5% stake in Nederlandse Credietbank (NCB), raised after a few years raised to 30% (Wilson, 1986, p. 174). NCB was a commercial bank operating sixty branches and carrying deposits of 120 million US dollar, searching for a minority partner for additional capital to fund its (international) expansion plans.

The financial participation in NCB was successful in helping Chase's customers; more than 30% of NCB's loans in 1982 were related to US Chase customers (Wilson, 1986, p. 174). At the height of Chase's presence in 1984, NCB was the fourth largest bank in the Netherlands, maintaining an extensive network of 75 branches focusing on electronic banking for large corporate customers and operates "Direktbank", a financial direct writer to retail clients. In 1983 Chase acquired full ownership, only to be sold three years later to the international expanding *Crédit Lyonnais*.

Of the German banks, Deutsche Bank had a long standing presence in the Netherlands from 1919 onwards with the ownership of Albert de Bary and Co, a small bank engaged in banking and trading for its own account. In 1954 the Dutch state sold shares, after having seized it after 1945, to Credit Suisse, Deutsche Banks, Generale Bank, French Banque de l'Indochine, and a Dutch trading company.<sup>9</sup> In 1977 Amro bank and Deutsche Bank bought out the shareholders, each holding 50 percent. Deutsche bank finally bought out Amro Bank in 1988. Other German banks, such as Commerzbank and Dresdner bank have also been active on the Dutch market with smaller acquisitions.

### **11.3. Case studies**

The following case studies are discussed: the realized internationalization strategies of ABN (1980-89), Amro (1980-89) and the merger combination ABN Amro (1990-2000). Also, NMB (1980-89) and its successor ING(1990-2000). One of the few co-operative banks in the sample is Rabobank (1980-2000); the final bank discussed is Fortis, one of the few cross-border banks headquartered in Belgium but with extensive operations in the Netherlands.

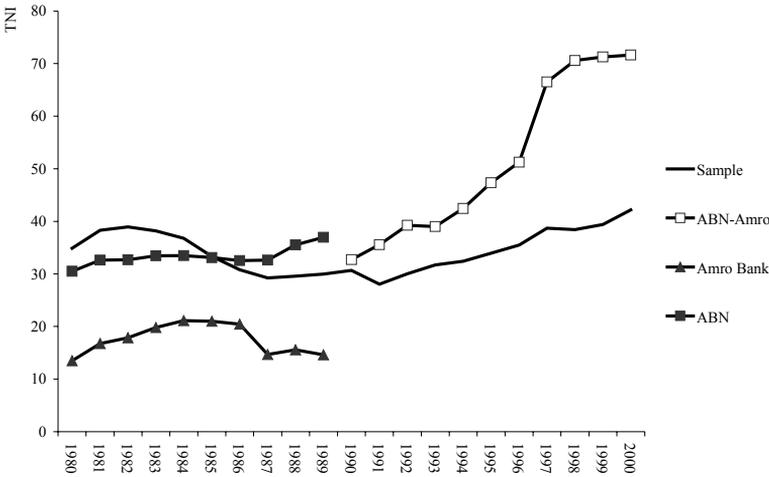
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<sup>9</sup> These joint financial participations suggest that the concept of banking consortia was not entirely a new financial innovation when the predecessor of EBIC was founded in 1958. The new element was not the joint co-operation, but the combination of a) de joint co-operation in de novo ventures, and b) specific catering of corporate and investment banking markets.

11.3.1. ABN

ABN has been the most outward oriented bank in the Netherlands, constantly working on the enlargement of its international network. ABN had the ambition from the start to increase its own network of foreign branches, or acquire shares in foreign banks (De Vries et al., 1999, p. 364). Historically, ABN had built up a branch network in South East Asia and in the Middle East (Sijbrands, 1994). In 1967 ABN acquired Hollandsche Bank-Unie, a bank with a strong branch network in Latin America.<sup>10</sup> Halfway through the mid 1970s ABN began redefine its international strategy, triggered by the regular occurrence of political turmoil in Latin America, and nationalizations in Saudi Arabia, Surinam, and Iran. Activities should be wider spread across regions.

Figure 11.4. TNI ABN, Amro, and ABN Amro



The United States, a market with large wealth and growth potential, was targeted as an area for expansion. So ABN decided to concentrate its efforts on Western Europe and North America (de Vries et al., p. 370). The decision to narrow the geographic focus in Northern America down to the Midwest turned out to be a stroke of luck. In this period, it was a logical choice for a foreign bank to open or acquire business in the East Coast, the location of the financial center of the US. This resulted in an overbanked East Coast region, accompanied by limited growth opportunities which limited the attractiveness

<sup>10</sup> Where Amro in the beginning embraced consortium banking and joint ventures as an optimal way for internationalization, ABN had some reservations about it. It acknowledged its importance, and ABN also ventured into consortium banking, but probably only to appease its shareholders or perhaps internal critics. The going-alone strategy remained steadfast on the foreground. In 1973, ABN co-founded ABECOR (Associated Banks of Europe Corporation) whose ambitions were toned down in comparison to EBIC. It was supposed to be a research, training and joint marketing centre. Joint ventures or joint branches were not included in this strategy (de Vries et al., p. 368). Only in specialized areas active involvement in consortium banks were considered helpful, such as the International Nuclear Co-operation Consortium in 1972.

there. Moreover, ABN already had a number of branches in the East Coast. Thus by method of elimination, ABN turned its attention to the Midwest with the acquisition of LaSalle in 1979<sup>11</sup>, which became the flagship through a string of acquisitions in that area, especially after legislation allowed multibank companies in 1982 (Tschoegl, 2000).

Table 11.4. *Activities ABN*

Period	Phase	Objective	Arena	Client				Product				Organizational form							
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset managment	Insurance	Services	Alliance	Joint venture	Fin Part	Acquisition	Greenfield	Merger
'70-'78	Broad expansion (1)	1. Enlarge domestic marketshare	Domestic			■	■												
		2. Rebuild foreign branch network	Financial centers, trade related countries		■	■													
		3. Form alliances in specialized area's	Financial centers		■	■													
'79-'90	Broad expansion (2)	1. Expansion in three stable world regions	Western-Europe United States Singapore/Hong Kong			■	■												
		2. Outside world regions: passive expansion, on client demand	Rest of World			■													

This strategy formed the basis for ABN's "core-satellite" approach:

- Concentration in the economic most important regions of the world: active expansion in North America, Western Europe, and South East Asia
- Passive presence in other regions, branches outside the regions were only established to service multinational corporate clients
- Alliances in global specialized area's

The strategy and the resulting product-client mix proved successful in the short term. Among other things, ABN decided to scale down its (comparatively modest) emerging market loan activities. When the debt crisis hit banks worldwide in 1982, ABN had to make one off charges, but to a far lesser extent than other banks.

11.3.2. Amro Bank

In comparison to ABN, Amro Bank viewed internationalization as a necessity too, but judging from the resulting course of action, it was not quite willing to commit the same amount of capital to it. It initially held the conviction that it should be achieved through consortium banking, and not by building a network of branches on its own. The thought of

<sup>11</sup> LaSalle's parent, a non-banking company, had to sell because of a change in legislation, barring such firms from owning a bank.

co-operation of some kind was already instilled into the bank's predecessors<sup>12</sup>, and in 1970 Amro participated in European Banks International Company (EBIC) with the purpose to build an international network of EBIC subsidiaries. EBIC became the main vehicle for Amro's internationalization strategy (de Vries et al., p. 372) amounting to co-operation with partner banks within the EBIC framework within Europe, and joint ventures outside Europe.

The role EBIC played in Amro's internationalization strategy closely followed the general pattern of the rise and fall of consortium banking in those years. Initially, different joint ventures were set up, and the depth of co-operation was enhanced (de Vries et al., p. 367), for example by creating intra lines of credit between EBIC banks in 1972. After the Deutsche Bank became the foremost EBIC-defector by opening its own branch in London, Amro bank changed its course in 1976 and developed a two-fold strategy, opening branches in some countries and making acquisitions in others (Blanden, 1984). Its foreign policy embraced the opening of 15 to 20 new branches, the first one being in London in 1976 (de Vries et al., 1999, p. 368). Amro bank suffered from falling profitability between 1980-1983; management tackled this by restructuring the company and concentrating on a limited number of banking activities.

Table 11.5. *Activities Amro Bank*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset mngmt	Services	Insurance	Alliance	Joint venture	Acquisition	Fin. Part	Greenfield	Merger
'76-'83	Entry	Shift international activities from joint ventures to own network	Western Europe, United States		■	■				■									
'83-'85	Restructuring, refocus	Restructure domestic and foreign branch network to increase profitability	Bank organization																
'85-'90	Expansion, broad	Expand foreign branch network	Western Europe, United States, major financial centers															■	■

By 1985 the restructuring was successfully implemented and new goals for expansion were set. Domestic expansion was not possible - the Dutch regulatory authorities would not allow it until 1989. International expansion seemed a good alternative for more than one reason (de Vries et al., 1999, p. 378). The fear existed that Amro might not be so attractive any more for large Dutch firms with international operations. Amro bank's major clients were demanding further internationalization of banking services and domestic growth opportunities, both in terms of growth or market

<sup>12</sup> The Amsterdamsche bank joined Midland Bank, Deutsche Bank and Societe General of Belgium in 1963 to form the European Advisory Council, with the aim to have a platform for mutual consultation, and to set up branches for large-scale international finance. In 1970 the members of the EAC took this co-operation a step further by setting up European Banks International Company, EBIC (de Vries et al., p. 364).

share, were not that promising. From a world perspective, the fear grew that Amro slowly would become a second tier bank.

However, the number of acquisitions remained modest compared to other banks. Its London presence was strongly enhanced when Amro bought out its partners in the former consortium bank European Banking Company, renaming it EBC Amro (Blanden, 1984). These activities however were modest in size. A more substantial deal would be a merger of equals, and Amro started talks with EBIC partner Generale Bank of Belgium. The threat of a hostile bid for Generale Bank by an outsider compelled both parties to hastily draw up a co-operation agreement in February 1988, with the intention to merge into a single bank within 3 years (de Vries et al., 1999, p. 382). The alliance was short lived, as the hostile take over threat waned away and Generale Bank and Amro dug into the details. A combination of legal problems, shareholder problems and different strategy insights ended this alliance.

### 11.3.3. ABN Amro

The failed Generale bank deal with Amro was the starting point for Dutch banks to reconsider relative positions in the domestic banking market (Laurie, 1990). Around the same time, ABN aborted indicative merger talks with Dutch insurer Nationale Nederlanden. For both parties, their substantial interests in the United States turned out to be the breaking point as the American regulatory authorities would force the possible merger bank to make a choice between its insurance activities or its banking activities in the United States. Next, ABN and Amro successfully initiated talks and merged in 1990.

Meys (1991) defended the merger between ABN and Amro with four arguments. First, the home market was too small to sustain an acceptable growth strategy. Second, to sustain this growth strategy and organizational continuity an internationalization strategy was needed to keep offering a competitive product range to clients. Third, this had to be funded through cost savings combined with economies of scale and stable funding in the home market where domestic market share was assured through the merger in the first place. Finally, these cost savings were necessary because of the upcoming liberalization of financial services in the European Union in 1992, leading to the expected cross border competition and lower margins, in itself an incentive for further economies of scale .

At the end of 1989 Amro had broadly the same market value as ABN, but lacked a substantial international operation. ABN Amro continued ABN's foreign strategy after the merger, albeit in a faster pace since the capital base of the merger combination increased substantial. ABN Amro's strategy consisted of four pillars: expand in investment banking, expand in the Midwest of the United States, create another home market, and retain the Dutch market share.

The bank continued to target the United States, primarily the Midwest, for expansion. Around LaSalle National Bank of Chicago, purchased in 1979, ABN Amro acquired other banking operations in the United States to become the largest foreign bank in the United States, contributing over 25% of pre-tax profits by the year 2000 compared to 11% in 1990. Its investment banking activities were reorganized in 1993, when equities

trading was centered in London and built around the brokerage firm Hoare Govett it bought in 1992.<sup>13</sup> The bank also acquired a majority holding in Swedish investment bank Alfred Berg in 1994, and set up a joint venture with Rothschild & Sons to underwrite and distribute shares.

Table 11.6. *Activities ABN Amro*

Period	Phase	Objective	Arena	Client	Product			Organizational form														
					Insurance	Asset managment	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture								
90-95	Broad expansion	1. Increase capital market activities	Major financial centers																			
		2. Increase retail banking activities in United States																				
		3. Reorganize activities after merger	Whole organisation																			
96-98	Focused expansion	1. Increase capital market activities	Major financial centers																			
		2. Acquire 'third' home market besides the Netherlands and the United States	Brazil																			
		3. Increase branch network	Major economic centers																			
99-	Restructuring, refocus & exit	1. Increase efficiency domestic network	Domestic																			
		2. Restructure foreign branch network, refocus capital market activities	Whole organisation																			
		3. Single brand strategy	Whole organisation																			

ABN Amro's attempts to acquire another substantial commercial bank in Europe, to broaden its home base, were initially unsuccessful. A bid for French bank CIC failed in 1997, and the bid for Belgian Generale Bank in 1998 was concluded in favor of Fortis. The alternative for another large retail market outside the United States became Brazil. In 1997-98 the bank bought Brazilian banks Banco Real and Bandepe. With the purchase of Banco Real, a large retail bank, ABN Amro became a universal bank in Brazil, allowing the bank to specialize in Latin American pension fund management and personal insurance, areas where Banco Real was strong (de Paula, 2002, p. 37). In 2000, total Latin American earnings amounted to 13% of the group's total, making it the third-largest contributing region after the Netherlands and the United States. To enhance its presence in the European market, ABN Amro bought a 9% stake in Banca di Roma. It also acquired Dutch property group Bouwfonds Nederlandse Gemeenten to increase its domestic real estate activities.

In November 2000, ABN Amro decided that the bank would operate in the retail markets in the Netherlands, the United States and Brazil. Retail operations in countries

<sup>13</sup> Security Pacific divested it while merging with Bank of America.

where the bank did not have enough size to compete effectively would be ended (de Paula, 2002, p. 37). It announced a substantial reorganization, aimed at restructuring the domestic branch network, closing a third of its branches and shedding a quarter of its domestic retail operations staff. One of the motives for the reorganization was the lagging share price compared to competitors, despite comparatively high profitability.<sup>14</sup> Active in 76 countries, management identified 11 countries from which it would exit completely, and a further 29 in which it would close its retail operations. Unprofitable operations such as in Bolivia, Netherlands Antilles, Surinam, Sri Lanka and Hungary were disposed of.<sup>15</sup>

Table 11.7 Acquisitions in the United States by ABN Amro, 1990 - 2001

Year	Acquisition
1990	Exchange Bancorp
1992	Talman Home Federal Savings Bank
1996	Comerica-Illinois
1996	CNBC Bancorp
1997	The Chicago Corporation
1997	Standard Federal Bancorporation
2000	Atlantic Mortgage Investment Corp
2000	Olympian New York Corporation
2001	Alleghany
2001	Michigan National Corp
2001	Prime United States securities business from ING Barings

Source: Taken from Credit Suisse First Boston, 2002, Equity Research, ABN Amro.

#### 11.3.4. Rabobank

On the subject of internationalization, the newly formed co-operative Rabobank in 1972 trod far more carefully than Amro or ABN bank. Foreign activities to serve its domestic clients formed the core of its internationalization strategy in the 1970s and 1980s (de Boer and Graafsma, 2002, p. 113). To join the international capital market operations, Rabobank set up activities in London and New York.<sup>16</sup> In the following years, Rabobank actively participated in consortium banks and alliances, with UNICO as a linking pin within this strategy.<sup>17</sup>

<sup>14</sup> Organisatie ABN Amro op de schop. (2000, May 29). *NRC Handelsblad*, p. 1.

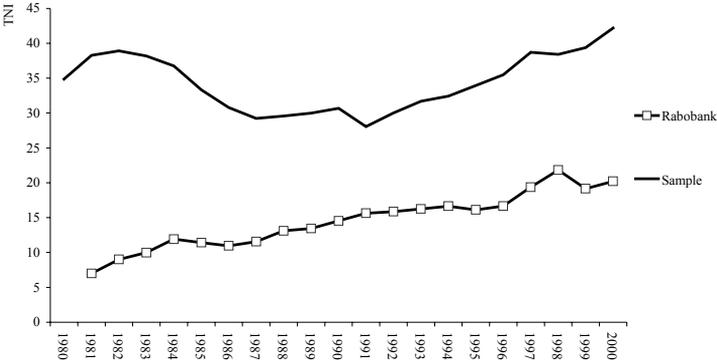
<sup>15</sup> Credit Suisse First Boston (2001). *Equity Research, ABN Amro*.

<sup>16</sup> Rabobank took a stake in the London and Continental bank, a consortium bank located in London in 1972. The other major financial centre, New York, was covered through a short-lived joint venture with Bank of America in New York by establishing Rabomerica International in 1974. Rabobank bought out its partner in the joint venture two years, optimistically stating that its goals were easily achieved. (Sluyterman et al., 1998, p. 247).

<sup>17</sup> Co-operative banks have a preference for alliances and consortium banks. A reason might be that with co-operative banks, the control of capital is allocated to the local banks, leaving the central offices little financial manoeuvring space to engage in (high risk) international activities.

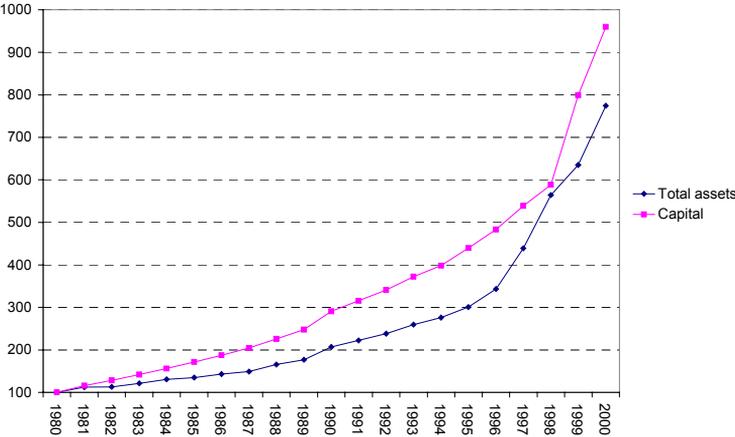
In 1980 Rabobank became a partner in London based BEG Bank, also a consortium bank. Here it was confronted with the same problems Amro bank faced with consortium banking a few years earlier, and in 1980 the strategy broadened: foreign expansion through greenfields and acquisitions became additional means of international expansion, though the concept of alliances was not abandoned.

Figure 11.5. *TNI Rabobank*



An important change in internationalization was the approval of the cross-guarantee system in 1980, making all banks and other legal entities within the Rabobank organization mutually liable for each other's liabilities. This strengthened Rabobank's solvency considerably, making it possible to achieve the highest international credit rating ("Triple A"). From 1980 onwards, capital and reserves grew at a faster pace than total assets, providing scope for Rabobank to expand activities abroad (Pohl and Freitag, 1994, p. 787).

Figure 11.6. *Growth of capital and reserves, total assets Rabobank, rebased*



Over the next ten years Rabobank opened a string of offices in the major OECD countries. 1990-1995 was a period of redefinition: it participated fully in the Bankassurance wave by acquiring Dutch insurer Interpolis, creating the third all-finance provider in the Netherlands. It was the starting point for a three pillar strategy: in the home market, Rabobank built its organization into a broad financial service provider, strengthening the retail, corporate finance and asset management side. Second, it remained loyal to the legacy of earlier decades. Rabobank strengthened ties with existing UNICO partners, especially German DG bank and Spanish bank Banco Popular.

Table 11.8. *Activities Rabobank*

Period	Phase	Objective	Arena	Client				Product			Organizational form						
				Institutional Government	Corporate	Private Retail	Credit	Securities	Asset management	Insurance Services	Joint venture Alliance	Fin Part	Acquisition	Greenfield	Merger	Divestiture	
'73-'80	Entry	1. Domestic growth strategy	Domestic		■	■		■		■						■	■
		2. International expansion to service existing clients	United States, United Kingdom, Germany		■			■		■			■				
'80-'94	Broad expansion	1. Development branch network	Western, Eastern Europe		■			■		■					■	■	
		2. Domestic diversification (insurance)	Domestic		■	■		■	■	■	■		■		■		
'95-'98	Focused expansion	1. Foreign expansion agriculture corporate finance	United States, Australia		■			■		■					■	■	
		2. Diversification into asset management	Domestic			■	■		■	■					■		
'99-	Restructuring, refocus and exit	1. Rationalization domestic growth strategy, focus on cost control	Domestic														
		2. Scale down investment banking to corporate finance for existing clients	Domestic, United Kingdom		■												

Rabobank also redefined its foreign activities. The rising costs of the foreign branch network forced a reorientation, and in 1996 the bank decided to provide corporate, investment and private banking services to clients in the agricultural, pharmaceutical and food industries in the major regions<sup>18</sup>, initiating a string of acquisitions worldwide. Somewhat more opportunistic, its London branch was heavily upgraded in 1997 into an investment banking department, trying to reap the fruits of a booming securities underwriting and distribution climate on the back of a steadily rising markets for almost a decade (de Boer and Graafsma, 2002, p. 114).

However, Rabobank suffered a string of setbacks forcing it to reconsider its strategy: two announced large scale mergers fell through and its investment banking activities delivered poor results. In 1998 Rabobank unsuccessfully contemplated a full-fledged merger with Achmea, a Dutch insurer with a co-operative organization structure similar to Rabobank. More bad news accumulated in 1999 when its investment banking activities in London were not delivering the expected returns, and no improvement was to

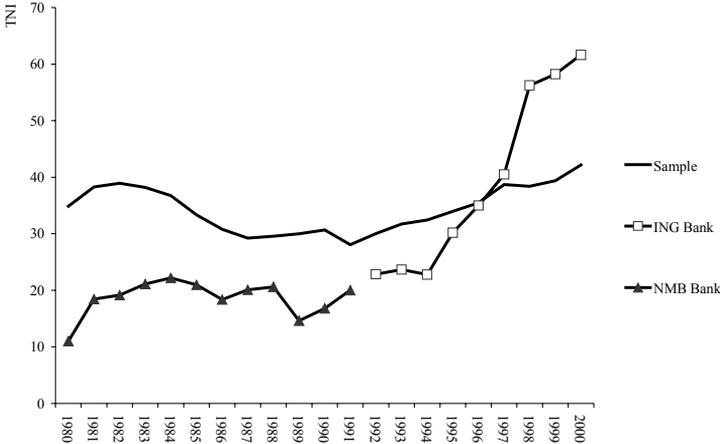
<sup>18</sup> North- and South America, Europe, Asia and Australia (de Boer & Graafsma, 2002, p. 114).

be expected. An alternative, to combine the investment banking activities with DG Bank in a joint venture, fell through. Also, the domestic cost efficiency was lagging in comparison with other competitors. These events signalled a period where management reconsidered the bank's strategy, and in anticipation of a new direction investment banking activities were scaled down significantly and costs cutting measures announced. The restructuring was beneficial to the solvency of the bank: while the TNI decreased from 1999, the growth of capital increased (Figure 11.6).

11.3.5. NMB Bank

Of the Dutch banks, the growth strategy of ING Group since 1991 was perhaps the most spectacular, creating a financial conglomerate shaped by large mergers and acquisitions. The international activities of ING were originally developed by Nederlandsche Middenstands bank (NMB) (Sijbrands, 1994), a Dutch commercial bank founded in 1927 whose client base consisted of smaller and medium business. Its international activities in the 1970s were limited to participation in a consortium bank, the Inter Alpha Bank group. The activities of Inter-Alpha were modest in size but management of NMB probably acquired detailed knowledge of its partner banks since ING later targeted BHF Bank in Germany, and (unsuccessfully) CCF Bank in France for acquisition in the 1990s.

Figure 11.7. TNI NMB, ING



The NMB transformed in the 1980s from a domestic oriented bank into a bank with high profile international operations before merging with Dutch Postbank in 1989. It basically set up a two-tier strategy, engaging in high-risk and high growth activities outside the Netherlands, and gaining market share inside the Netherlands. The international activities proved to be successful. The bank built a corporate banking network in Latin America. By the end of the 1980s, NMB had successful results with the emerging market debt business, conducted from New York where it first set up an office in 1978 and



international operations. Financially strengthened, expansion in emerging markets became an important strategic focus.

11.3.6. ING Bank

The new strategic focus of the NMB Postbank was not yet to be fully effectuated after 1989. For the next two years, NMB Postbank had to reconsider its relative position as the other competitors gained in scale (merger of ABN and Amro in 1990) or scope (merger of Rabobank and Interpolis, merger of VSB and Amev). NMB Postbank’s reaction was to initiate a merger with the insurer Nationale Nederlanden. The insurer was not only blessed with deep cash pockets, it also had a long time experience with international activities, and faced a similar strategic reorientation as NMB Postbank (1991). In 1991 the merger was announced, going by the name of Internationale Nederlanden Group (ING). ING aimed to:<sup>21</sup>

- Be a "total finance" provider for clients, offering both banking and insurance products.
- Retain its current domestic market share by offering its clients products from both insurance and banking products.
- Increase its international activities on both banking and insurance side, with the goal to achieve a foreign share of gross income of 50% within a couple of years.

Table 11.10. Strategic activities ING Bank

Period	Phase	Objective	Arena	Client							Product					Organizational form				
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset mgnt	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'92-'97	Broad expansion	1. Retain domestic market share	Domestic			■	■			■	■	■	■							
		2. Create second home market	Western Europe				■	■									■	■		
		3. Expansion in emerging market regions	Eastern Europe, Latin America, South East Asia		■	■				■	■		■				■	■	■	
'97-'00	Focused expansion	1. Scale down expansion strategy in emerging markets, focus on cost control	Eastern Europe, Latin America, South East Asia																	
		2. Find second 'home' market (Belgium) in Europe.	Belgium			■	■	■		■	■	■					■			
		3. Focus expansion on stable economic regions	Western Europe, United States																	

An organizational model was set up to accommodate this. Each home market (at the time the Netherlands) became a major division, further split up by business lines. For the other activities outside the home market, the main business lines were changed into

<sup>21</sup> ING Groep (1992, May). *Presentation for institutional investors* ["Bijeenkomst voor institutionele beleggers"], on May 14, 1992.

divisions, further split up in geographical areas (Leeuw, 1996, p. 128). This structure remained intact until 1999, when the home markets were redefined (Netherlands became Europe, North-and South America, and Asia Pacific are added) and Financial Services split up into ING Direct and E-Business.

To retain the domestic market share, costs were cut by shedding redundant offices and unprofitable operations. If possible, labels were rebranded to ING, except for direct banking (Postbank) and insurance (Nationale Nederlanden). Domestic uproar by insurance salesmen caused a setback for the total service concept from the start; ING pledged not to sell insurance through banking outlets to placate insurance salesmen.

Outside the Netherlands ING aimed to create a second home market. This was achieved in Belgium, starting with financial participations in 1992 and the acquisition of Banque Bruxelles Lambert in 1997. Expansion in corporate finance and investment banking shifted into a higher gear, focusing on Eastern Europe and South East Asia.<sup>22</sup> After several years of greenfielding in Eastern Europe, the acquisition of the bankrupt British merchant bank Barings seemed to fit the bill. This bank had extensive experience in both investment banking and emerging markets, especially South East Asia and Latin America. The acquisition turned out to be less successful than initially expected by management. By the time the organization was embedded into ING (with staff defections along the way), the Russian and Asian crisis of 1997 forced ING to take drastic measures. Baring staff was laid off, branches closed, and finally Barings' ambitions were downscaled from investment banking to corporate finance.

Just as with ABN in 1978 (after being chastened by economic and political turmoil), ING decided to reorganize its banking activities, and focus on more geographically stable markets. The United States was targeted with the failed acquisition of Dillon Read in May 1997, shortly after which it bought US brokerage firm Furman Selz. Europe as a home market was broadened, taking a controlling interest in German Direct bank in 1998. In that same year, former Inter Alpha partner BHF Bank was bought, but an attempt to buy the other former Inter Alpha partner CCF failed.

On the insurance side, ING acquired insurance companies, focusing on the United States. This culminated in the acquisition in 2000 of ReliaStar, a US life insurer and provider of financial services, increasing ING's market share in the United States life insurance from 19th to 8th position in terms of total life and annuity premium.<sup>23</sup>

In short, the strategy ING laid out in 1992 was more or less effectuated in the 1990s. However, since 1997 its ambitions and scope were scaled down. "Stability" was added to "growth" as the second keyword: relatively more stable fee income (meaning less investment bank) and more stable regions (less emerging markets, more Europe and United States).

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<sup>22</sup> Although consortium banking played a decreasing role in ING's strategy, in 1991 ING opened a representative office together with its Interalpha partners in Moscow (Sijbrands, 1994).

<sup>23</sup> ING Group (2000, May). *Shareholders' News No. 2*.

### 11.3.7. Fortis Group

Fortis is the youngest entrant in the Dutch banking scene. Three characteristics stand out: 1) its formation and growth was largely domestic and shaped by Belgian politics, 2) its origins are saving bank oriented and 3) it is a Dutch-Belgian conglomerate. Its internationalization has been deviant from the other Dutch banks. Starting with the Netherlands, the founding date of Fortis might be set in 1989. At this point, Dutch saving banks were in the middle of a consolidation phase. Small independent saving banks found their capital base too small and their overhead costs too large to fend off the continuously increasing competition for new financial products and also to increase returns on existing products. A pooling of resources, created by mergers, led to the formation of two saving banks, the Verenigde Spaarbank (VSB) and (a smaller) Stichting Nederlandse Spaarbanken (SNS). Both banks were keen to stop the deterioration of its client base by other banks. Broadening its strategic scope to bankassurance was the answer for VSB, and in 1989 a merger was announced between VSB and Amev, a mainly Dutch insurer with additional operations in the United Kingdom and United States. On the other side of the Dutch border two merged Belgian saving banks, ASLK and CGER, mainly on the same grounds as in the Netherlands, were stimulated by the Belgian government (their main shareholder) to grow into a national champion. The merger with VSB/Amev fit into this strategy, creating a financial conglomerate whose power base was mainly in Belgium. The merged group lacked a relatively strong banking unit, especially in the Netherlands and over the next years the following strategy developed:

- gradually buy out the Belgian government, gaining the right to downsize the high Belgian cost structure
- buy a banking unit in the Netherlands
- build an internationalization strategy on the existing Amev activities (mainly United States), and acquire or build alliances with comparable (saving bank) organizations.

A second home base outside the Benelux was created with the alliance with Spanish saving bank Caixa. In theory, Fortis should be an active partner in the French banking market, given its cultural and organizational inclination to the French. This however did not materialize. In 1995 a corporate banking unit was created with the acquisition of MeesPierson, the corporate banking daughter of ABN Amro. MeesPierson was not so much competing for new clients as competing with its parent-organization for the same clients.

Figure 11.8. *TNI Fortis*



Fortis gained considerably in size by acquiring Generale Bank in 1998. Generale Bank, one of the oldest and largest retail banks in Belgium, became active in the Dutch arena in 1988 with the (aborted) merger talks with Amro bank, and in 1995 with the purchase of Dutch Crédit Lyonnais subsidiaries where its main contestant was Fortis, already keen to buy another banking unit in the Netherlands. Two factors played an important role in this acquisition. First, management of Fortis felt that its market position was under threat by the continuing growth of ABN Amro, Rabobank, and especially ING after acquiring Belgian BBL in 1997. Fortis felt it needed to reinforce its position by buying market share. Second, the Belgian government worried about the growing influence of foreign partners in key areas of the Belgian economy, such as finance and industry. They became keen to create a Belgian champion, or to further an existing one.

Table 11.11. *Activities Fortis*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset managment	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
'90-'98	Entry	1. Gain control over financial participations in organization	Belgium				■	■									■		
		2. Strengthen market position banking unit	Benelux				■	■		■	■						■		
		3. Alliance with co-operative / saving bank institutions	Spain				■	■		■	■		■	■					
'99-	Restructuring, refocus	1. Restructure organizational structure effectively	Whole organization										■						

ABN Amro, having recently defined the need for a third home market, also took a stab at acquiring Generale Bank, but underestimated the political angle described earlier. The international activities of Generale Bank also marked the boost in international banking activities outside the Benelux. Since then, integration became one of the main focuses of Fortis' management, striving to enhance the efficiency ratio and replace the bloated cross border management structure with a more Anglo-Saxon oriented governance. In a period of ten years, Fortis transformed itself into a Dutch/Belgian variant of a United States super regional bank.

#### **11.4. Commonalities and differences**

Dutch banks historically have competed in a concentrated banking market where 4 major banks held market shares larger than 75%. The economy was also outward oriented: extensive trade links and a small domestic economy implied that Dutch banks were oriented on its most important trading partners, foremost European countries and the United States. The Dutch banks did not share a common internationalization strategy in the 1980s. The most internationalized bank at the beginning of the 1980s was ABN. From a long history of international banking, the bank focused on expanding its branch network in the main financial and economic centers, as well as expansion in the three stable economic regions. Here it emphasized retail banking (in the United States) as well as capital market activities. Its main domestic competitor, Amro, was less internationalized. Amro had built its internationalization activities around the banking club EBIC, but the co-operation dissolved in the early 1980s. Amro initiated a substantial expansion program to make up for lost time, buying old EBIC banking activities as well as setting up new ventures. For ABN and Amro, an initial link between clients and internationalization existed; this also applied to the co-operative Rabobank, who similar to Amro started internationalization in the 1970s with joint ventures, but subsequently built up its own branch network in the main economic and financial centers. The relatively small NMB also ventured into international banking, growing especially from the mid-1980s. For NMB it was less obvious to detect a client incentive to internationalize when the bank built up a considerable LDC debt trading desk.

By the 1990s the Dutch banks had built up a sizeable experience in international activities. However, they found it difficult to maintain their relative position compared to other foreign banks. Dutch banks feared that they would become second league banks, accentuated by gradually slipping rankings worldwide (de Vries et al., 1999, p. 378). Besides that, their income still came from local business. In the European Union, the round of deregulation and harmonization measures affected credit institutions and capital markets, and sent the message home that increasing foreign competition would be a structural trend in the capital markets. Dutch banks reacted by domestically merging with banks and insurers between 1989 and 1991, and subsequently increased their pace of internationalization:

- The merger of ABN and Amro may have been a merger of equals, but the internationalization activities in the 1990s suggest that ABN Amro continued the internationalization activities ABN had set up, not Amro.
- Rabobank and ING(NMB) have similar levels of TNI between 1980 and 1986. The composition of TNI is similar too: the foreign share of assets is relatively high to the share of foreign staff.
- The TNI of Rabobank remained relatively stable until 1996, when foreign investment banking as an autonomous business activity expanded. This was short lived, and the investment banking activities were scaled down in 1999.
- Fortis maintained a mid-sized position in TNI compared to the other banks: it acquired full control of its domestic parent organization lowering TNI levels in 1993-94, while the acquisition of Generale bank in 1998 on average increased TNI again. Focusing on the Benelux as its home market, its activities show parallels with the super-regional banks in the United States (and HypoVereinsbank in Germany).

## **12 Internationalization of American banks**

The internationalization of American banks blossomed after the Second World War. Similar to French and British banks who profited from a colonial network to expand their international activities, American banks benefited from the strong economic and political situation of the United States after 1945.

American banks had three incentives to internationalize. First, domestic clients expanded abroad and American banks followed to continue their banking services. Second, American banks dealt in the world currency, the US dollar. Third, the introduction of the Voluntary Foreign Credit Restraint Programme limiting foreign lending from head office, in effect from 1965 to early 1974, also was a major incentive for the growth of foreign activities (Bellanger, 1978).

The major growth period took place between 1970 and 1975, when the 10 largest banks earned 17.5% of their income abroad, rising to 52.5% in 1975 (Dombrowski, 1996). In 1950 only 7 United States banks operated 95 branches abroad; by 1976, 126 United States banks operated 731 branches abroad (Rabio, 1984, p. 117). The degree of internationalization declined in the early 1980s, when economic recessions and LDC problems made banks focus on domestic activities and regain financial health. United States banks put the asset quality problems of the 1980s and early 1990s behind them and renewed their expansion outside the United States.

Table 12.1. *Incentives for internationalization of American banks*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Net interest margin relatively high, incentive for foreign banks entering the United States</li> <li>• Economic structure: large capital markets, higher fee income</li> <li>• Regulation: deregulation in the 1980s, 1990s stimulating domestic expansion of US banks (interstate banking deregulation, 1993) and abolishment separation banking and insurance (1999).</li> <li>• Client: US multinationals in foreign markets, although less important incentives than in 1960s, 1970s</li> <li>• Perception of the market: Large internal market, extension home region with NAFTA from 1995, especially Mexico</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: similar entry LDC loans 1960s, 1970s, similar exit in the 1980s and concentration on domestic market and profitability. Since 1990s divergent strategies: re-emergence international growth (jpmorgan, Citicorp) versus increasing focus domestic market (Chase, Chemical, Bank of America, Manufacturers)</li> <li>• Market power and banking concentration: market concentration not high due to regulation, deregulation has not increased concentration much. High concentration in specific services</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies of scale and scope: size and specialization in investment banking and corporate finance, retreat from international retail banking in the 1990s with the exception of Citicorp.</li> <li>• Shareholder return: low price earnings ratio's in 1980s, made it attractive for foreign banks to enter the United States, in the 1990s, high price earnings ratio's were used to acquire</li> </ul>

## 12.1. Incentives to internationalize

### *Spreads, profitability*

Financial indicators between 1980 and 2000 do not provide an incentive to internationalize, they rather provide an incentive for foreign bank entry in the United States. Interest margins have been consistently among the highest of the countries in the sample, while profitability also has been among the highest, except for 1985-1990.

### *Clients*

For most foreign banks, activities in the United States were initially client-related. They followed their home clients to the United States, as the share of imports in United States GDP increased from 8.9% in 1980 to 12.5% in 2000. Foreign banks expanded their activities to domestic United States customers: the United States economy has been a large open market, offering political stability and a key global currency. Rising government deficits increased demand for foreign capital, and the American trade deficit left large

dollar denominated deposits abroad that provided foreign banks with a funding base to enter the United States (Gilmer and Hopper, 1997). Nolle and Seth (1996) compared the lending patterns of foreign owned banks to the financing patterns of foreign owned non-financial firms between 1981 and 1992. They found that banks from Japan, Canada, the Netherlands, and the United Kingdom allocated a majority of their loans to U.S. customers during the whole or some of the period between 1981 and 1992. On the other hand, the theoretical loan capacity of German banks remained consistently lower than the funding needs of German owned companies in the United States. This suggests that Japanese, Dutch and British banks targeted more domestic customers in the United States, than for example German banks.

### *Regulation*

The internationalization of foreign and domestic banks and its effects on the American financial system has been a consistent focus of United States regulators. Between 1978 and 1981, competitive disadvantages for American banks compared to foreign banks were alleviated. Regulation and policy initiatives between 1983 and 1989 were directed at restoring the financial health of (internationally operating) American banks, while regulation in 1991 and 1999 once again focused on leveling competitive disadvantage of American banks (Table 12.2).

Prior to 1980 United States regulation stimulated American banks to undertake foreign activities. Regulation Q introduced interest rate caps, helped to ensure the growth of the Eurodollar market outside of New York, as multinational corporations and other banks preferred to place funds earned overseas in London, rather than return them to New York. The United States government also imposed controls on the flow of capital overseas, effectuated from the early 1960s through the interest equalization tax, the Voluntary Foreign Credit Restraint Program and restrictions on direct foreign investment (Channon, 1977, p. 153).

Entry of foreign banks can be traced to 1974, when relaxation of capital controls increased the attractiveness of U.S. markets to foreign banks for extending loans free of restraint (Terrell, 1977). In the Californian state, restrictions of the entry of foreign banks were lifted (The Banker, 1974, p. 345). Being one of the largest and richest states in the United States with a growing international sector (Johnston, 1977), this state created an attractive expansion region for the next decades, especially for Japanese and British banks.

In the early 1970s foreign banks also operated under a larger degree of freedom than their American competitors. Under the Bank Holding Company Act foreign banks had not been defined as "banks". Even if they offered the full range of commercial banking services, they had not been forced to limit their operations to only one state but had been free to negotiate with individual state legislators of the states that allowed them in.<sup>1</sup> Foreign banks could undertake activities in more than one state, while this was denied to

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<sup>1</sup> In 1974, 40 states barred foreign banks (The Banker, 1974, p. 341). By 1992, at least 21 states still barred any form of foreign banking (Goldberg & Grosse, 1994, p. 371).

domestic banks. Also, domestic banks had to maintain reserves at the Federal Reserve System, while foreign banks did not have to.

Table 12.2. *Major regulatory events in the United States, 1978 - 1999*

Year	Regulatory event	Effect on Internationalisation	Effect on entry foreign banks
1978	International Banking Act: removed competition advantages foreign banks in the United States due to regulatory differences.		Competitive advantage compared to American banks reduced.
1981	International Banking Facility: goal was to attract Eurocurrency business back to the United States without creating offshore facilities.	American share in Eurocurrency market increases (modest)	The IBF was mostly used by foreign banks, not American
1983	International Lending Supervision: encouraged more internationally responsible lending	Lending to LDC further reduced.	
1991	Foreign Bank Supervision		Raised entry requirements.
1993	Interstate banking	American banks can consolidate in different states, negatively affecting internationalization	Levels of economies of scale, and market power was raised deterring foreign banks to expand in American retail banking
1999	Gramm-Leach-Bliley Act	American banks can increase domestic consolidation, should negatively affect internationalization	Foreign banks can expand in the United States with full range of services also provided in home countries

The activities of foreign banks in the United States attracted the attention of Congress, perceiving that foreign banks enjoyed a competitive advantage over the domestic banks. After four years, the International Banking Act (IBA) was approved in 1978, creating a regulatory structure for agencies and branches, with the aim to eliminate competitive advantages of foreign banks (State of New York Banking Department, 1999). The Act limited interstate deposit taking activities, imposed reserve requirements for monetary policy purposes, required federal deposit insurance for foreign branches engaged in retail deposit taking activities and imposed the non-banking prohibitions of the Bank Holding Company Act.<sup>2</sup>

<sup>2</sup> Besides this, the IBA allowed foreign banks to directly own Edge Act corporations. One of the first vehicles that the US commercial banks used to participate in the international capital markets was the Edge Act corporation

Having curtailed the competitive regulatory advantage of foreign banks in the United States, another competition issue was the legacy of prior regulation: the growth of the Eurocurrency markets, conducted at European offshore centers. The initial reaction of regulators to the growth of the Eurocurrency markets was to insulate the American system from Eurodollars (Dombrowski, 1996, p. 69), worried that large scale inflows would represent a potential hazard to the American banking system. By the mid-1970s, these steps were considered ineffective: American banks entered the eurocurrency markets from their foreign branches, and American banks were losing business to foreign banks, because the extra expenses associated with operating from foreign branches put American banks at a price disadvantage. In 1981, regulators allowed American banks to participate in Eurocurrency markets from their domestic offices, by creating international banking facilities (IBF) that were allowed to do large scale transactions with foreign customers. Contrary to expectations at the time, the largest and most successful IBFs were not opened by American banks but by foreign banks marginally affecting competitiveness of American banks (Dombrowski, 1996, p. 70).<sup>3</sup>

The LDC debt crisis from 1981 onwards created great anxiety about the condition of the largest banks. Although regulators at first did not respond to this pressure, the International Lending Supervision Act of 1983 stipulated that all banking institutions maintain adequate capital levels, also increasing information standards, and failure to do so was made an unsound and unsafe practice. Although economic growth in the United States gradually revived, the LDC debt crisis did not resolve itself.

Between 1982 and 1985, 40 countries had rescheduled their debts, mainly engineered by banking committees, while the financial needs of a number of countries were alleviated by the IMF. During the resulting debt restructuring process, banks exercised much control and influence over the process, forming a cohesive bloc at the beginning (United Nations Centre on Transnational Corporations, 1991, p. 3). The much higher exposure of United States banks than other banks, and the natural concern of United States officials to safeguard the domestic financial system, also meant converging interests of the United States government and their banks in the restructuring process. The debt

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(EAC). The act was effective since 1919 but became a vehicle for international expansion with the implementation of Federal Reserve Regulation K. The new regulation allowed the use of special Edge Act corporations to engage in transactions in equity and loan financing of non-banking foreign corporations and to hold equity positions in overseas banks. Until the strategy of establishing direct overseas presence was developed, the EAC was the only means of participating in international operations. Even after having set up establishment overseas, the EAC remained the principal method for holding shares in foreign banks. This is because Federal Reserve Regulation M limits to 25 percent of the investing bank's capital and surplus the amount that it may invest in the equity of foreign commercial and investment banks. The result is an organizational divide between financial participations overseas and direct investments overseas (Channon, 1977, pp. 153-156).

Also the IBA allowed a foreign bank wishing to open a United States office to choose between a federal or state licensed one, just as for domestic banks. The federal branches are licensed and supervised by the Office of the Comptroller of the Currency, residing under the Treasury Department. The multitude of regulatory instances is complemented by the Federal Reserve, who regulates the activities of the foreign banks, but behind state and federal regulators.

<sup>3</sup> In March 1990, 63% of the 522 IBFs were foreign owned. Of the 57 IBFs with more than 2 billion US dollar in assets, 31 were controlled by Japanese banks, and 10 by American banks (Bodrowski, 1996, p. 94).

crises worried United States policy makers for a number of reasons<sup>4</sup> prompting two government initiatives, the Baker initiative (1985) and the Brady plan in 1989. The Baker initiative extended existing policies, and depended heavily on the banks involved to lend an additional 29 billion US dollar between 1986 and 1988, while they in effect had been reducing their net lending to those countries. The plan offered few incentives for banks to agree to the Baker plan, and the initiative stranded (Dombrowski, 1996, pp. 129-130). Disagreement on the resolve of the crisis also caused the banking committees overseeing the restructuring of loans to fall apart.

The creation of a plan by Nicholas Brady, US secretary of the Treasury, in 1989 finally solved the debt problem by acknowledging that troubled debtors could not fully service their debt and restore growth at the same time. Approximately 32% of 191 billion US dollar in outstanding loans was written off, while the remaining debt was rescheduled by converting loans in other financial instruments, creating a new financial market.<sup>5</sup> In exchange developing countries had to agree to introduce economic reforms.

Foreign banks were again in 1991 the subject of regulation with the passage of the Foreign Bank Supervision Enhancement Act (FBSEA). Direct reaction for drafting this regulation were the fraud scandals of two banks, the Bank of Credit and Commerce International (BCCI), a Middle-East bank chartered in Luxembourg, and Banca Nazionale Del Lavoro, an Italian bank. The FBSEA gave the Federal Reserve Board a more direct role in the supervision of foreign banks, mandating annual on-site examinations of all foreign branches. Also, the FBSEA imposed that the Federal Reserve Board approved the establishment of any new organizational activity by a foreign bank (State of New York Banking Department, 1999).

The Gramm-Leach-Bliley Act in 1999 also had potential far-reaching consequences for foreign banks operating in the United States. Prior to the Act in 1999, a consequence of the separation of investment, banking and insurance activities was that entrants (from Europe) had to choose which activity the bank would undertake. This theoretically limited the application of the universal banking model, and its potential profitability in one of the largest banking markets. Domestic mergers and acquisitions could have far reaching consequences for activities in the United States. When the Dutch ING was formed it had both insurance and banking activities in the United States. ING was given leeway to operate with a banking licence in the United States until the group decided itself to give up its banking licence (Wolffe and Waters, 1998). The opposite was also true, domestic mergers were influenced by United States regulation. Merger talks between Dutch insurer Nationale Nederlanden (forerunner of ING) and ABN (forerunner of ABN Amro) were discontinued because if the merger would have taken place, either the substantial activities

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<sup>4</sup> Specifically, continuing economic instability in Mexico, Argentina and Brazil could endanger United States' regional security interests where left opposition parties used the debt crisis against centrist governments. Also, the debt crisis entailed domestic costs besides banks. Latin America had been the primary market for North American exports, and the United States had been the primary market for Latin American goods and commodities: North American exports came under pressure, causing domestic lay-offs, while price-cutting Latin American imports hurt American competitiveness, due to reduced domestic demand (Dombrowski, 1996, p. 129).

<sup>5</sup> For example, the internationalization strategy of Dutch NMB was largely based on the trade of Brady bonds.

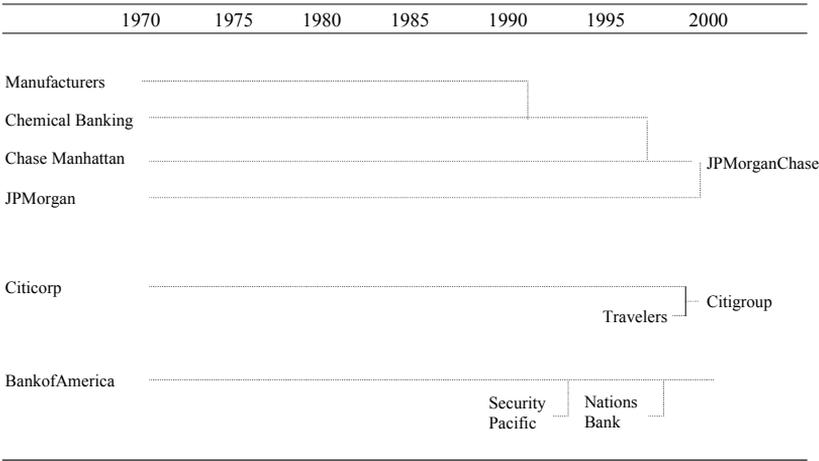
of insurance or banking in the United States would have to be divested, which neither party agreed to.

The anticipated merger and acquisition activity due to the Gramm-Leach-Bliley Act did not materialize in 2000-01; falling stock markets and decreased economic growth reduced the willingness and financing capability of foreign banks to do so, and American banks focused on cutting costs and building their operations internally (Harrison, 2002). Also, the Federal Reserve set different requirements for foreign banks, and initially made them subject to a slower approval process than domestic banks (Nicholson, 2000).

*Market power and concentration*

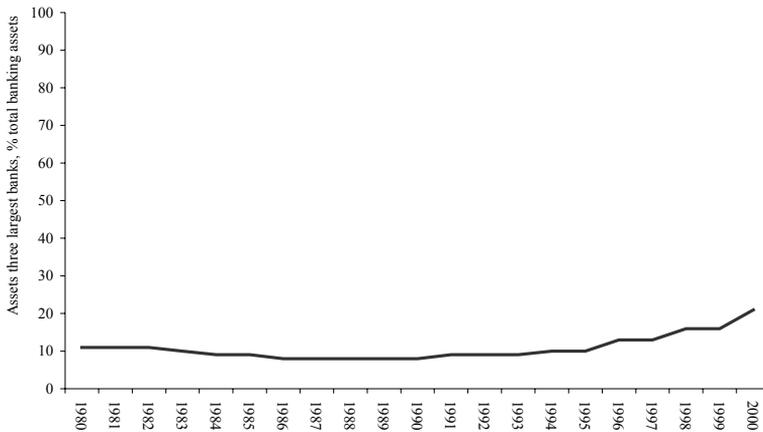
The American banking system was been less concentrated in terms of market share than other banking systems in other countries between 1980 and 2000. In the 1980s domestic merger activity increased when (interstate) branching restrictions were deregulated (reference not available). The market share of the largest banks rose significantly from the mid-1990s, mainly caused by mergers among the largest banks: Chase Manhattan and Chemical Bank (1995), Bank of America and Nationsbank (1998), Citicorp and Travelers (1998) and Chase Manhattan and J.P. Morgan (2000).

Figure 12.1. *Mergers and acquisitions of five largest banks*



While the regulated banking market were an incentive for banks to internationalize in the 1960s and 1970s, the combination of ongoing deregulation from the 1980s onwards and low domestic concentration ratio's offered ample opportunities to grow domestically, and has been an incentive for a number of banks to engage in domestic consolidation.

Figure 12.2. Market share three largest American banks, % total banking assets



Source: Assets largest three banks taken from the Banker Top 1000, various issues. United States total banking: Federal Reserve.

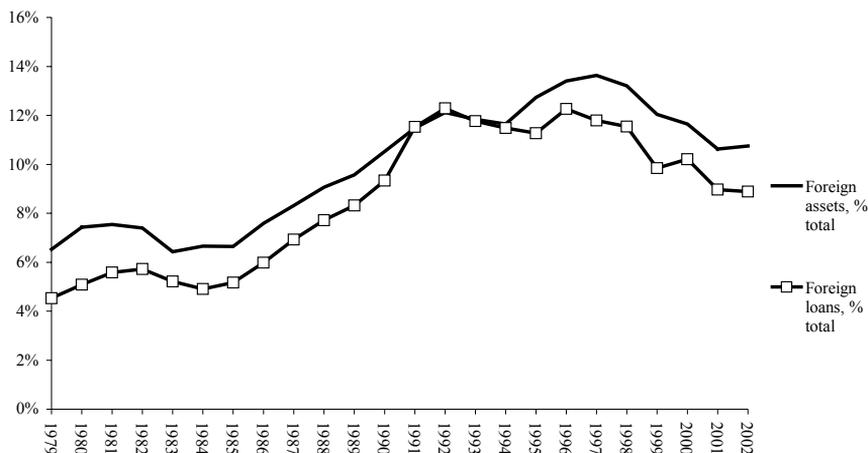
## 12.2. Foreign banks

Foreign banks have had a significant presence in the United States, helping finance growth and development of the economy during the nineteenth and twentieth centuries. Growth in New York offices expanded after the First World War when banks sought access to foreign bonds and equities. In the late 1940s growth was resumed (Institute of International Bankers, 1997); the rate of expansion accelerated in the 1970s and steadily continued to grow in the 1980s. In the 1990s, the expansion began to level off.<sup>6</sup>

Between 1973 and 2000, assets of foreign banks doubled in size every four years, compared to six years for domestic banks. Due to the sheer size of the American banking market, their market share remained modest however. From 1983 to 1992 a strong expansion took place, showing higher growth rates than domestic banks. Walker (1983) investigated the behavior of foreign banks in the United States between 1973 and 1982. Total assets of foreign activities increased 310% during that period, compared to 99% for domestically owned commercial banks. Regional differences were found, the growth of foreign banks did not differ much from domestically owned ones in the more highly regulated states of New York and California, but took place in less regulated states. Also, the balance sheet structure did not differ significantly from domestically owned banks. Finally, of the acquisitions done by foreign banks in 1979, one out of five acquired banks were considered problem banks (Walker, 1983). Figure 12.3 shows the foreign market share of loans and total assets of commercial banks in the United States.

<sup>6</sup> Foreign banks are also important for the United States economy, employing over 118,000 at the end of 1996. In New York, the financial center of the United States, foreign banks employed over 50,000 staff with a total payroll of 4 billion US dollar.

Figure 12.3. Share assets and loans foreign banks in the United States



Source: calculated from the Federal Reserve, Assets and Liabilities of Commercial Banks in the United States (H8), year end figures, monthly basis. Total loans include commercial and industrial loans, real estate, consumer and other items, but exclude interbank loans.

From 1980 onwards, the balance sheet structure of foreign banks started to change. While the share of total loans did not differ much from domestic banks, its composition did - foreign banks actively participated in commercial and industrial (C&I) loans, and held an approximate 25% share of C&I loans.<sup>7</sup> On the other hand, foreign banks shied away from real estate loans, which proved to be advantageous in the late 1980s when the US property market collapsed. Also, foreign banks held a large share of interbank loans in the 1980s, rising from 8% in 1980 to 23% in 1987, but this declined in the 1990s under 10%.<sup>8</sup>

Japanese banks played a special role, owning 55% of foreign United States banking assets in 1990 (Hasegawa, 1995, p. 421). In 1984, US government demanded that Japan increased the value of the Japanese Yen compared to the dollar and open its markets, attempting to reduce its trade deficit with Japan. The value of the Yen increased by more than one third between 1983 and 1986; due to its trade surplus Japanese institutions held large capital reserves and found that the devaluation of the US dollar made investments in American real estate and bank assets a bargain. Japanese banks left their imprint on investment banks in 1988 when Nomura Securities bought 20% of Wasserstein & Perella, a merger and acquisitions boutique; Sumitomo bought a stake in investment bank Goldman Sachs and Nippon Life acquired a substantial share of Shearson Lehman (Barnet and Cavanagh, 1994, p. 406). By 1989, Japanese banks provided 20% of all credit in California. From 1992, loan expansion seemed to have reached a plateau, coinciding with

<sup>7</sup> Source: assets and liabilities foreign banks in the United States Retrieved September 2002, from website Federal Reserve, <http://www.federalreserve.gov/releases/h8/data.htm>.

<sup>8</sup> Data source: Federal Reserve Bank.

the decreased lending capacity of Japanese banks as a result of the Japanese stock market bubble (Tschoegl, 2000).

In the 1990s asset growth of foreign banks in the United States was more or less kept at the same pace as domestic banks. At its pinnacle in 1997, foreign banks controlled almost 14% of United States commercial banking assets, doubling the market share since 1980. Profitability and spreads suggest a permanent attractiveness of the United States market during 1980 and 2000, abstaining from exchange rate movements. There is a large volume of research on foreign banks in the United States suggesting that foreign owned banks perform less than domestic US banks (Seth, 1992, Nolle, 1995). This can partly be explained by the acquisition of problem banks. Foreign banks carried some of the burden of restructuring in the American banking industry, paying for poorly performing banks in return for market presence. Assuming that foreign banks do not achieve above average returns in the United States, and restructuring takes several years, the average return is bound to be lower than domestically owned banks (cf. Seth, 1992, p. 5). Common explanations are that foreign banks sacrificed profitability in exchange for increased market share during the late 1980s and early 1990s (DeYoung, 1996, p. 634), or that transfer pricing took place, shifting earnings to tax friendly countries (Seth, 1992, p. 5).

### **12.3. Case studies**

The internationalization activities of six American banks are analyzed in more detail: Citicorp, Bank of America, Manufacturers Hanover, Chemical Banking, J.P. Morgan, and Chase Manhattan. By 2000, the latter four banks had built up a common heritage: Chemical Banking and Manufacturers merged in 1991, and then merged with Chase Manhattan in 1995. In 2000, Chase acquired J.P. Morgan. The other banks also changed considerably: Citicorp merged with Travelers group to form the first bank-insurance combination, and Bank of America was transformed by its merger with Nationsbank in 1996.

#### **12.3.1. Citicorp**

If financial experts were to name one "global universal bank par excellence", it would likely be Citicorp (Canals, 1997). In the 1960s, the expansion of international banking business followed American clients expanding in Europe. Also, the bank aimed to offer a full range of financial services, a strategy which was not common among banks during that period (Canals, 1997, pp. 92-93). During the 1970s, the bank grew in complexity, expanding the bank's business along the formulated I's: institutional banking, individual banking, investment banking and information technology.

Figure 12.4. *TNI Citicorp, 1980 - 2000*



The 1980s were a difficult period for Citicorp, coping with an economic recession in 1981-2 and 1989-90. In the early 1980s, volatile interest rates for funding, and interest rate ceilings hurt the profitability of consumer banking activities such as credit cards and mortgages.<sup>9</sup> From 1982 loans extended to emerging markets, and transformed into the LDC crisis, and began to affect the financial performance of Citicorp. In 1987 John Reed, chairman of Citicorp, announced that his bank was establishing a 3 billion US dollar reserve against LDC loans, creating the largest quarter loss in banking history.<sup>10</sup> In the same year, the stockmarket crash in October meant heavy losses for the bank. Another strategic choice was the purchase of Quotron, an electronic data vendor of stockmarket information. Quotron clients were also competitors of Citicorp, and the company lost 40% of its clients inducing a net loss of 1 billion US dollar for the bank (Barnet and Cavanagh, 1994, p. 381).

Citicorp refocused, aiming to stay dominant in its chosen main businesses: consumer banking worldwide, international banking, and securities and transactional banking such as foreign exchange.<sup>11</sup> The scope of activities in the investment banking division was cut back. On the other hand, the retail banking unit was to be expanded, which was profitable and less risky, growth was also to be achieved abroad. In the early 1990s, Citicorp was the US bank offering the most financial services; the retail unit was particularly strong in mortgages and credit card services. In these years, an aggressive program of cost cutting, and divestiture of non-strategic activities was pursued.<sup>12</sup> To

<sup>9</sup> Wels, A. (1981, June). Citicorp climbs to the top. *The Banker*, pp. 45-49.

<sup>10</sup> The announcements was favorably received by the stock market, but the write off also forced other American and British banks with large LDC loan exposure in South America to do the same, because Citicorp's action questioned the real book value of their standing loans (Madura, 1991).

<sup>11</sup> *The Economist*. (1991, July 27), p. 66.

<sup>12</sup> Citicorp was also pressured by its regulators, the New York Federal Reserve Bank and the Office of the Comptroller of the Currency, to do so. From November 1990, Citicorp had to consult the regulator for all its strategic decisions, for two and a half years (Barnet and Cavanagh, 1994, p. 382).

emphasize Citicorps role in foreign operations, Onno Ruding, a former Dutch finance minister and executive at ABN Amro, was brought in as vice chair, to attract more foreign capital, and promote its role in financial transactions in Europe (Rogers, 1993, p. 45). By the end of 1992, the bank operated in 92 countries and had about 88,000 employees (Canals, 1997, pp. 94-95).

Table 12.3. *Activities Citicorp*

Period	Phase	Objective	Arena	Client			Product			Organizational form											
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture	
'80 - '91	Restructuring, refocus & exit	1. Restructure foreign activities	Europe, Asia, South America			■															
		2. Internal restructuring, cost cutting measures	Domestic		■																
		3. Focus on consumer banking, reduce investment banking	Domestic		■	■															
'92 - '97	Broad expansion	1. Expand foreign activities	Europe, Asia			■															
		2. Focus on domestic retail and corporate clients	Domestic			■	■														
		3. Diversification in financial services	Domestic		■	■	■	■	■												
'98 - '00	Focused expansion	1. Expand in consumer finance	Domestic			■	■														
		2. Expand in investment banking	United Kingdom		■	■	■														
		3. Expand in foreign consumer and corporate finance services	Mexico, Japan		■	■	■														

Fragmentation of the banking market (creating opportunities to create more efficiency by cutting costs), rising shareprices (increasing merger and acquisition opportunities) spurred a consolidation wave in the United States banking market from the early 1990s onwards. Its zenith was reached when in April 1998 Citicorp agreed to be acquired by Travelers for 82.5 billion US dollar, the largest acquisition in the banking history of the United States.<sup>13</sup> A driver for the merger was the cross selling of retail financial services.<sup>14</sup> Travelers Group evolved in the 1980s and 1990s as a financial services firm, diversifying in areas as life insurance, mutual funds, (secured and unsecured) consumer loans and credit cards. In 1997 Travelers bought Salomon and formed investment bank Salomon Smith Barney. The newly formed company was acclaimed to be the worlds largest financial services firm, being a full service bank for customers in 100 countries. Citicorp and Travelers received regulatory approval for the

<sup>13</sup> In April, several other of the most expensive acquisitions were announced; the 66 billion US dollar purchase of California's BankAmerica by NationsBank of North Carolina was announced as well as the 29.5 billion US dollar takeover of First Chicago NBD by Banc One. Source: Authers, J. (1998, May 5). USA: Big may not be so beautiful - consolidation in US banking has acquired its own momentum, but some doubt the underlying logic. *Financial Times*.

<sup>14</sup> Corrigan, T. (1998, April 9). USA: Pair looks at options on banking side - synergies. *Financial Times*.

merged, providing that the United States Congress would drop its restrictions against banking and insurance combination. This was achieved in the Gramm-Leach-Bliley Act in 1999.

The merged company was renamed Citigroup and set out to balance retail activities on the one side and wholesale and investment banking on the other side. Retail activities were strengthened with consumer finance acquisitions in the area of sub prime lending, an old focus of Travelers: in 1999 Commercial Credit Company was acquired, and 100 branches of Associates First Capital Corporation. Continuing this development, Citigroup bought the largest listed US finance company, Associated First Capital, for over 31 billion US dollars, specialized in making loans to consumers who have difficulty obtaining bank credit. With the acquisition, Citigroup also attained a stronger foothold in Japanese consumer finance.<sup>15</sup> This prompted the Financial Times to remark that "Citigroup now more looks like a finance company than a bank when it comes to consumer financial services, particularly in the United States" (Silverman, 2000).

Outside the United States, the bank stepped up its acquisition pace in Japan and Europe. In Japan it raised its stake in Japan's third-largest broker, Nikko Securities, to almost 21% considering co-operation in a broad range of financial services. The two banks already had an investment banking joint venture operating in Japan.<sup>16</sup> Citicorp had long been active in Japan, forming for example in 1986 an alliance with Dai-Ichi Kangyo to share each other's ATMs, act as financial intermediary, and distribute Citicorp's Mastercard in Japan (Smith and Walter, 1997, pp. 109-110).

Citicorp also had a long history in the United Kingdom, entering the market in the 1970s, when Citibank acquired 49% of Grindlays as part of a rescue operation in 1974 (most of Grindlays' operations were outside the United Kingdom). Citibank was actively developing the Eurocurrency markets, and ventured into the corporate domestic market. The UK market had some attractive traits, such as the structurally high interest rates, the low degree of financial products compared to the United States and the ongoing deregulation (Hindle, 1980).<sup>17</sup> Citibank announced in 1980 that it would revamp all its 40 UK offices providing a "comprehensive range of savings and loans products under one roof" and introducing new products.<sup>18</sup>

The importance of the United Kingdom was reinforced in 2000, when European investment banking was expanded with the 2.2 billion US dollar acquisition of the investment banking unit of Schroder in the United Kingdom. Citigroup intended to make its investment banking unit, Salomon Smith Barney, into a serious player in Europe's

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<sup>15</sup> Hill, A. (2000, September 7). Associates attracts mixed reception. *Financial Times*, p. 18.

<sup>16</sup> Nakamae, N. (2000, March 27). *Financial Times*, p. 4.

<sup>17</sup> The following factors made the United Kingdom market attractive for Citibank: relaxations of exchange controls open the way for more sterling deposits, attractive profitability of UK banks in recent years, structurally high interest rates and the relatively 'underbanked' market in the United Kingdom. Source: Hindle, T. (1980, November). Sizing up the retail market. *The Banker*.

<sup>18</sup> Innovative new products were a cheque account combined with a savings facility and an automatic right to borrow up to 30 times the monthly savings payment, in effect creating the United Kingdom version of an interest bearing deposit account.

M&A market<sup>19</sup>, effectively doubling Salomon's equity and investment banking activities in Europe. It also bought Polish bank Handlowy, one of Central Europe's largest corporate banks.<sup>20</sup>

Within the home region, Citigroup purchased Mexican Grupo Financiero Banamex in 2000. The company was the country's largest financial services group, also having a Californian subsidiary. The purchase served as a "reverse internationalization": Citigroup intended to use the bank to reach the growing market of Mexicans and Hispanics living in the United States (McQuerry, 2001).

### 12.3.2. J.P. Morgan

As one of the three successors of the house of Morgan, J.P. Morgan committed itself since 1933 to commercial banking for large corporate clients. The Financial Times commented in 2000 that "during much of the past two decades, J.P. Morgan has laboured to correct [...] its decision to become a commercial rather than an investment bank under the Glass-Steagal Act".<sup>21</sup> Until the late 1970s, J.P. Morgan's most important source of business were wholesale banking activities. The bank began a process in the early 1980s to change from a commercial bank to an securities firm when Morgan's large customers, corporations like General Motors or Ford, abandoned bank borrowing in favor of capital markets for their financing needs. This prompted a variety of new financial services, such as separate affiliates for private banking and fund management that were created in 1984. In an effort to maintain relationship banking as an organizational trait, the strategy was based on internal growth, not acquisitions.<sup>22</sup>

J.P. Morgan has historically been one of the most internationally oriented banks in the United States. In 1980, more than 50% of its assets and gross income were located outside the United States, a pattern that would not change significantly over the next decades. J.P. Morgan shaped its internationalization strategy by essentially internationalizing its domestic lending policy and practices by emphasizing wholesale corporate lending and correspondent banking relationships. Half of its assets were located abroad, with a strong emphasis on Europe, especially the United Kingdom. The different regulatory environment in Europe meant that J.P. Morgan started its investment banking build-up at an earlier stage in Europe than in the United States<sup>23</sup>, concentrating on the United Kingdom as a financial center.

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<sup>19</sup> Portanger, E. & Beckett, P. (2000, January 19). In Buying Schroders, Citigroup Places Bet on Europe's Future.. *Wall Street Journal Europe*, p. 1.

<sup>20</sup> One of the stakeholders was Commerzbank, holding a 10% stake after Handlowy merged with BRE where Commerzbank held a stake in. Source: Williamson, E. & Beckett, P. (2000, February 11). Citigroup Wants to Purchase Majority of Bank Handlowy. *Wall Street Journal Europe*, p. 6.

<sup>21</sup> Silverman, G. & Lewis, W. (2000, April 5). House of the New Economy. *Financial Times*, p. 29.

<sup>22</sup> Preserving a culture proved costly. (2000, October 19). *Wall Street Journal Europe*.

<sup>23</sup> Silverman, G. & Lewis, W. (2000, April 5). House of the New Economy. *Financial Times*, p. 29.

Table 12.4. *Geographic distribution assets J.P. Morgan*

period	1980-5	1986-90	1991-95	1996-99
Home	47,9%	53,8%	54,6%	54,1%
Asia, Pacific	8,9%	6,2%	5,3%	7,6%
Europe	29,1%	32,2%	35,2%	33,9%
Middle East, Afric	2,4%	0,7%		
ROW	11,7%	7,1%	3,7%	0,0%
South America	0,0%	0,0%	1,3%	4,4%

The bank had also been historically involved in Latin America. Between 1980 and 1982, the bank set up branches in Mexico, entered a joint venture for leasing activities, and acquired minority interest in a Brazilian commercial bank, and a Chilean commercial bank. The LDC debt crisis also hit earnings of the bank hard, the exposure to Brazilian and Mexican loans alone amounted to 89% of its capital in 1982. This percentage compared favorably though to the other top five United States banks, being higher capitalized and probably also somewhat more restricted in lending policies. In September 1989, the bank announced that it would add 2 billion US dollar to its loan. In 1998 after the peso crisis, the bank even assumed the role of banker of last resort for Mexican businesses, when the economy ran short on US dollars, installing a special advisory committee to assist the Mexican government.<sup>24</sup>

After restructuring in 1987, J.P. Morgan entered into mergers and acquisitions with the intention to change to a investment bank, being allowed to trade and underwrite corporate equities from 1991 onwards. Non interest income amounted to 31% of gross income in 1980; by 1990 it had diversified its non interest revenue base to 51% of gross income. This consisted of capital market activities (predominantly in interest and exchange rate swaps), investment banking revenues and asset and pension fund management. The fourth major business was custody (Canals, 1997, pp. 96-97). In 1999, the year before Chase acquired the bank, non interest income had further increased to 82% of gross income.

Also in the 1980s, Asian banking activities became more dominant. The bank opened several branches in the major Asian financial and economic centers; by 1994 the bank had opened branches in Beijing, Shanghai, celebrated its 25th anniversary in Tokyo, opened a securities representative office in Seoul, and formed a second joint venture with the Industrial Credit and Investment Corporation of India to offer investments services in India.<sup>25</sup> The ongoing liberalization of the Japanese capital market also created new opportunities. Having established a presence in Japan since 1969, J.P. Morgan further formed an alliance with Dai-Ichi Kangyo in 1998 to distribute international mutual fund

<sup>24</sup>Crawford, L. (1998, June 9). Companies & Finance International: JP Morgan rides high after Mexican comeback. *Financial Times*, p. 26.

<sup>25</sup>J.P. Morgan & Co Inc. (1994, December 31). *10-K Filing*, p. 88.

products in Japan through Dai-ichi Kangyo's retail channels.<sup>26</sup> Two years later Dai-ichi Kangyo merged into Mizuho; in light of this merger the joint venture was ended.

Figure 12.5. *TNI J.P. Morgan, 1980 - 1999*



In its transformation to an investment bank, J.P. Morgan began to rationalize its operations, outsourcing activities which it no longer considered its core business (proprietary IT, or custody) or divesting smaller activities in which it had to invest considerably to increase its position. Despite its head start in equities, it could not catch up with the top securities firms. Its traditional focus on the wealthy customers meant that it had missed out on the mass consumer market. To fill this void, J.P. Morgan bought a 45% stake in Century Investments in 1998, an American fund manager.

By 1998, the bank's strategy was questioned. Although it had made considerable advances, its investment banking expertise had lagged in telecommunication, media and technology sectors which were the major revenue sources in the late 1990s. The bank also managed its capital conservatively, implying a high credit rating but also a lower than average return on equity. Its strategy to create internal growth raised the question of size. Could the bank effectively compete with other larger competitors who had both the funding through the retail network and the size to maintain the relatively high cost base of investment bankers? Shareholders did not seem to think so. Since 1990, the share price had consistently lagged compared to Citicorp or Chase. The bank's reputation was damaged in 1998 by the Bre-X minerals fiasco, when J.P. Morgan became financial advisor to a Canadian mining company that wrongly claimed to have found gold in Borneo. It was also one of the banks heavily exposed to the LTCM hedge fund loans, and played a similar role in transactions with the Energy company Enron.

<sup>26</sup> Tett, G. (1998, October 2). Companies & Finance: Asia-Pacific: JP Morgan in Japanese mutual fund deal. *Financial Times*, p. 28.

Table 12.5. *Activities J.P. Morgan*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Asset management	Securities	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Diverture
'80-'87	Broad expansion (1)	1. Diversification into new financial services	Domestic, Europe		■	■	■													
		2. Joint ventures with banks for corporate clients	Latin America		■	■														
		3. New greenfields, focus on Japan	Asia		■	■														
'87-'97	Broad expansion (2)	1. Diversification into securities underwriting	Domestic		■	■														
		2. Establish branches in developing economies	Developing countries			■														
		3. Set up securities activities in Europe	Europe		■															
'98-'99	Restructuring, refocus	1. Shift to consumer market	Domestic				■													
		2. Outsourcing and divesting internal operations	Domestic																	
		3. New ventures in Japan, India	Asia			■														

By 1999 the bank concluded that it had missed out on a decade of consolidation in the United States investment banking industry. Its response to its decreased market position in investment banking was to be acquired by a larger bank. After overtures domestic securities firms (but also Deutsche Bank) the bank agreed in 2000 to be acquired by Chase Manhattan, twice the market capitalization of J.P. Morgan who had sought to increase its investment banking activities from 1998 onwards.<sup>27</sup>

### 12.3.3. Chase Manhattan

Between 1980 and 2000, the degree of internationalization of Chase Manhattan decreased, showing a reversal in 2000 with the acquisition of J.P. Morgan. The declining importance of international activities for Chase since the 1980s was reversed in 2000. In 1980, the internationalization index was 47%, steadily declining to 26% in 1994. The merger with Chemical banking decreased the TNI to 17% for the next four years, rising to 31% in 2000. The acquisitions of U.K. based Robert Fleming and J.P. Morgan in 2000 naturally changed the international profile considerably, with J.P. Morgan reporting a TNI of 72% in its last year of independence. The internationalization strategy of Chase can be divided into three periods: strategy for a nationwide bank (1980-94), domestic consolidation (1995-98), and expansion in worldwide investment banking (1999-2000).

<sup>27</sup> Gasparino, C. & Sapsford, J. (2000, October 19). Preserving a Culture Proved Costly For J.P. Morgan. *Wall Street Journal Europe*, pp. 1, 6.

Chase's strategic plans in the early 1980s for expansion focused more heavily on domestic than international activities. Whereas domestic loans almost doubled in size in the 1970s, foreign loans had risen nine fold. In 1980, foreign assets, income as well as profit before tax had overtaken the domestic numbers. Chase had built a considerable international network from the early 1960s, motivated by the same reasons as the other banks - regulation, the rise of the Eurocurrency market in London, and direct presence in Common Market and EFTA (Wilson, 1986, p. 124). In the United States, the banks' customers included large corporate clients, (governmental) institutions and retail clients, served through its branch network in New York competing directly with Citibank (Wilson, 1986, pp. 138-9). Geographic spread of its branch network would be a recurring theme for Chase.

Figure 12.6. *TNI Chase Manhattan, 1980-2000*



In the early 1960s Chase expanded its network in Latin America<sup>28</sup> while other American banks were more active in Europe. After a failed attempt to penetrate the Canadian market, Chase aimed to expand in Europe, taking financial participations or setting up branches between 1966 and 1969 (Wilson, 1986, p. 172). United States commercial banks were barred from investment banking activities in the United States but could undertake develop such activities abroad. Chase initiated the Orion bank in 1970, a consortium of several European banks<sup>29</sup>, to underwrite Eurocurrency loans and provide investment banking activities (Wilson, 1986, p. 184).<sup>30</sup>

Chase started new branches in the 1970s outside the United States. Most of them were small in size or supplemented existing representation by leasing or merchant banking

<sup>28</sup> Acquiring banks in Brazil, Venezuela, Peru, Colombia, Argentina and Honduras (Wilson, 1986, p. 164).  
<sup>29</sup> Before the creation of Orion, Chase had attempted to form an alliance with European banks to provide Chase customers with local funding, prompted by the capital controls of the U.S. government for subsidiaries.  
<sup>30</sup> In 1973 Chase independently set up underwriting activities similar to Orion's (Wilson, 1986, pp. 233-234).

institutions. An attempt to expand in foreign retail banking was attempted in West-Germany in 1973, opening a chain of branches in Germany through a subsidiary, Familienbank AG (Wilson, 1986, p. 236). Chase entered this strategy to alleviate funding problems in Europe by creating a local deposit base, and hoped to earn more than the slim margins of international banking. At the time it planned to open 75 branches in 5 years.<sup>31</sup> It also hoped to open 30 branches in the United Kingdom, expecting resistance after the New York banking superintendent barred Barclays proposed takeover of the Long Island trust. The plans for the United Kingdom were aborted because the start up investments were difficult to recoup in a competitive market. In Germany, Chase eventually opened 13 branches but the Familienbank never became the success it hoped for and was closed down in 1977.

The 1980s were a difficult period for the bank. Adequate country risk analysis was emphasized in Iran, where it held a 35% interest in the International bank of Iran. Freezing of the assets by the revolutionary government invoked difficult negotiations. In 1982, the bank's earnings and solvency was hit hard by the LDC debt crisis. Furthermore, loans to two brokerage companies defaulted and an investment in Penn Square failed due to the energy crisis. On average, the bank was in a similar deteriorated financial shape as the other top five U.S. banks. The strategic response was a more cautious banking strategy, assessed by Canals as a certain degree of lethargy (Canals, 1997, p. 86).

Stability of earnings and increasing the share of non interest income became an important issue. The domestic presence was strengthened with the purchase of a New York bank with 172 branches and six savings and loans associations, converted by Chase in commercial banks. The bank was reorganized in three areas: retail banking, investment banking and institutional banking. Outside the United States, private banking activities would be targeted. Chase decided to exit retail banking abroad (Caltina and Tschoegl, 2002, p. 26). Also, a separate unit was established to generate more income from the existing branch network and correspondent relationships outside the United States (Wilson, 1986). In 1985, Chase entered into a joint venture with Australia Mutual Provident to enter retail banking, becoming one of the three leading banks in Australia (Caltina and Tschoegl, 2002, p. 25).

The implementation of this strategy proved difficult. The bank's organization did not easily adapt to the new structure. Also, the American economy slowed down and slipped into recession in 1989-91. In 1987, 1989 and 1991, the bank had to report negative returns on equity. With change of management strategic focus changed. The unprofitable and competitive commercial banking activities in Europe were discontinued, and Chase also decided to withdraw from the leasing and pension fund business there. The bank would further concentrate on retail banking, accounting for 50% of the bank's revenues, cash management and portfolio management. Capital market activities became a lower priority (Canals, 1997, p. 87). To accommodate this, the organization was restructured.

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<sup>31</sup> Chase Manhattan: European Strategy (1984). *The Banker*, p. 546.

Table 12.6. *Activities Chase Manhattan*

Period	Phase	Objective	Arena	Client				Product			Organizational form							
				Government	Institutional	Corporate	Private	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80 - '94	Restructuring, refocus & exit	1. Increase domestic branch network, focus on retail client	Domestic															
		2. Exit from European commercial banking	Europe			■												
		3. Exit from foreign specialized financial services	Europe		■	■												■
'95 - '98	Consolidation, balanced growth	1. Merger with Chemical, focus on cost savings	Domestic															
		2. Continue exit and rationalisation foreign activities	Europe, Japan, South America															
		3. Expand in domestic custody, credit card	Domestic		■	■	■											■
'99 - '00	Restructuring, refocus	1. Expand domestic investment bank, acquire J.P. Morgan	Domestic		■	■	■											
		2. Expand foreign investment bank and fund management	United Kingdom		■	■	■											

The financial performance of Chase improved steadily. In August 1994, Chase Manhattan and Chemical Banking announced their merger. Although Chemical Banking became the senior partner in this merger with 55% ownership, the bank adopted the Chase Manhattan name because of the stronger brand name. The principal motive of this deal was to cut costs. From the outset, cost savings of 1,5 billion US dollar annually and a worldwide staff reduction of 12,000 from the combined 75,000 staff were targeted.<sup>32</sup> The first years after the merger were spent on integration and further rationalization of activities. The strategy set by Chase in 1991 was continued, divesting commercial banking activities outside the United States.<sup>33</sup> In 1998, additional cost cutting measures were announced to realize further annual savings.<sup>34</sup> At the same time, custodial services and credit card activities expanded through domestic acquisitions.

From 1998 onwards, the bank seemed ready to significantly increase its share in investment banking activities. Using its traditional dominance of syndicated lending as a platform, the bank moved into debt underwriting, mergers and acquisitions advice and equities.<sup>35</sup> To this purpose Chase bought within a time span of two years investment bank Hambrecht & Quist in 1999 (increasing its equities business and coverage of the technology sector), British investment bank Robert Fleming in 2000 (a leading Asian fund manager and equities underwriter in Asia), Beacon Group in 2000 (a New York based merchant bank) and finally at the end of 2000 J.P. Morgan. The combined investment amounted to almost 45 billion US dollar.

<sup>32</sup> Marriage of equals. (1995, September). *The Banker*, p. 5.

<sup>33</sup> In 1996 to Deutsche bank in Japan, and also in 1996 to Banco Chemical in Portugal.

<sup>34</sup> *Financial Times*. (1998, August 5), p. 28.

<sup>35</sup> Another piece laid in the jigsaw. (2000, March 24). *Financial Times*.

#### 12.3.4. Chemical

Chemical operated as a large bank in the New York region, when its international operations significantly grew in the late 1960s and 1970s. The bank's strategy was to concentrate on establishing branches in major financial and economic centers, instead of building large foreign branch networks that would make the bank vulnerable to fluctuations in foreign economies.<sup>36</sup> Offices in the Bahamas and Frankfurt were opened in 1969, branches in Zurich, Paris and Brussels in 1971, and in Tokyo in 1972. By 1977 Milan, Singapore and Taiwan branches were added and a 30% equity stake in a London merchant bank was acquired. Besides that, several activities with banks in Austria, the Philippines and other countries were started. The foreign branches also participated in foreign exchange activities and securities trading.

The bank was also active in LDC loans, just as the other large U.S. banks. From the early 1980s, the degree of internationalization fell steadily. More prudent foreign lending, combined with domestic growth, instigated the decline in internationalization from 37% in 1984 to 15% in 1990, the year before merging with Manufacturers Hanover who had a larger share in international activities.

Chemical grew through acquisitions in the 1980s, buying Texas Commerce Bancshares in 1987, one of Texas' largest banks. This acquisition was the largest interstate banking merger in U.S. history and allowed Chemical to expand in a major regional banking market. Another regional diversification of banking activities was the acquisition of Horizon Bancorp of New Jersey in 1989.<sup>37</sup>

Although relatively successful compared to the other major banks, Chemical was confronted too with large LDC losses in the 1980s, particularly in Brazil and Argentina. In 1990 Chemical exited from international securities trading activities in Switzerland and Japan<sup>38</sup>, also closing its branch in Taiwan.

In July 1991, Chemical Banking and Manufacturers Hanover announced that they would merge creating the second biggest bank in the United States. The merger of Chemical and Manufacturers Hanover tried to span two strategies. It first aimed at cost savings, then to position the new bank as a strong, primarily domestic retail and wholesale bank for the 1990s. Raising equity (an estimated 1.25 billion US dollar on top of the merged equity base of 6 billion) was to serve as a cushion against bad loans on both banks' balance sheets.<sup>39</sup> Manufacturers Hanover was strongly exposed to LDC debt. Chemical Banking also had to cope with the aftermath of the LDC crisis, and also had accumulated losses from its costly acquisition of Texas Commerce Bancshares, which suffered from the

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<sup>36</sup> Chemical Banking Corporation. (1988). In Grant, E.T., *International Directory of Company Histories*, vol. 2, p. 251.

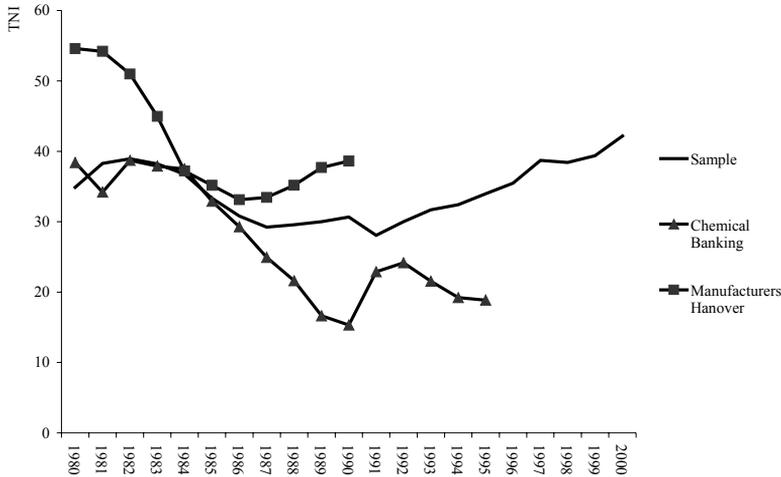
<sup>37</sup> The merger was announced in 1986 and delayed until 1989 when interstate banking between New York and New Jersey was allowed. Source: Chemical Banking Corporation. (1988). In Grant, E.T., *International Directory of Company Histories*, vol. 2, p. 252.

<sup>38</sup> USA: Chemical cuts third quarter dividend by 63% (1990, October 12). *Financial Times*, p. 23.

<sup>39</sup> Just Trust Us. (1991, July 20). *The Economist*.

oil decline in Texas.<sup>40</sup> The higher capital base not only served as a cushion for the bad loans, it also raised the credit worthiness of the bank attracting safety-conscious customers for cash management, letters of credit and other services.<sup>41</sup>

Figure 12.7. TNI Chemical Banking (1980-1995), Manufacturers Hanover (1980-1991)



Chemical, the new name of the merger, continued to expand its Texas operations, buying branches and banks in 1992 and 1993. In 1993 Chemical was permitted to deal and underwrite in securities, broadening the range of financial services for its clients. Profitability of the merger bank remained lower than its domestic competitors, by the end of 1994 the bank announced a broad ranging restructuring of the bank. Staff was to be reduced by 9%, peripheral business would be sold and as well as 1 billion US dollar of non-performing real estate loans, and the bank announced an increase in its share buy back program. These measures were at the time viewed as a belated attempt to deal with the 1991 acquisition of Manufacturers Hanover. Furthermore Chemical planned significant reductions in its German subsidiary, employing a staff of 300 in capital market and corporate finance activities; it also would reduce its presence in Chile.<sup>42</sup> Unable to acquire a significant share of the market outside the New York metropolitan region, it sold 60 branches of Horizon Bancorp in 1995, acquired 6 years earlier, and integrated the remaining branches into its existing network.

<sup>40</sup> USA: Challenges ahead for Manufacturers and Chemical Banking Tie up (1991, July 17). *Financial Times*, p. 22.

<sup>41</sup> Mendes, J. (1992, June 29). Chemical Banking: When Mergers Make Sense. *Fortune*, p. 85.

<sup>42</sup> Waters, R. (1994, December 2). International Company News: Chemical Banking to axe 3,700 jobs in shake up. *Financial Times*, p. 22.

Table 12.7. *Activities Chemical Banking*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80 - '91	Restructuring, exit	1. Reduce foreign activities	Europe, Asia, South America																	
		2. Internal restructuring, cost cutting measures	Domestic																	
		3. Domestic market growth, acquiring regional banks	Domestic																	
'91 - '95	Restructuring, refocus & exit	1. Maintain existing foreign activities	Europe, Asia																	
		2. Focus on domestic retail and corporate clients	Domestic																	
		3. Diversification in financial services	Domestic																	

In 1995 the bank sold its participation in Philippine based Far East Bank & Trust Company. Apart from this, Chemical did not change its international operations significantly after the merger. Walter Shipley, CEO of Chemical, stated that because of the merger the bank had the client base to make full use of the international branch network, suggesting that profitability from foreign activities had risen.<sup>43</sup>

### 12.3.5. Manufacturers Hanover

Manufacturers was the 9th largest bank in the United States at the time of the merger with Chemical Bank, itself the result the result of the 1961 merger of Manufacturers Trust Company and Hanover Bank. The 1961 merger started troublesome, when almost immediately the US Department of Justice filed an antitrust junction, to be withdrawn five years later, but which initially held back the bank's expansion plans. International expansion did not suffer though; in 1967 the bank generated 20% of its income from foreign banking activities, increasing to 40% in 1972. During the 1970s the bank had difficulties adjusting to the changed economic environment, depending for 75% on loans for income, more than any other major bank. Diversification in (more stable) retail banking activities were developed; the bank acquired domestic mortgage and consumer finance businesses over the next years. International activities were continued too. In 1970 it acquired banks in Brussels and London to gain access to the euromarkets. Branches were opened in Tokyo, Singapore, Rio de Janeiro, Oslo, and in 1974 a branch in Bucharest (the first Western bank to do so behind the Iron Curtain). By 1980, more than half its income was earned outside the United States: the bank had 436 branches in the United States, and 78 offices or branches in 37 countries with a wide range of financial products and services.

The 1980s were challenging for the bank. By 1979 the bank had to increase its loan loss reserves when debt repayments from LDC borrowers became uncertain. Piling up bad

<sup>43</sup> A second act for Walter Shipley. (1994, March). *US Banker*, pp. 24-30.

loans came to haunt the bank in mid 1984, when a 30% drop in the bank's stock prices forced management to announce publicly that it would write off 1.3 billion US dollar of Argentina's loans. During the 1980s, the bank would rationalize and retreat from foreign activities, restructure its domestic operations and domestically diversify in new financial activities. In 1983, the bank bought CIT Financial, a financial consumer company, from RCA for 1.51 billion, at the time the largest sum a bank had spent on an acquisition.

To streamline the organization, over 5,000 employees were made redundant and the bank installed new information systems to more accurately determine profit and losses by various units. Foreign operations, such as the Belgian subsidiary and consumer unit in the United Kingdom were sold off. Manufacturers issued 750 million US dollar in common stock to increase capital, and sold 60% of CIT to Dai-Ichi Kangyo Bank for 1.28 billion US dollar in 1989.

These measures partly offset additional bad loan provisions. The bank incurred losses in 1987 and 1989, after further increasing reserves against South American loans, but also energy loans and (domestic) real estate loans. In 1989 and 1990 Manufacturers agreed to buy 24 New York branches of Goldome, a savings bank. Manufacturers merged with Chemical Bank on December 31, 1991.

#### 12.3.6. Bank of America

In 1980 Bank of America reported record earnings and became the largest bank measured by assets a year later. More than 45% of its assets were located outside the United States, indicating an active internationalization strategy. Seven years later, the bank was not among the largest 25 banks in the world, a position it achieved again in 1998. By 1998, foreign assets had dropped to 11%, a steady decline since the 1980s caused by an active combination of increased domestic mergers and foreign divestitures.

Bank of America built a strong position in California, having been restricted in branching out to other states. In the 1970s, the bank had established a presence in all major financial centers, with commercial branching networks in Europe and Latin America. The bank acquired Seafirst, a Washington based bank in 1983, and diversified into securities buying Charles Schwab. The 1980s demonstrated that the asset seeking strategy of the 1970s and early 1980s had major flaws: operating expenses were hard to control<sup>44</sup>, management had difficulties coping with the organization, and the foreign expansion turned out to be over-ambitious<sup>45</sup>, having lent considerably to LDC's.

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<sup>44</sup> Bergsman, S. (1990, February). BankAmerica: Shake, Rattle and On a Roll. *Bankers Monthly*, pp. 15-18.

<sup>45</sup> Palmer, G. (1994, October 31). Back On Top. *The Banker*, pp. 31-34. The expansion of the 1970s and subsequent restructuring are discussed in Hector (1988) and Johnston (1990).

Figure 12.8. *TNI Bank of America, 1980-2000*



Between 1985 and 1987 the bank had to reveal losses. Rumors about its capital adequacy forced the share price down, even prompting a takeover bid from smaller bank First Interstate in 1985. This event did not succeed but forced a change in management.<sup>46</sup> Subsequently a restructuring program was announced with three goals (Canals, 1997, p. 89). First, the retail and commercial banking unit was strengthened, since BankAmerica had an extensive distribution network. Second, poorly performing lending activities were divested or cut back. Third, international activities also cut back. Divesting foreign activities raised capital - the retail branches of Bank America d'Italia were sold to Deutsche Bank<sup>47</sup>, as was German Bankhaus Centrale Credit. At home FinanceAmerica, the bank's consumer finance arm was sold to Chrysler and the trust business went to Wells Fargo.<sup>48</sup> In 1987 Charles Schwab was sold back to the founder, and new capital was issued, mainly invested in by Japanese institutions.

After cutting costs and restructuring bad loans, the bank returned to profit in 1988 and steadily increased its financial performance. In 1990 the operations of Bank of America were expanded into seven other states by acquiring thrifts.<sup>49</sup> In 1992 Bank of America acquired Security Pacific, the largest U.S. banking merger at that time. Loan losses, unsuccessful diversification in investment banking and over-expansion in Australia had hurt the bank badly. Internationally, Bank of America had retreated since the mid-1980s. The number of European staff decreased from 7,500 to 1,700 in 1994, the number of Latin American countries it was active in decreased from 20 to 6.

In acquiring Californian bank Security Pacific it gained an Asian network of 22 branches. The branches were kept, aiming at a niche strategy serving large customers from

<sup>46</sup> Tom Clausen, who also was chairman from 1970 until 1981, engineering the growth strategy of the 1970s.

<sup>47</sup> This was Bank of America's first foreign subsidiary with the purchase of Banca d'America e d'Italia in 1957. It had set up a London branch in 1931 (Brützel, 1981, p. 44).

<sup>48</sup> Palmer, G. (1994, October 31). Back On Top. *The Banker*, pp. 31-34.

<sup>49</sup> Profile of BankAmerica Corporation. (n.d.). Retrieved January 1, 2003, from www.hoovers.com.

the United States. Other foreign activities were rationalized, selling the British securities firm of Security Pacific<sup>50</sup> in 1992 to ABN Amro. As a result of the merger, Bank of America increased its position in California, increasing total assets by 56%. The bank acquired additional banks and mortgage businesses, and in 1994 Continental Bank was bought, expanding Bank of America with a large corporate banking franchise.<sup>51</sup> In 1996 the bank restructured: 120 branches in California were to be closed, reducing staff by 3,700. To raise capital, BankAmerica spun off its credit card operations in a 1996 IPO; it also sold its institutional trust and securities services and a consumer finance unit. It acquired investment banking group Robertson Stephens in 1997, which was soon afterwards sold to BankBoston.

Table 12.8. *Activities Bank of America*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Private	Credit	Securities	Asset mgmt	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Diversure
'80 - '84	Broad expansion	1. Diversify in financial services (securities)	Domestic																
		2. Maintain a global network	Europe, Asia, South America																
		3. Expand domestic branch network	Domestic																
'85 - '98	Restructuring, refocus & exit	1. Reduce foreign activities	Europe, Asia, South America																
		2. Focus on domestic retail and corporate clients	Domestic																
		3. Mergers with regional banks (1992, 1994, 1998)	Domestic																
'99 - 00	Restructuring, refocus	1. Divest foreign consumer and private banking	Europe, Asia																
		2. Expand investment banking unit	Domestic, United Kingdom																

Bank of America and Nationsbank announced their merger in 1998. Nationsbank emerged as a regional bank from North Carolina, expanding by acquiring assets, branches and (defunct) banks from the savings and loans crises late 1980s and early 1990s, nearly doubling its assets when the FDIC chose the bank to acquire Texas largest (defunct) bank. From 1993, it diversified into securities trading (1993) and investment banking (1997), further expanding its network by acquiring more regional banks.<sup>52</sup> The merger was domestically driven and came in a period when consolidation in the U.S. banking market was considered to be increasing. Combining BankAmerica, the fifth largest bank in the U.S. with a strong West-Coast presence, and Nationsbank, the third largest bank with a strong presence in South-Eastern part of the United States, created the largest and most

<sup>50</sup> Hoare Govett, after a failed management buy out.

<sup>51</sup> Hylton, R.(1994, March 21). BankAmerica: Go where the money is. *Fortune*, p. 70.

<sup>52</sup> *Bank of America Corporation*. (n.d.). Retrieved October 12, 1999, from Hoover's Inc, Bloomberg.

broadly based bank in the United States at the time, controlling 8.1% of consumer deposits, double its nearest competitor.<sup>53</sup>

Just after completing the merger, the bank had to write down a 1.4 billion US dollar bad loan to investment firm D.E. Shaw, being financially hit similar to LTCM by the Russia crisis. The Russian crisis, and the merger activities between Nationsbank and BankAmerica led the bank in early 1999 to restructure its foreign activities, selling its private banking operations in Europe and Asia to UBS<sup>54</sup>, and its consumer banking business in Asia to ABN Amro.<sup>55</sup> Simultaneously, it announced that it planned to expand its securities activities in at home as well as in the United Kingdom, attempting to build it up internally.<sup>56</sup>

#### **12.4. Commonalities and differences**

The six American banks in the sample followed similar internationalization strategies in the 1980s, but these strategies diverged in the 1990s. The growth of foreign activities halted with the LDC debt crisis in 1981. Between 1980 and 1990, American banks were struggling with their financial solvency and profitability: besides non performing LDC loans, economic recessions in 1981-82 and 1990-91 added problem loans from areas such as project finance and real estate.

The six banks reduced their international exposure to loans or exited from banking activities. Retail banking and commercial banking in Europe was abandoned by Chase and Bank of America, all banks restructured the scope of their foreign services. The weakened financial position also led to the merger of Chemical Banking and Manufacturers Hanover.

From 1991 strategies diverged; Bank of America, Chemical Banking and Chase Manhattan expanded their domestic activities through mergers or acquisitions of (super)regional banks to gain market share as deregulation progressed. Asset seeking strategies were resumed, but compared to a decade earlier, growth areas were domestic banking compared to international banking activities, having the advantage of less volatility and more scope for cost cutting measures due to the home market bias.

J.P. Morgan and Citicorp on the other hand remained committed to their international activities throughout the 1980s and 1990s. In some ways the banks were each others mirror: J.P. Morgan spent most of its energy transforming itself to an investment bank on a global scale, building activities in the major financial centers throughout the industrialized and developing countries. As the other domestic competitors transformed into universal banks, it found that it had missed out on the retail market from 1998 onwards, and moved towards a merger with retail bank Chase. Citicorp on the other hand focused on consumer banking on a worldwide scale since the late 1980s and almost a

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<sup>53</sup> USA: Bank consolidation gathers pace - banking mergers. (1998, April 14). *Financial Times*, p. 26.

<sup>54</sup> *Bank of America Corporation*. (n.d.). Retrieved October 12, 1999, from Hoover's Inc, Bloomberg.

<sup>55</sup> ABN Amro in Asian deal. (1999, May 20). *Financial Times*, p. 32.

<sup>56</sup> Bank of America to build European Arm. (1999, March 23). *Financial Times*, p. 35.

decade later, through the merger of Travelers, it focused its international expansion on investment banking.

The five banks that remained at the end of the 1990s developed a common approach towards investment banking. Driven by the growing size of the capital markets and the expectation that securities markets in Europe were at the beginning of a long and prosperous growth era, the banks expanded aggressively in European investment banking. Chase is especially noteworthy since it bought J.P. Morgan for this purpose, while Citicorp bought British investment bank Schroders in 2000. The Bank of America took a more cautious approach, believing that greenfields and autonomous growth would lead to similar market shares in European investment banking.

## 13 Internationalization of British banks

The international expansion of the British banks during the 1970s was delayed, compared to American banks. Barclays, Lloyds and the National Westminster each held a network of foreign subsidiaries and affiliates built up from the 1910s. This network was to a large extent rooted in former colonies but not developed, high-income economies which had enjoyed a strong expansion in the 1950s and 1960s.

This changed from the 1970s. Domestic consolidation had changed the Big Five into the Big Four (merging National Provincial and Westminster Bank into National Westminster bank), creating a high degree of concentration in the commercial banking market. Interest rate pricing cartels were abolished, increasing competition. The banks sought to regain their dominant international position before the ascent of American banks, and set on an international expansion course. Common denominators were the targeting of the United States as an expansion region for retail banking, but also Europe. Syndicated lending was boosted with loans to the lesser developed countries, but to a lesser extent than American banks. The banks were conscious of each other's relative position: to regain lost ground to the other British banks, Midland tried to catch up by one large American acquisition. This started almost a decade of losses, ended by being acquired by HSBC in 1992.

The expansion exacted its toll on banks in different manners. Lloyds effectively retreated from international banking, as the smallest bank of the Big Four with the least reserves to absorb the losses accumulating from the 1980s in emerging markets and the United States. National Westminster and Barclays maintained their growth strategies and added (global) investment banking as a pillar after the Big Bang in 1986. However, spurred by financial losses the two banks eventually withdrew from commercial banking in the United States and Europe in the 1990s, reorganized and scaled down their investment banking activities and refocused on the home market.

Table 13.1. *Incentives for internationalization of British banks*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Net interest margin in the United States generally higher in the 1980s, UK net interest margins converging to European averages in the 1990s</li> <li>• Economic structure: Strong financial sector, attractive for incumbent banks but also entry foreign banks</li> <li>• Regulation: between 1983-86, financial markets were deregulated, in 1990s monitoring banks formalized and increased, creating new regulator (FSA)</li> <li>• Historic and cultural determinants: English speaking advantage, sharing same lwa tradition with the United States</li> <li>• Client: historically large FDI outflow to the United States, large FDI inflows</li> <li>• Perception of the market: presence Europe's largest financial center, presence eurocurrency market capital pool for mergers and acquisitions</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: expansion in the United States (1970s, 1980s), entry in investment banking (1980s). Similar retreat but with different time schedules</li> <li>• Market power and concentration: Largest banks have had stable market position, continued liberalization of building societies increased competition in the 1990s</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies: foreign scale enlargement in the 1980s, domestic scale enlargement in the 1990s after diversiting foreign banking activities</li> <li>• Shareholder return: negatively related to degree of internationalisation for British banks, relative high valuation compared to European banks.</li> </ul>

### 13.1. Incentives to internationalize

#### *Clients, markets*

British banks played an active role in cornering a market share in international lending to developing countries (the LDC loans) in the 1970s and early 1980s. Especially Lloyds Bank pursued an aggressive strategy, being classified by the UNTNC as one of the "challengers" to the hegemony of the five American banks dominating the LDC loan syndication process (United Nations Centre on Transnational Corporations, 1991). The other British banks were more considered to more passive. In general British banks were more active than European banks, and therefore were confronted with higher provisioning. "Perhaps the main criticism of the British banks was that, given Britain's unique history of international banking, they should have been so willing to disregard past experience and to follow the American lead" (Jones, 1993, p. 352). Especially at Lloyds Bank International, with the Bolsa network active in Latin America for more than a century, a more cautious approach would have been expected.

In 1987, British banks were effectively forced by the bank of England to increase their loan-loss reserves for LDC loans, caused by Citicorp's announcement that it would

take a 3 billion US dollar write off of LDC loans.<sup>1</sup> The success of recouping part of the loans for British banks depended on the efforts of American banks who played a major role in the restructuring process, but now effectively surrendered. The write off hit British banks relatively harder, where the provisioning mainly fed through the income statement, compared to American banks (Madura, 1991).

### *Regulation*

Until 1979, English commercial banks were restrained by government regulation, both qualitative involving lending priorities and quantitative. Between, 1945 and 1979, there were only two three-year periods when the banks were not subjected to government direction (Pohl and Freitag, 1994, p. 1153). Political factors, such as the Korean War and the Suez crisis, but more importantly the relative weakness of the British economy, manifested in recurrent balance of payment crises, and the pro-cyclical economic policies of the government heavily influenced banking regulation, leading to restrictive interest controls throughout the 1970s.<sup>2</sup>

The growth of foreign banks into London was initially not a concern of the Bank of England, as long as they were not involved in domestic credit. Exchange controls were aimed at transactions by UK residents, transactions by non-residents using other currency than sterling were not restricted. The continued growth of the activities of foreign banks and their relative freedom compared to domestic banks finally forced a response by the British regulators in 1971, when the Competition and Credit Control reforms ended the interest rate cartel for the domestic clearing banks and subjected foreign banks to the same reserve requirements on sterling liabilities as domestic banks (12.5%). However, Eurocurrency deposits were left unregulated (Schenk, 2002, pp. 95-96).

The 1979 Banking Act sought to ward off conditions leading to the Secondary Banking crisis of the mid-1970s, by formalizing depositor protection, minimum capital requirements for banks, and the role of directors (Tickell, 2001). The financial deregulation in the 1980s was marked by the “Big Bang” of the financial markets in October 1986. Like New York’s “May Day” in 1975, the Big Bang started when the London stock exchange abolished fixed broking commissions on British shares and government bonds in July 1982, pressured by government. In 1986, the distinction was ended between the cartel of brokers, who dealt with the public, and the cartel of market makers (“jobbers”), who dealt with the brokers. Foreign and domestic banks, notably investment and commercial banks, increasingly acquired or took equity stakes in jobbers and brokers to create integrated securities activities.<sup>3</sup> So did the British banks, who invested substantially in developing the securities operations.

The financial deregulation presented had some unexpected consequences: business controls were not effectively monitored, as came to light with the Blue Arrow affair in 1987 (Augar, 2000, p. 127).

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<sup>1</sup> See also chapter 8 for a discussion of the LDC crisis.

<sup>2</sup> Pringle, R. (1977, August). The British four stake their claim. *The Banker*, pp. 113-121.

<sup>3</sup> Those munificent men in their dealing machines (1991, January 19). *The Economist*, pp. 81-84.

Another significant development that increased competition for British banks was the deregulation of the building societies. The 1986 Building Societies Act deregulated them to the extent that up to 25% of their total commercial business was permitted to be in non-traditional (i.e. home mortgage) services such as insurance, credit cards and personal banking.

Table 13.2. *Major regulatory events in the United Kingdom, 1980 - 2000*

Year	Regulatory instrument, policy initiative	Effect on internationalization	Effect on entry of foreign banks
1979	Abolishment exchange controls, Banking Act		
1982-1986	Deregulation financial market	Diversification British banks into investment banking, expanding it in other financial centres	Acquisition brokers and dealers by foreign banks.
1986	Building Societies Act	Partial liberalization building societies, increased domestic competition	
1991	Failure BCCI		Increase in regulation.
1995	Failure Barings		Failed domestic rescue operation by Bank of England, takeover by Dutch ING
1996	Establishment FSA		
2000	Cruikshank report		
2000	Financial Services and Markets Act		

English regulators had to cope with two big bank failures in the 1990s: BCCI and Barings. BCCI had been active in Britain for more than two decades, serving Pakistani clients. Its headquarters however were located in Luxembourg. In 1991 the bank defaulted, when a large fraud scandal came to light, embarrassing the Bank of England because there had been no formal agreement on how to supervise the bank, while its main activities were in the United Kingdom. On 26 February 1995 the Bank of England put Barings Bank into administration. The Singapore subsidiary of Barings, trading in futures, had tried to fraudulently misrepresent its own trading positions when the derivatives exposure were escalating losses after a wrong bet on the direction of the Nikkei index. One week later,

ING bought the bank for one pound sterling and a commitment to meet all of its liabilities. While initial blame went to the trader, Nick Leeson, it also became clear that the bank did not adequately supervise nor apply separation of functions. The Bank of England organized a lifeboat operation as soon as it found out that Barings capital based might be wiped out, but the 600 million pounds sterling pledged by the large British banks were not enough, since the derivative contracts were open-ended and the rescue operation failed. The informal supervision, where the Bank of England trusted verbal assurances from managers had proved inadequate (Tickell, 2001).

In 1996, a new regulator, the Financial Services Authority (FSA), was established to merge banking supervision and investment services regulation. In 1998, responsibility for banking supervision was transferred from the Bank of England to the FSA. The Financial Services and Markets Act in 2000 further transferred responsibilities to the FSA (such as building societies) and gave the FSA new responsibilities, for example to regulate mortgage lending and to set up and monitor conduct for market behavior.<sup>4</sup> The debate on regulation became heated again when in 2000 Cruickshank, chairman of the Banking Review<sup>5</sup>, concluded that the relationship between banks and government are tighter than strictly needed for ensuring systemic soundness, creating excess profits in the domestic banking market and entry barriers.<sup>6</sup>

Summarizing, regulation in the 1960s and 1970s was strict for domestic banks, and lenient for foreign banks, stimulating the entry of foreign banks and the growth of London as a financial center. Monitoring was done informally. Over the next decades, the monitoring became more formalized and was eventually centralized, this has been done especially since the mid 1990s, while differences in competitive advantages between foreign and domestic banks were abolished.

### *Market power and concentration*

The banking concentration of British banks has historically been high, comparable to levels in the Netherlands and France. These levels have been relatively stable, guarded closely by the monopolies and mergers committee. For example, in 1982 a proposed merger between Standard Chartered and Royal Bank of Scotland was prohibited on these grounds.

The high market share did not imply that banks dominated the banking market as well. Building societies played an important role too, especially from 1986 onwards when they were allowed to provide more financial services, and the mid 1990s when they “demutualized”. Given the relatively high and stable share, it would suggest that a likely avenue of growth was internationalization.

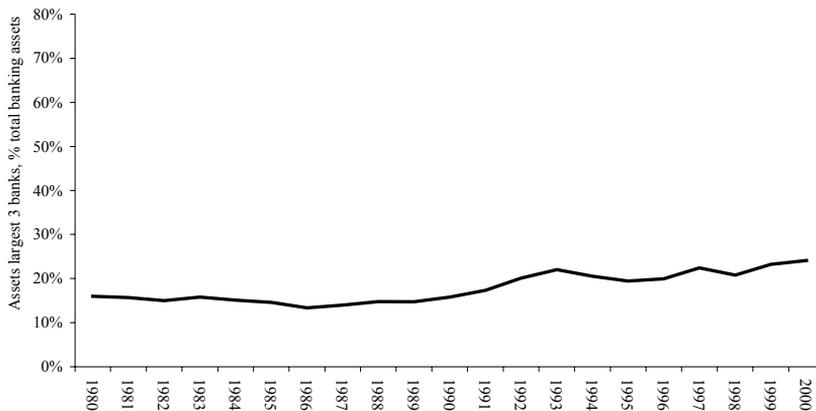
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<sup>4</sup> Retrieved May 24, 2003, from [www.fsa.gov.uk/history](http://www.fsa.gov.uk/history).

<sup>5</sup> Independent review of banking services in the United Kingdom, announced in 1998 by the Chancellor of the Exchequer. The approach taken was similar to the competition investigation by the European Commission's DGIV (Cruickshank, 2000, p. 1).

<sup>6</sup> Plender, J. (2000, March 21). Too close for comfort. *Financial Times*, p. 16.

Figure 13.1. *Share of largest three banks in United Kingdom, % total assets*



Note: assets three largest banks as % total banking assets. Source largest three banks: The Banker Top 1000, 500, issues 1981-2001. Source total banking assets: broadest measure banking assets in OECD Bank profitability database ("All banks"). Banking assets prior to 1984 missing, weighted growth rate of British banks in Top 1000, 500 taken as proxy for change in total banking assets.

### 13.2. Foreign banks

The United Kingdom played an important role in international banking after the second world war, especially since the 1970s. London became the major European financial center for securities trading and the Eurocurrency market and its securities and investment banking houses were targeted for co-operation and acquisition by European and American banks, especially after the deregulation in 1986.

London as an international banking center owed much of its dominant position from the 1960s to the growth of the euro-currency market and the support of the Bank of England. Before that, the role of the sterling as a reserve currency positioned London as a financial center when Commonwealth countries transacted their trade and held their reserves in sterling. As a result the city had a well developed banking structure, and enjoyed attractive features<sup>7</sup> which helped it offset the disadvantage of not having a large domestic currency base like the financial center of New York (or Tokyo).

Until 1960 foreign banks in Britain had been largely concerned with servicing the international offshoots of their own domestic corporate customers, gaining access to sterling resources. This situation changed in the late 1960s, when entry was motivated by the participation in the rapidly growing euro-currency market (Shaw, 1979, p. 244). US banks, already present from the 1960s, increased their activities significantly from 1968-

<sup>7</sup> Main features are: the informal regulatory framework of the Bank of England, a universally accepted language, good location well placed in the time zone to communicate with other major financial markets during working hours (Shaw, 1979). In addition to this, London enjoyed a concentration of financial information services, some of the world's leading money publications, specialist printers, and a substantial skilled labor forces. For American bankers, the use of English Law and English language was particularly attractive (Roberts and Armander, 2001, p. 14).

69, targeting the domestic market as well as the euro currency market. An attraction for the US banks was the opportunity to develop expertise in investment banking activities, which was not possible in the United States because of the separation between investment banking and commercial banking enforced by the Glass-Steagal act (Roberts and Arnander, 2001, p. 24).

The penetration of the domestic corporate market was led by the First National City Bank (later renamed Citibank). Besides having branches itself, First National City Bank held a 40% share in Grindlays, active in commercial banking and merchant banking.<sup>8</sup> By introducing and developing a market for medium term lending, they held 9% of the domestic sterling market in 1976 and probably accounted for 15% of industrial and commercial lending. The foreign banks in the United Kingdom held at that time a combined 30% market share of loans to British manufacturing companies (Pohl and Freitag, 1994, p. 1157). By 1984, the foreign banks accounted for 17% of the domestic sterling market, while commanding a 69% share in foreign currency loans.

In London, a total of 35 consortium banks were formed between 1964 and 1984, besides a host of foreign consortium banks that set up offices in London. This reflected London as a focal point for the Euro currency markets, and the lenient regulatory environment created by the Bank of England, who was supportive of the consortium bank concept (Roberts and Arnander, 2001, p. 23). By the early 1980s, the position of consortium banks was declining: the introduction of liability guarantees in the 1970s increased moral hazard for the shareholders<sup>9</sup>, and some shareholder banks had separately developed internationalization activities that competed directly with the consortium bank.

In the late 1980s, LDC loan provisioning contributed further to the demise of consortium banks. At the end of the 1990s, six consortium banks survived, mostly rooted in the Arab world (Roberts and Arnander, 2001, p. 177-197).

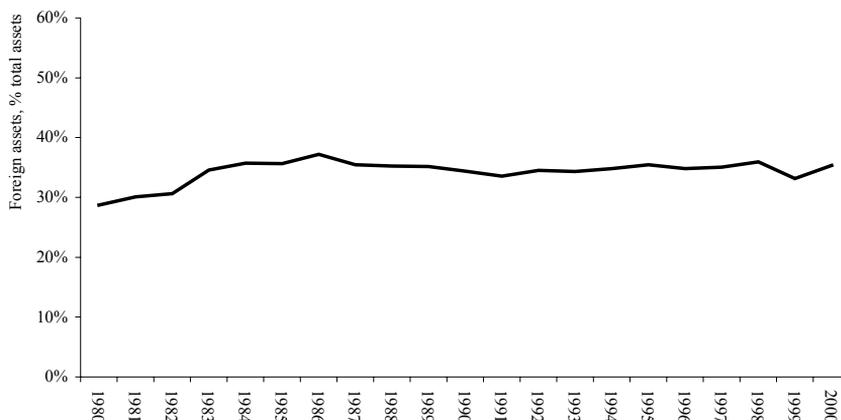
Under the Banking Act 1979, authorization for foreign banks to operate in the United Kingdom was subject to the same requirements as for British-owned banks. For establishing representative office, only a notification was needed, although the Bank of England as regulator preferred to discuss such proposals beforehand. Foreign banks acquiring domestic British banks were subject to the Monopolies and Mergers legislation, in the same way as domestic acquisitions (Pecchioli, 1983, p. 186).

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<sup>8</sup> Lloyds held 41% of Grindlays Holdings, the holding company that controlled 60% of Grindlays, and Citibank directly held 40% of Grindlays. "The structure satisfied the Bank of England's desire to prevent Grindlays from falling under American domination, but worked to prevent either large shareholder from intervening in the management of Grindlays [which] was less than optimal" (Jones, 1993, p. 337). The bank never recovered from the Secondary Banking Crisis of 1974-5 and the economic recession in the early 1980s; the bank was sold to ANZ in 1984.

<sup>9</sup> In the wake of the secondary banking crisis and the Herstatt failure, the Bank of England required each shareholder in 1974 to provide a letter of comfort, pledging support for their consortium banks. While larger banks provided these letters of comfort, banks with smaller shareholdings reacted by withdrawing from consortium banks in the mid 1970s, not wanting to risk the chance of standing bail for their weaker shareholders. For example, Paribas withdrew from three consortium banks, although it had a long history of joint venture banking (Roberts and Arnander, 2001, p. 179).

Figure 13.2. Foreign bank share in the United Kingdom, % total assets



Source: Bank of England. Note foreign assets: for 1975 - 1996 foreign assets is calculated as the sum of total assets of Consortium banks (RPAATFUCSBK), Japanese owned banks (RPAATFUJAPT), United States owned banks (RPAATFUUSAT) and other foreign owned banks (RPAATFUOFBT). For 1997-2000 foreign assets is calculated as the sum of total assets of European owned banks (RPATBGVOTEU), Japanese owned banks (RPATBGVJAPN), United States owned banks (RPATBGVUSAN) and other foreign owned banks (RPATBGVODEV). Data 1997-2000 adjusted for trend discontinuity.

From the early 1980s the foreign banks began to compete for retail banking business. In 1980 Royal Bank of Canada acquired Western Trust & Savings as an entry in the domestic retail market, while Citibank announced the conversion of its 40 British loan shops into full bank branches. Incentives to further develop retail banking were in place: exchange rate controls had been removed, so that the pound sterling could increase its role as an international currency, the British retail banking market was the most profitable in the world at the time, and a high percentage of the British population did not yet have basic banking services like a current account (suggesting “underbanked”-ness). This did not materialize, due to the high costs of starting new branches, the possible changes in rules on foreign takeovers, and the fact that most household had accounts with other financial institutions, like building societies.<sup>10</sup>

The other foreign banks operating in the British retail banking market were largely those serving ethnic minorities such as the Irish and Pakistanis, such as the “Arab-owned, Luxembourg-registered but largely Pakistani-staffed”<sup>11</sup> Bank of Credit and Commerce International (BCCI), having 45 branches in the United Kingdom.<sup>12</sup> The position of London as a financial center (and therefore the contribution of foreign banks to the British economy) came under pressure from the late 1970s: the emergence of many offshore centres, and the increasing use of the euro-bond market in West Germany, Switzerland and Luxembourg eroded the position of London (Shaw, 1979, p. 240). The government responded with a broad financial deregulation program, culminating in the Big Bang in

<sup>10</sup> Hindle, T. (1981, November). Modest impact in the retail banking market. *The Banker*, pp. 125-133.

<sup>11</sup> Hindle, T. (1981, November). Modest impact in the retail banking market. *The Banker*, pp. 125-133.

<sup>12</sup> Hindle, T. (1980, November). Sizing up the retail market. *The Banker*, pp. 111-119.

1986. Foreign banks responded very strongly to this: between 1983 and 2000, almost all British investment and merchant banks were acquired by (European and American) banks.

Table 13.3. *Major acquisitions of British merchant banks and brokers, 1983-2000*

Bank	Activity	Year	Acquiring bank	
			Domestic	Foreign
Hoare Govett	Bought by Security Pacific	1983		•
de Zoete & Bevan	Bought by Barclays	1984	•	
Philips & Drew	Bought by UBS	1986		•
James Capel	Bought by HSBC	1986		•
Wedd Durlacher	Bought by Barclays	1986	•	
Vickers da Costa	Bought by Citibank	1986		•
Hill Samuel	Bought by TSB	1987	•	
Morgan Grenfell	Bought by Deutsche Bank	1989		•
Hoare Govett	Equities sold to ABN Amro	1992		•
Barings	Bought by ING	1995		•
S.G. Warburg	Bought by SBC	1995		•
Kleinwort Benson	Bought by Dresdner Bank	1995		•
Smith New Court	Bought by Merrill Lynch	1995		•
Barclays/BZW	Equities and corporate finance sold to CSFB, ABN Amro	1997		•
NatWest	Equities business sold to Bankers Trust	1997		•
Schroders	Investment bank bought by Citigroup	2000		•
Flemings	Bought by Chase Manhattan	2000		•

Source: adapted from Augar, 2000, pp. 371-373.

At the end of 2000, three independent investment banks were left.<sup>13</sup> Augar found this remarkable, “given that in 1983 all of the top ten merchant banks in the UK were home-owned; that Continental Europe was so far behind [investment banking] that it scarcely had an equities culture [...], and that the Americans regarded London as a last posting for retiring partners” (Augar, 2000, p. 310). He attributes this to two factors. First, the commitment of the British government and the Bank of England to the doctrine of the free market exposed British firms to American firms who had spent the last fifty year accumulating experience and market positions in running integrated capital market operations, while the British banks were just getting accustomed to this business. Second, the financial deregulation was at odds with the light regulatory regime. Higher standards and more formal control would have prevented some of the managerial mistakes (and losses) leading to selling the banks to foreign parties (Augar, 2000, pp. 311-312).

Foreign banks also played another role, that of white knight in domestic take over battles. In 2000 Spanish BSCH injected Royal Bank of Scotland (RBS) with 1.7 billion

<sup>13</sup> The three remaining independent investment banks in the United Kingdom were Cazenove, Lazards and Rothschilds.

pounds, raising its ownership in RBS to 9.2%, helping RBS to take control of National Westminster and become the United Kingdom's second largest bank. RBS returned the favor later that year when it funded 500 million Pounds for BSCH to take over Banespa, a Brazilian bank.<sup>14</sup>

Japanese banks, as in most countries, played an important role in the London foreign banking market. By the end of the 1990s, the decline increased. The number of Japanese branches dropped from 27 in 1997 to 18 in 1999, falling further to 8 in 2002. In a similar fashion, Japanese banks' share of total banking assets in the United Kingdom changed considerably during the years. At its height in 1988, it commanded 24% of total assets, falling steadily to 5% in 2000. The drop in numbers, especially since the mid 1990s, was mainly attributable to the departure of a number of smaller Japanese banks, hit by the Japanese banking crises. From 2000, the decrease followed mainly from the mergers in Japan, and did not indicate a sharper decline in Japanese presence (Davies, 2002).

### **13.3. Case studies**

The internationalization activities of six British banks are analyzed: Barclays, Lloyds, Standard Chartered, Midland bank, National Westminster and HSBC. Four British banks have stayed independent between 1980 and 2000 (Barclays, Lloyds, HSBC and Standard Chartered); two banks were acquired (Midland bank and National Westminster). Midland bank, in the 1970s one of the largest banks in the worlds, remained independent until 1991, when it was taken over by HSBC who relocated from Hong Kong to the United Kingdom, as part of the merger condition. The case study for Midland is therefore covered between 1980 and 1991, while HSBC is discussed for the 1992-2000 period. National Westminster became an acquisition target itself after failing to acquire British insurer Legal and General in 1999; the bank was subsequently acquired by Royal Bank of Scotland.

#### **13.3.1. Barclays**

The internationalization of Barclays was based on the British Empire, when it created the Colonial Bank in 1917 and its Dominion, Colonial and Overseas (DCO) unit in 1925. Having started in the 1920s in developing countries, DCO's largest overseas banking activity was in South Africa, where it had to exit in the 1980s after protests against apartheid gained momentum. A second wave of internationalization began in the mid-1960s, when Barclays concentrated on expansion in the major financial centers in the United States, Western Europe and Asia (Rogers, 1999, p. 73). Barclays regrouped its international activities in 1971, and by 1974 the bank held 1,700 offices in 174 countries. In 1985 one bank was created, merging the domestic and international bank. In 1985 Barclays had 2,900 domestic branches and about 2,400 foreign branches.

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<sup>14</sup> Burns, T. & Wilman, J. (2000, November 26). UK bank returns favour in Banespa deal. *Financial Times*, p. 10.

Barclays had a long standing presence in the United States. It established a presence in California, selling the network in 1987 to Wells Fargo. In 1974, it acquired First Westchester Bank in New York. In 1979 it bought 28 branches from Bankers Trust (Tschoegl, 2000). By 1979, Barclays had 8,000 employees in the United States, and 135 branches in New York and California, besides several wholesale branches throughout the country. American expansion “was one of aggressive expansion without much consideration for its likely impacts on profitability“ (Rogers, 1999, p. 74). By 1988, Barclays shifted its focus within the United States and sold its retail banking activities between 1988 and 1990. The bank remained however committed to the investment banking activities, and also acquired the private banking business from Marine Midland, a HSBC subsidiary.<sup>15</sup>

In the early 1980s, Barclays developed a profitable business in Spain, but encountered difficulties elsewhere in Europe, where it acquired French Compagnie Europeenne de Banque from the recently privatized CCF in 1987 and German private bank Merck Finck in 1990, both at the top of the market (Rogers, 1999, p. 74). The domestic organization was reorganized along business lines in 1987, when Barclays defined its long term strategy (Canals, 1993, p. 162) to:

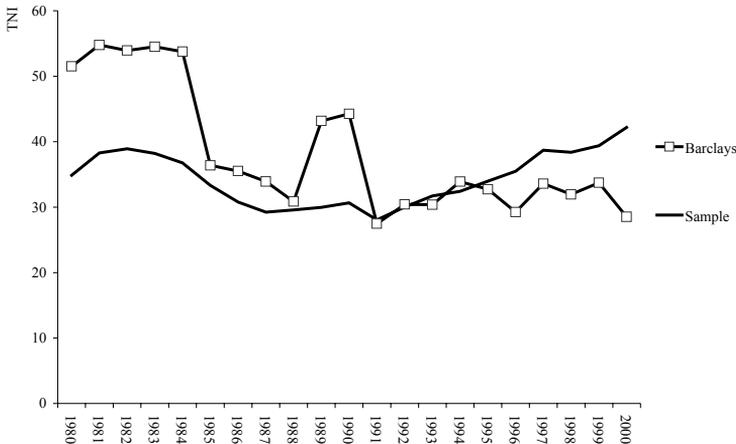
- Retain and exploit the current (strong) market position in the United Kingdom.
- Create a worldwide network of integrated offices that offer a global service to large corporations.
- Increase activity in three major economic regions: Europe, the United States, and Japan.

To finance international development, bank capital increased by a 900 million pounds rights issue in 1989. The creation of a worldwide network was further prompted by the creation of a single European market in 1992. Barclays, compared to other British banks, at the end of 1988 had the greatest presence in the European Community (EC), with a total of 250 offices in 10 EC countries. Canals observes that "the internationalization of its activities proves it to be one of the few banks with the vision of becoming a truly global institution" (Canals, 1993, p. 162). For example, it introduced a cash management product in 1988, offering a 24-hour service in any country. The extra capital to fund international expansion was not well spent. Barclays booked many bad loans in commercial real-estate projects and made several questionable acquisitions of retail banks in Europe, particularly France and Germany (Rogers, 1999, p. 34).

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<sup>15</sup> Barchard, D. & Bush, J. (1990, May 31). UK Company News: Barclays expands in US private banking. *Financial Times*, p. 26.

Figure 13.3. *TNI Barclays, 1980-2000*



A very unsuccessful adventure was Barclay’s array in investment banking. A merchant bank was formed in 1976 and in 1986 this bank merged with the acquired securities firms de Zoete & Bevan and Wedd, Durlacher, Mordant & Co. to form Barclays de Zoete Wedd (BZW) as a reaction to the deregulation of the financial markets in the United Kingdom (Pohl and Freitag, 1994, p. 1198). BZW had substantial independence within the bank in the early years and absorbed almost all of Barclays’ corporate finance business. By the late 1990s, BZW was also one of the last remaining British owned investment banks (Rogers, 1999, p. 81). From the outset, BZW was a problematic activity. Large differences in numeration between BZW and the "traditional" bank, an overlap in activities and client acquisition rivalry between BZW and Barclays, its smaller size compared to other investment banking competitors, and an unclear strategy made that BZW<sup>16</sup> did not become the success that was initially expected (Vander Weyer, 2000).

Responding to pressure from institutional investors after BZW incurred large losses, and to the implication of the merger in the United States of Travelers and Salomon Brothers, Barclays announced late 1997 that it was abandoning its ambitions to build a full-scale global investment bank (Rogers, 1999, pp. 68-69). BZW was sold in parts; CSFB bought the equities business and activities in Taiwan and Singapore, while ABN Amro acquired the Australian operations (Vander Weyer, 2000, p. 244). Barclays decided to concentrate on debt market business, scaling down and re-branding remaining activities to Barclays Capital; other activities were closed such as the Japanese equity business in November 1997 (Vander Weyer, 2000, p. 245). Barclays Capital created large losses in 1998, mainly through the default of Russian bonds and a stake in LTCM. The chairman

<sup>16</sup> An infamous example is the takeover of 40 American salesmen and analysts from bankrupt Drexel Burnham Lambert, announced as a strong addition of its global equity strategies. These employees were made redundant within a year. The Economist commented that “BZW [...] has shown up its American adventure for the opportunistic grab it was.” Source: Limey, go home. (1991, April 27). *The Economist*, p. 97.

was forced to exit late 1998, and Barclays closed down its Moscow representative office in 1999 (Vander Weyer, 2000, p. 7).

Table 13.4. *Activities Barclays*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Joint venture	Alliance	Fin. Part	Acquisition	Greenfield	Merger
80-86	Broad expansion	1. Expand in the United States	United States																
		2. Build commercial bank network	Continental Europe			■	■	■	■	■	■								
		3. Build network to service clients	Major financial centers Europe, South East Asia			■												■	
87-96	Restructuring, refocus	1. Increase domestic market position	Domestic		■	■	■	■	■	■									
		2. Build worldwide network to service large corporations	Major financial and economic centers			■												■	■
		3. Acquisitions in retail banking, restructuring from 1988 onwards	United States			■												■	
		4. Increase market position	Continental Europe		■	■	■	■	■	■								■	
97-00	Restructuring refocus & exit	1. Increase domestic market position	Domestic			■	■	■	■	■									
		2. Scale down international securities and corporate finance	Major financial centers Europe, South East Asia		■	■													■
		3. Rationalize foreign branch network	Whole organization			■													■

By scaling back its investment activities and selling off (minor) diversified activities internationally, Barclays created a strategy similar to the domestic oriented one Lloyds started ten years earlier. The mid-1990s were characterized by cost cutting measures and a revived interest for the large domestic consumer base which was expanded with the acquisition of former building society Woolwich.<sup>17</sup> Barclays Capital, the slimmed down debt market activities of BZW, also contributed to profitability.

13.3.2. National Westminster

National Westminster resulted from the merger between National Provincial and Westminster Bank, effectuated in 1970 and created one of the largest banks in the world. The merger led to a rationalization of the domestic network, where the number of branches fell from 3,600 in 1970 to 3,200 in 1979. International banking on the other hand was an area where National Westminster had the greatest scope for expansion (Pohl and Freitag, 1994, p. 1236). National Westminster developed an active international presence. The strategy was to be a diversified international bank, with a significant presence in global wholesale banking, domestic and international retail banking, and in private banking (Rogers, 1999, p. 129). National Westminster, similar to Barclays, pursued a universal

<sup>17</sup> Mackintosh, J. & Targett, S. (2000, August 10). Barclays sets up agreed move for Woolwich. *Financial Times*, p. 17.

banking strategy from 1986, the Big Bang year, to the late 1990s, maintaining a large domestic retail bank, and a global investment bank, NatWest Markets. From 1997, wealth management was added, including fund management and international private banking. (Rogers, 1999, p. 121).

Between 1972 and 1975, it bought into European banks, such as French Credit du Nord. It entered the Spanish market through financial participations in NatWest March in 1985 and Banco de Asturias in 1988 (Pohl and Freitag, 1994, p. 1236). Westminster entered the American market with a New York branch in 1970. In 1979 it acquired 75% of National Bank of North America, and purchased First Jersey National Corporation in 1988. In 1995, National Westminster sold NatWest Bancorp to Fleet Financial after it had spent 15 years building up a network of 330 branches in New York and New Jersey, and had struggled without success to make the business profitable, earning an average yearly 1% return on investment during its ownership (Tschoegl, 2000). The sale itself was triggered by the increasing consolidation of the super-regional banks in the United States, further raising competition (Rogers, 1999, p. 125)

In the late 1980s and 1990s, National Westminster suffered a series of drawbacks, damaging its financial performance and subsequently leading to its decline and takeover by Royal Bank of Scotland in 2000. In the late 1980s, problems arose in its investment bank and US banking operation, a few years later losses cumulated in its European activities, and its investment bank was an embarrassment in 1997. In anticipation of the financial deregulation in the United Kingdom, National Westminster had established an investment bank, County NatWest with a limited presence until 1986. Although it did not aggressively build its investment banking unit, like Barclays did with BZW, it closed some aggressive deals. In 1987, NatWest became underwriter for a 837 million Pounds rights issues for Blue Arrow, leaving NatWest with a considerable amount of shares which it hid in foreign subsidiaries to prevent a fall in share price, violating domestic regulation. The stockmarket crash of 1987 forced disclosure, and led to government inquiries, damaging the reputation of the investment banking arm, which did not create any profit anyway between 1985 and 1990 (Rogers, 1999, pp. 131-133).

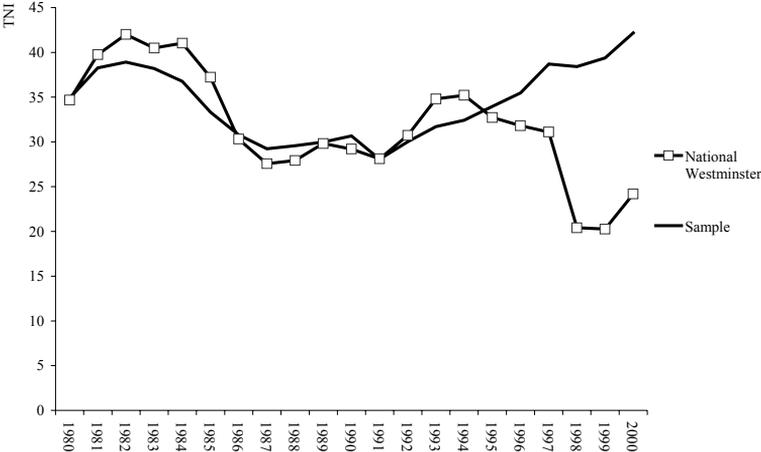
Its retail operations in the United States fared no better. It had expanded considerably during the 1980s, as part of a strategy to build a major regional bank in the North-East United States. Banks acquired at a high price, and an accumulation of problem loans. LDC loans in emerging countries, project finance and especially real estate<sup>18</sup> in the United States caused a series of losses, even surpassing the earlier record set by Midland in 1984. Between 1992 and 1994, results recovered, but the case for selling Bancorp became more convincing when the super regional banks forced more consolidation in the banking industry, and the acknowledgement that there were no existing synergies between Bancorp and the other NatWest operations. In 1995, NatWest exited from the retail business after 16 years (Rogers, 1999, pp. 132-134).

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<sup>18</sup> In general, foreign banks expanded to a lesser extent their activities in real estate loans than domestic banks in the United States.

In the same period, European operations were also disappointing. By 1993, after many years of expansion, National Westminster was reporting big losses in France and Spain and was scaling down and/or exiting as a result. The bank announced its that it would concentrate on investment and private banking there.

Figure 13.4. *TNI National Westminster, 1980 - 2000*



National Westminster’s financial performance had been lagging compared to its competitors since the mid 1990s. Shareholders expressed concern, given the bull market at the time. An analysis suggests that the problems were caused by a series of events: the sale of US NatWest Bancorp was well below market prices, and the majority of the proceeds went to several investment banking acquisition that subsequently produced disappointing performance. Also, a 85 million Pound loss from mis-pricing interest rate derivatives negatively influenced its reputation, raising doubts about how the bank had been managed and would be in the near future (Rogers, 1999, p. 125). Since 1997, much like Barclays, National Westminster sold off much of its investment bank after a series of high costs and disappointing performance (Rogers, 1999, p. 122).

The end of National Westminster as an independent bank started when in September 1999 it announced that it would take over Legal & General, an insurance company. Trigger was the acquisition of Scottish Widows by Lloyds TSB three months earlier, creating speculations about bank-assurance mergers.<sup>19</sup> Shareholders found the proposition from National Westminster not viable, and the price to be paid for Legal & General too high. The bank’s share price and market value declined sharply, triggering a hostile bid by Royal Bank of Scotland. Ultimately, this bid went through ending National Westminster’s independence.

<sup>19</sup> Steketee, H. (1999, September 7). Britse banken openen jacht op verzekeraars. *NRC Handelsblad*.

Table 13.5. *Activities National Westminster*

Period	Phase	Objective	Arena	Client	Product	Organizational form														
						Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset managment	Insurance	Services	Joint venture	Alliance	Fin. Part	Acquisition	Greenfield
80-92	Consolidation, balanced growth	1. Maintain domestic position	Domestic	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		2. Build investment banking unit (1986 onwards)	Domestic	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		3. Market growth acquiring regional banks	Continental Europe	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		4. Domestic market growth, acquiring regional banks	United States	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
93-99	Restructuring, exit	1. Divest European activities	Continental Europe	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		2. Divest American activities	United States	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		3. Divest investment banking unit	Domestic	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
		3. Increase domestic position by diversifying (failed)	Domestic	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■

### 13.3.3. Standard Chartered

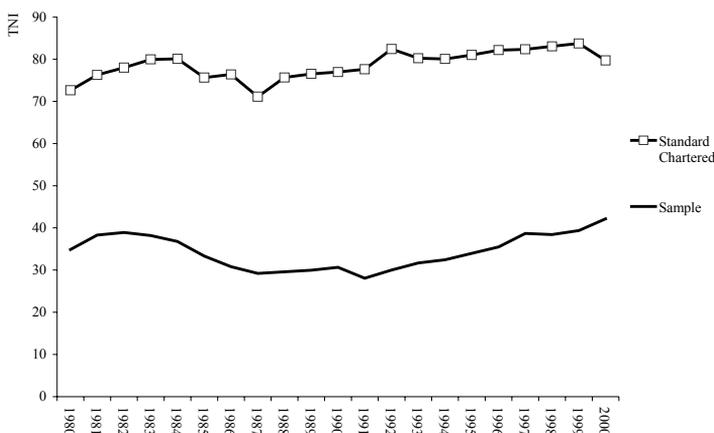
Standard Chartered, a British overseas bank with activities largely in Africa, America and the Far East, was formed in 1969, and could be described as “an institution which combined London-based international banking activity with an extensive commercial branch network [...] in the Asia-Pacific region, and a profitable banking business in parts of English-speaking Black Africa” (Jones, 1993, p. 346). The bank expanded its banking activities in Europe, the United Kingdom and the United States. The merchant bank of Standard was built up from a number of acquisitions made during the 1970s.

During the 1970s, Standard Chartered realized that the ownership of its equity by National Westminster, Midland and Chase Manhattan raised more questions than profit. In 1975, Chase was the last one to sell its shares (Jones, 1993, p. 339). In the same year, integration really materialized by combining the two head offices, and management launched an ambitious five year plan, with two corner stones: gain sizeable presence in the United States through the acquisition of a bank, and establish a strong domestic base in the United Kingdom (Jones, 1993, p. 340).

Chartered bought the Union Bank in California in 1979, merging it with the branches it already had established in that state. In 1984 the bank bought United Bank of Arizona (Jones, 1993, p. 345). In 1988, Standard Chartered withdrew from retail banking in the United States, selling the Union Bank to California First Bank, a subsidiary of Bank of Tokyo.

It remained less successful with establishing a strong domestic base. After establishing and acquiring activities in the United Kingdom, the domestic share still remained 27.5% of total assets in 1980 (Jones, 1993, p. 342). In March 1981 Standard Chartered was closer to this goal by announcing an agreed bid on Royal Bank of Scotland. Hongkong bank, similarly lacking a strong presence in the United Kingdom, made a counter bid, and two smaller banks joined the battle which ended when the Monopolies and Merger Commission rejected all bids.

Figure 13.5. *TNI Standard Chartered, 1980-2000*



The financial situation of Standard Chartered deteriorated between 1981 and 1983. The bank acquired a clearing bank status in 1984, allowing it to conduct commercial banking activities, and acquired a United States bank. Its geographical diversification had been shifting, with a declining importance of African banking activities as subsidiaries became localized. For political reasons, Standard Chartered reduced its involvement in South Africa when the bank did not subscribe to an equity issue in 1985 of its subsidiary Standard Bank Investment Corporation (SBIC), becoming a minority shareholder.

In April 1986 Lloyds made a hostile take-over bid for Standard Chartered, who fought back by finding 3 shareholders in South East Asia to take on 40% of the bank's shares, enough to block Lloyds' bid. The bank's independence was saved, but the bank encountered more problems and reported a large loss in 1987 because of LDC loan provisions, and poorly performing subsidiaries in Canada and elsewhere. Restructuring followed; in 1987 the minority stake in SBIC as sold, and in the following year both American banks were sold ending Standard Chartered's American strategy. Also in 1988, a rights issue increased the bank's capital, and the shareholding structure was simplified (Jones, 1993, p. 346). In 1989 Standard Chartered sold all of its continental European banking operations to Westdeutsche Landesbank, together with half its merchant bank, which then became the basis a new joint venture, Chartered WestLB (Jones, 1993, p. 369).

The bank confined itself to its traditional core business, with South East Asia and Africa as the main geographical markets, focusing on activities such as trade finance. Commercial banking was to be confined to countries where the bank had presence, like Hong Kong and Zimbabwe. The bank had in short returned in 1990 to what it had been two decades earlier (Jones, 1993, p. 346). In the 1990s Standard Chartered would consist of two businesses. One was the retail bank, which is legally headquartered in London but effectively managed from Hong Kong and Singapore. The other business focused on commercial banking, being a "commercial bank's banker" for corporate clients such as

National Westminster Bank and UBS Warburg Dillon Read<sup>20</sup>, multinational companies and institutions.<sup>21</sup>

Table 13.6. *Activities Standard Chartered*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
80-86	Focused expansion	1. Gain sizeable presence in the United Kingdom	Domestic			■	■													
		2. Gain presence in the United States	United States			■	■													
		3. Maintain commercial branch network	South East Asia, Africa		■	■		■												
87-90	Restructuring, refocus & exit	1. Sell United States branch network	Domestic			■	■		■	■	■								■	
		2. Sell European network and other poor performing activities	Continental Europe, Canada, South Africa		■	■	■		■	■										■
		3. Restructure organization structure	Domestic																	
91-99	Focused expansion	1. Shift to consumer market	Taiwan, India			■	■		■		■									
		2. Strengthen consumer business	Hong Kong				■		■		■									
		3. Strengthen trade finance business	Whole organization			■					■									
		4. Divest consumer finance activities	Domestic				■													■

After the Asian crisis, Standard Chartered reinforced its focus on emerging markets. The Asian crisis provided opportunities for Standard Chartered, buying Nakornthon Bank in 1999, a distressed Thai bank with 67 branches after aborted talks two years earlier.<sup>22</sup> In 2000, it announced a partnership with Taiwanese Fubon, acquiring a 15 percent stake in the group’s financial services operations which include a commercial bank.<sup>23</sup> In the same year, the bank also acquired the retail business in Hong Kong from Chase Manhattan for 1.3 billion US dollar, adding more than 700,000 credit card customers to Standard Chartered’s Hong Kong operation.<sup>24</sup> To partly finance this, it sold its consumer finance business in the United Kingdom, being “an uncomfortable fit with our strategy of expanding into emerging markets”.<sup>25</sup>

Having bought the non-Swiss trade finance business from UBS, the bank also purchased Grindlays Bank from Australia and New Zealand Banking Group in 2000. Grindlays not only strengthened Standard Chartered’s position in Middle East and Asian

<sup>20</sup> Raghavan, A. & Portanger, E. (2000, April 19). Standard Chartered Bids to Buy Grindlays for \$1.6 Billion.. *Wall Street Journal Europe*, p. 13.

<sup>21</sup> Standard Chartered. A necessary evolution (2000, September 14). *Equity Research: Credit Suisse First Boston*, p. 19.

<sup>22</sup> Bardacke, T. (1999, September 14). Standard Chartered gets free reign over Nakornthon. *Financial Times*.

<sup>23</sup> Tett, G. & Dickie, M. (2000, May 18). StanChart sets sights on Taiwan. *Financial Times*, p. 23.

<sup>24</sup> Willman, J. (2000, August 30). StanChart likely to win Chase business. *Financial Times*, p. 15.

<sup>25</sup> Batchelor, C. (2000, May 31). StanChart puts consumer arm up for sale, *Financial Times*, 31/5/2000, p. 22.

markets, it would also propel Standard Chartered as the largest foreign Indian bank by assets, where Grindlays had 850,000 customers serviced by 39 branches.<sup>26</sup> By the end of the 2000, the bank seemed to continue to look to develop its business mix in order to reduce its reliance on Hong Kong, with Taiwan and India as preferred markets.<sup>27</sup>

#### 13.3.4. Midland Bank

Compared to the other large British banks, Midland's internationalization activities were modest until the 1960s when it aimed to cooperate more with European banks, and develop business within the British Commonwealth. The first led to the formation of EBIC, and subsidiaries formed with EBIC partners. The second pillar led to the formation of Midland and International Banks (MAIBL), together with the Commercial Bank of Australia, the Standard Bank, and the Toronto-Dominion Bank. This is claimed to be the first consortium bank (Pohl and Freitag, 1994, p. 1224), followed by the creation of a further 34 consortium banks by 1976, mostly based in London.

From the mid-1970s, the emphasis of Midland changed to direct representation in the main foreign markets. It restructured its international activities by forming the Midland Bank International, and setting up representative offices. It founded Midland Bank SA in France in 1978, and bought a controlling interest in German private bank Trinkaus and Burkhart from Citicorp in 1980 (Pohl and Freitag, 1994, p. 1224), which held branches in major cities in Germany and subsidiaries in Switzerland and Luxembourg. Also, Midland owned the travel company Thomas Cook. In 1982, Midland bought a majority stake in Handelsfinanz Bank in Switzerland. It also divested during that year, selling its shareholding in MAIBL to Standard Chartered, who became sole owner, and 40% of Samuel Montagu to American Aetna Life & Casualty Company, the largest US insurance company.

The sale of MAIBL was prompted by a change in its international strategy, seeking direct presence in the major financial centers to "diversify our interests and to better serve the needs of our rapidly growing clientele".<sup>28</sup> The United States and Europe were identified as areas of continued expansion, and in 1981 Midland bought a majority stake in Crocker National Corporation of California, a large Californian bank with total assets of 80 billion US dollar. Midland bought the bank in an attempt to catch up in market position internationally after a slow start in the 1970s.<sup>29</sup> The acquisition took place "without taking into account Crocker's weaknesses and without developing controls over its operations.

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<sup>26</sup> Raghavan, A. & Portanger, E. (2000, April 19). Standard Chartered Bids to Buy Grindlays for \$1.6 Billion.. *Wall Street Journal Europe*, p. 13.

<sup>27</sup> Standard Chartered. A necessary evolution (2000, September 14). *Equity Research: Credit Suisse First Boston*, p. 19.

<sup>28</sup> Midland (1981). *Annual Report 1980*, p. 6.

<sup>29</sup> By the end of 1976, Barclays held 1,715 branches and offices outside the United Kingdom, Lloyds 501, National Westminster 27 and Midland 14, although the EBIC joint ventures and offices of subsidiary companies of Midland are not incorporated in that number. Source: Pringle, R. (1977, August). The British four stake their claim. *The Banker*, pp. 113-121.

[...] Widely known as one of the low-performing banks in the US, with an abundance of poorly performing loans, [Crocker] proceeded to squander Midland’s capital in more bad loans.” (Rogers, 1999, p. 33). Midland stated at the time of the acquisition that “our alliance with Crocker will preserve their operational autonomy and the infusion of capital will ensue that they are in a strong position to take advantages of any changes in the structure of banking in the United States” (Annual report 1980, p. 7). From 1982, Crocker reported large losses, adding to the LDC problems Midland had by also having extended loans to the problem countries, and creating a large portfolio of problem loans in the United States.

Figure 13.6. *TNI Midland 1980-1992, TNI HSBC 1992-2000*



In 1984, Midland identified its strategy as 1) rehabilitating Crocker to financial health as soon as possible, 2) continue to have a strong position on the domestic market, 3) continue developing an international network to serve a wide range of customers, and 4) enter the new (capital) markets created as the UK financial markets were to be deregulated.<sup>30</sup> Restoring Crocker to financial profitability was left to another bank; in 1986 the bank was sold at a total loss of one billion US dollar<sup>31</sup> to American bank Wells Fargo. Midland financially never recovered, which contributed to its decline and subsequent acquisition by Hongkong and Shanghai Banking Corporation (HSBC).

From 1987 the bank made a series of reciprocal transfers of overseas business with the Hongkong and Shanghai Banking Corporation, which acquired a 14.9% stake in Midland in that year. Under the agreement, HSBC had to maintain its investment for at least three years. Also, cooperation between HSBC and Midland was agreed on, including

<sup>30</sup> Midland (1981). *Annual report 1980*, p. 6.

<sup>31</sup> The bank was sold at a 1 billion US dollar loss, but Midland also had to transfer 3.7 billion US dollar of Crocker’s bad loans to its own balance sheet.

the transfer of certain overseas assets and operations between the two banks.<sup>32</sup> During 1988, almost all of HSBC's commercial banking operations in Continental Europe were transferred to Midland, while a reciprocal activity took place in Asia. In Canada, Midland sold its activities to HSBC.

Midland experienced close to 12 years of losses, starting in 1980, before it was acquired by HSBC. Besides the acquisition of Crocker, other adverse developments contributed to its financial problems: the accumulation of LDC loans, a mismatch in treasury activities resulting in a large loss in 1990, high costs in domestic retail banking and HSBC's decision not to buy it in 1990, after much of Midland's planning had been based on the merger (Rogers, 1999, p. 177).

The two banks had moved towards greater integration since 1987. They were also complementary: Midland's strength was in the UK and Europe, while HSBC's was in the South East Asia and in North America. Midland had a strong retail franchise, while HSBC's was largely in wholesale banking. Also important, HSBC was well capitalized, and Midland was not. A potential obstacle was that HSBC would have to move its headquarters to the United Kingdom in event of a merger, but this seemed a realistic option in the wake of the return of Hong Kong to China. In 1990, when the merger might take place under the agreement in 1987, economic conditions were worsening deterring HSBC from a merger, although it wanted to continue the present relationship. In 1992, HSBC renewed its interest in Midland, shortly after Lloyds made a bid for Midland. Midland had rejected the bid, partly because Lloyds had rigorous cost saving measures in mind. In June 1992, HSBC acquired Midland at a cost of 3.9 billion Pounds.

Table 13.7. *Activities Midland Bank*

Period	Phase	Objective	Arena	Client			Product			Organizational form								
				Government	Institutional	Private	Securities	Asset management	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture		
'80 - '85	Focused expansion	1. Gain sizeable presence in the United States	United States			■												
		2. Build network for corporate clients	Continental Europe, main financial centers		■													
		3. Maintain domestic position	Domestic		■	■												
		4. Build capital market activities with domestic deregulation	Domestic		■	■	■											
'86 - '92	Restructuring, exit	1. Retreat from United States	Canada, Europe, South East Asia			■											■	
		2. Restructure foreign branch network through alliance with HSBC	Domestic		■	■								■				■
		3. Increase domestic market position	Domestic		■	■	■											

<sup>32</sup> Midland (1989). *20-F filing 1988*, p. 5.

### 13.3.5. HSBC

Hongkong and Shanghai Bank was originally founded and headquartered in HongKong, exemplified by the 9% stakeholding of the Hong Kong Monetary Authority.<sup>33</sup> Being set up in 1865, the bank initially financed and promoted British imperial trade. Hongkong and Shanghai Bank began expanding its activities in the late 1950s by acquiring the British bank of the Middle East and Indian Mercantile Bank. In 1965 it bought 62% of Hang Seng, Hong Kong's second largest bank. In the late 1970s and into the 1980s, China began to open up for foreign business. The bank bought operations in North America to capitalize on business between China and the United States and Canada, much of which was transacted through Hong Kong since China lacked financial infrastructure until the 1980s.

HSBC, having first opened an United States agency in 1875, acquired 49% of Marine Midland of New York, a bank in need for capital. In 1985, HSBC bought the branches and assets of the failed New York Golden Pacific Bank, taking a stake in 1986 in Westchester Federal Savings Bank, and acquiring in 1987 the remaining 51%. Acquisition intensified again in the mid 1990s, buying four banks between 1995 and 1999 (Tschoegl, 2000). In 2000, it engineered a major acquisition, the Republic National Bank of New York. In Canada, the bank purchased Hongkong bank of Canada in 1981, most of the assets and liabilities of the Bank of British Columbia in 1986, and Lloyds Bank of Canada in 1990. The Hongkong Bank of Canada was the largest foreign Canadian bank by the end of 1990 (Jones, 1993, p. 347).

During the 1980s, HSBC also had to face the problem of its home base. In 1984 the British government negotiated an agreement under which the entire Hong Kong colony would be returned to China in 1997, but with a guarantee of economic continuity for 50 more years. The agreement did not boost confidence in the viability of a Hong Kong under Chinese rule, and by the time of the Tiananmen Square massacre in Beijing in 1989, businesses and people were emigrating. HSBC already had a modest presence in the United Kingdom, buying a 29.9% stake in London securities firm James Capel & Co. in 1984 by joining the commercial banks to buy brokers, taking full control in 1986 (Jones, 1993, p. 346). Three years earlier, HSBC had also tried to gain a foothold in the United Kingdom by making a failed takeover bid for Royal Bank of Scotland. In 1987, pressed to reduce its independence on Hong Kong, it took an equity stake in Midland, then UK's third largest bank entering a cooperation agreement with the possibility of a full merger in 1990.<sup>34</sup> Midland bank was purchased in 1992 and – as part of the agreement to buy Midland - in 1993 HSBC formed HSBC holdings, transferring its headquarters from Hong Kong to London.

The strategy of HSBC in the mid 1990s has been to build the world's biggest financial services group, presenting itself as a contender of Citigroup.<sup>35</sup> HSBC took a different approach to investment banking than competitors like J.P. Morgan, and Deutsche Bank, building a far more modest investment banking unit, emulating Barclays Capital

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<sup>33</sup> History of HSBC. (n.d.). Retrieved October 12, 1999, from Hoovers, Inc.

<sup>34</sup> See also the internationalization discussion of Midland (13.3.4).

<sup>35</sup> Baker-Said, S. & Giles, T. (2002 April). HSBC: still not the champion, *Bloomberg markets*, pp. 38-45.

Market activities. HSBC began to expand further in Asia, where it established the first Malaysian foreign owned subsidiary with 36 branches. HSBC moved back to China, where it had withdrawn after Communist regime took control in 1949, opening branches in Beijing and Guangzhou.

Table 13.8. *Activities HSBC*

Period	Phase	Objective	Arena	Client					Product					Organizational form					
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset manage	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
81 - 92	Broad expansion (1)	1. Build presence in North America	United States, Canada																
		2. Gain market share/shift homebase to Britain	United Kingdom																
		3. Maintain market share in Hong Kong	Domestic																
93 - 00	Broad expansion (2)	1. Restructure domestic activities	Domestic																
		2. Expand in South East Asia	Korea, China, Malaysia, South Korea																
		3. Expand in Europe in commercial banking (CCF)	France																
		4. Expand in the United States by acquisitions	Domestic																

In 1997 it expanded in South America, buying banks in Argentina, Brazil, Mexico and Peru. The motivation of HSBC's expansion to South America seemed to be related to the strategy of risk diversification through geographical diversification, further decreasing its dependency on Asian activities (de Paula, 2002, p. 36). In Brazil it bought Bamerindus in 1997, the fifth largest bank in Brazil with the country second largest branch network<sup>36</sup>, planning to challenge local banks but eventually toned down and sought to increase its customer base to include more high income customers (de Paula, 2002, p. 37).<sup>37</sup> Negative financial effects of the Asian crises in 1998 were cushioned by HSBC's non-Asian operations, but the share price suffered from investor nervousness. The Hong Kong Monetary Authority even bought 9% of the bank to halt the fall of the stock exchange.

International expansion continued when the bank announced in 1999 that it would buy a controlling stake in South Korea's government-owned Seoulbank. It also bought Republic New York and Safra Republic Holdings, doubling HSBC's private banking business and adding 426 branches in New York State. In 2000, HSBC bought Credit Commercial de France for 11 billion euros, adding 1 million French customers and completing Europe's largest ever cross-border banking acquisition.<sup>38</sup> Also in 2000, HSBC formed a 1 billion US dollar joint venture with US securities firm Merrill Lynch to offer online brokerage services to wealthy clients. HSBC wanted to win new customers by

<sup>36</sup> HSBC (2001). *Annual report 2000*, p. 9.

<sup>37</sup> HSBC initially took an equity stake in Bamerindus in 1995; Midland bank was active in Brazil and when HSBC acquired Midland the involvement was continued. Source: Foster, A. (1995, August 29). *International Company News: HSBC Holdings set to take stake. Financial Times*, p. 17.

<sup>38</sup> Baker-Said, S. & Giles, T. (2002 April). HSBC: still not the champion. *Bloomberg markets*, pp. 38-45.

outsourcing research and brokerage services to Merrill, attempting to achieve through a partnership what Citigroup had tried to do with acquisitions.

### 13.3.6. Lloyds

As with Barclays, Lloyds' interest in international activities dates from the 1910s. After failing to pursue a domestic merger with Martins in 1968<sup>39</sup>, Lloyds bank was in need for a new strategy. Lloyds subsequently planned a "progressive 'group' concept - a bank with a strong domestic base, fit to withstand growing pressure from foreign, particular American, banks, and able to counter-attack abroad by having its own branches" (Pohl and Freitag, 1994, p. 1219). Internationalization took off after Lloyds acquired a controlling stake in BoLSA, active in South America, and merged it with Lloyds Bank Europe into Lloyds Bank International in 1974. Its American presence started in California, buying First Western Bank and Trust, and First State Bank in California in 1974.<sup>40</sup> Having acquired the New Zealand bank in 1966, the group concept showed a presence in 50 countries in the 1970s. In 1978, Lloyds entered investment banking through the formation of Lloyds Merchant Bank (Rogers, 1999, p. 44). German private bank Schroder, Munchmeyer, Hengst & Co was purchased a few years later.

In the early eighties, the strategy needed revision. Besides accumulating problem loans through BOLSA, the bank had also accumulated a large portfolio of non-performing commercial real-estate loans during the years. As the smallest of the four largest British banks, its portfolio of non-performing loans to South American countries was one of the biggest and it had less capital as a buffer to write down the loans than any other domestic competitor (Rogers, 1999, p. 45). Although its problems were not that different from the other British banks, its cushions were smaller and change of management in 1983 prompted a reorientation. Shareholder value would be leading, concentrating on activities that earned a high return on capital by growing business that were performing well and divesting or closing down those business that were not performing (Pohl and Freitag, 1994, p. 1219).

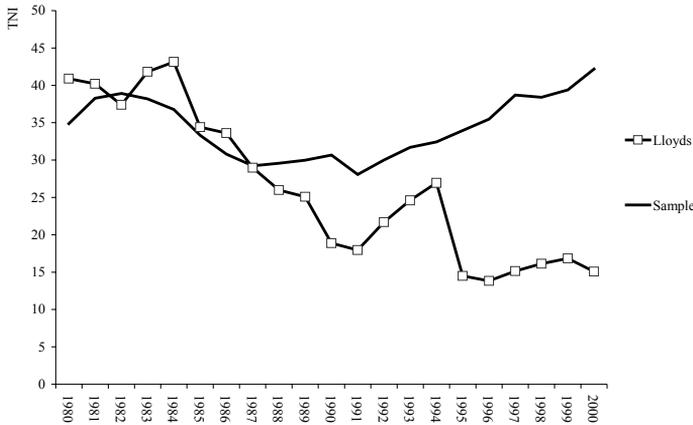
This meant a retreat from international and wholesale activities, as well as an increased focus on the retail client. Lloyds closed down its investment bank, Lloyds Merchant Bank, in 1987 and also closed many branches in the United States, Europe and the South East Asia. In 1986, Lloyds Bank sold Lloyds Bank California to Sanwa Bank (Tschoegl, 2000). Late 1987, Lloyds withdrew from market making in British government bonds and Eurobonds, withdrawing its application for a license to trade securities in Tokyo (Rogers, 1999, p. 46).

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<sup>39</sup> Which was later acquired by Barclays.

<sup>40</sup> Lloyds Bank acquired the First State bank in California when a change in the Bank Holding Company Act forced the owner to divest the bank, and no potential domestic buyer could pass the standards of the anti-trust law (Johnston, 1977, p. 77). Other similar cases are the purchase of the branches of Franklin National bank by European American Bank (owned by EBIC), and the purchase of LaSalle bank by ABN in 1979.

Figure 13.7. *TNI Lloyds, 1980 - 2000*



Retail financial services were expanded through a series of acquisitions. In 1988, it expanded its insurance activities with the purchase of Abbey Life insurance, designed to build a larger customer base and increase the product range (and profitability) for retail clients (Pohl and Freitag, 1994, p. 1220). A failed attempt was the takeover bid of Midland in 1992, which would have considerably expanded its domestic network, but the bank was outbid by HSBC and unprepared for the hostility of Midland managers in the wake of cost cutting measures.<sup>41</sup> The purchase of Cheltenham and Gloucester in 1995 added to its home mortgage business, and the acquisition of Trustee Savings Bank (TSB) in 1996 expanded its customers base and provided selling opportunities for its savings and insurance products (Rogers, 1999, p. 47).

Lloyds stepped up the pace in 2000 to increase its market size, as well as its range of financial products. Although the bank kept the option of an European merger or acquisition open<sup>42</sup>, the major activities were domestic. Scottish Widows, the country's sixth largest insurer, was acquired in 1999, buying one of the strongest brands in the life insurance and pensions industry. Lloyds also gained access to a network of independent financial advisors that have recommended Scottish Widows products, and the ability of distributing their products through the 2,500 bank branches.<sup>43,44</sup> Scope for further domestic growth became limited however. At the end of 2000, Lloyds unsuccessfully attempted to

<sup>41</sup> Sweet defeat. (1992, June 13). *The Economist*, p. 74.

<sup>42</sup> Booth, T. (1999, December). Searching for the perfect partner. *Institutional Investor*, pp. 35-44.

<sup>43</sup> Brown-Humes, C. (1999, June 24). A marriage of convenience. *Financial Times*, p. 15.

<sup>44</sup> Peter Ellwood, Lloyds TSB chief executive, observed in 1999 that only 4% of Lloyds TSB banking customers also bought its insurance products. Although this offered considerable room for improvement, it could also indicate that selling insurance products through bank branches remained difficult. Source: Graham, G. (1999, June 24). Revenue forms the main ingredient in the Lloyds recipe. *Financial Times*, p. 24.

acquire Abbey National, a former building society that had been trying to merge with Bank of Scotland to challenge the largest UK banks.<sup>45</sup>

Table 13.9. *Activities Lloyds*

Period	Phase	Objective	Arena	Client				Product			Organizational form							
				Government	Institutional	Corporate	Private	Securities	Asset management	Insurance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture		
'80 - '84	Consolidation, balanced growth	1. Maintain strong domestic position	Domestic		■	■	■											
		2. Build international branch network	Main financial centers			■	■						■	■				
		3. Expand in commercial banking in selected countries	United States, Germany		■	■	■						■					
'85 - '99	Restructuring, refocus & exit	1. Retreat from international activities	Europe, United States		■	■	■										■	
		2. Scale down capital market activities	Domestic		■	■												■
		3. Gain market share, by diversification in financial services and acquisitions	Domestic			■	■	■	■				■					
'00-	Restructuring, refocus	1. Gain domestic market share (failed)	Domestic			■												
		2. Consider foreign mergers	Europe															

Lloyds has been particularly successful in pursuing a domestic focus strategy during most of the 1980s and 1990s. Roger attributes this to an early recognition compared to its competitors that international asset growth and global investment banking did not equate profitability growth (Rogers, 1999, p. 46), and a first mover advantage by (re)embracing the domestic consumer, committing itself to retail banking when Barclays and National Westminster would address this issue almost a decade later (Rogers, 1999, p. 49).

The retreat from international activities has not always been consistent: in 1986 it made a bid to acquire Standard Chartered, that would have diverted Lloyds considerably from its domestic retail strategy. The blocked attempt to acquire Abbey National indicated domestic growth opportunities could become less in the near future, prompting remarks from management that activities outside the home market might be contemplated again.<sup>46</sup>

<sup>45</sup> Saigol, L. and Willman, J. (2000, December 13). Abbey rejects revised offer from Lloyds. *Financial Times*, p.19.

<sup>46</sup> See for example an interview with Lloyds TSB CEO Peter Ellwood and chairman Brian Pitman (Tanzin, B. [1999, December]. Searching for the perfect partner. *Institutional Investor*, pp. 35-59) or the interview with chairman van den Bergh (Gunther, R. & Schipper, J. [2002, Maart]. Big Blijft Beautiful. *Bank- en Effectenbedrijf*, pp. 6-11).

#### **13.4. Commonalities and differences**

The internationalization activities of British banks between 1980 and 2000 were varied. Barclays pursued the broadest internationalization strategy from 1980 until the mid 1990s: with a strong domestic base, it wanted to expand its asset size and market share, create a "global" presence, and achieve product and market diversity (Rogers, 1999, p. 130). National Westminster and Lloyds had a strategy very similar to Barclays.

Their strategies were partly based on historical heritage: Barclays, National Westminster and Lloyds had built up large branch network in the former British colonies and therefore had considerable experience with international banking. Most former colonies did not develop into major economic growth centers from the 1960s onwards. Over time, British banks divested or scaled down their operations in Asian, Middle Eastern and African countries. In some cases the banks were ousted by nationalization, and for the most profitable African operation an international boycott forced them out. Over the two decades, two banks have continued their presence in these regions: Standard Chartered (concentrating on Africa and Asia) and HSBC (concentrating on Asia and the Middle East). These two banks have in common that they have tried to build a large domestic base in the United Kingdom, which failed during the 1980s. It was not an issue anymore for Standard Chartered in the 1990s, while HSBC finally succeeded in 1992 with the acquisition of Midland.

The banks with dominant positions in the 1970s in the economic growth centers were American banks; British banks formulated strategies partly in response of the internationalization activities of American banks to withstand their growing pressure, especially their dominance in the capital markets. All British banks in the sample acquired banks in the United States, most of them in California where regulation was more liberal. Also, liberalization of the capital markets in the United Kingdom and deregulation allowed the British banks from 1984 to build up their own investment banking activities, in which they invested large sums to acquire a comparable scale to their American competitors.

The retreat from international banking for National Westminster, Lloyds, Barclays took place in a number of steps: 1) retreat from LDC loan activities, 2) retreat from foreign retail banking, and 3) retreat from full scale investment banking. First there was the fall out from the LDC loan crisis. The crisis was concentrated with the South American LDC's that hit Lloyds relatively hard, having built up the largest non-performing loan portfolio of the largest British banks. Also a smaller bank, Lloyds' retreat took place earlier because its capital and reserves to weather the crisis were less. The resolution of the LDC crisis spanned most of the 1980s, and here too the American banks were leading, heading the restructuring committees for the different countries, and in 1987 forcing a general write off of non performing loans.

Second, the retreat from retail banking spanned a longer period. All banks had built up retail banking operations in the United States from the 1970s, not with overwhelming success. Combined with the LDC crises, the failed acquisition of Crocker bank dissolving after 5 years eventually contributed to Midland's loss of independence; Standard Chartered sold its American operations 3 years after acquiring it. Lloyds exited in 1987, Barclays in 1991 and National Westminster in 1995. It was either acknowledged that the performance

and/or synergies were wanting, or that expected investments in the near future - the prospect of scale enlargement in US retail banking in the 1990s - were too large. The other main area for foreign retail banking was Europe, where retail branch networks were set up or acquired. The case studies suggest that this has been to a large degree pre-emptive behavior: acquisitions to have a foothold in Europe when European integration or consolidation of the European banking market would materialize. Here too the expectations of British banks did not materialize and Lloyds, Midland and Standard Chartered eventually retreated. Two exceptions are noteworthy: Barclays has maintained a long lasting commitment to Spain, and HSBC acquired at the end of the 1990s French bank CCF.

Third, the British banks entered investment banking activities in the 1980s with substantial investments and generally retreated in the 1990s from investment banking or limited the scope of their investment banking activities. With the liberalization in 1984, they started out by offering a broad range of investment banking services, opening up or increasing existing branches in the other major financial centers. The attempt to catch up with the learning curve of American banks proved costly. Lloyds closed down its merchant bank in 1987. Barclays could not find a proper balance in the organization between its traditional commercial banking activities and its investment banking unit BZW, and closed down the unit after the merger announcement of Morgan Stanley and Dean Witter, realizing that Barclays continuously had to invest in it instead of generate profitability from it. National Westminster finally closed down scandal ridden County NatWest in 1997. Two banks stayed aloof from investment banking: Standard Chartered remained focused on commercial banking and trade finance from the late 1980s; HSBC maintained throughout a modest debt market business and corporate finance unit, a model that Barclays adopted in 1998.<sup>47</sup>

In short, Barclays, Lloyds, and National Westminster had shared a common to a decreasing role of international activities, but applied different time frames to implement the retreat. They scaled down in geographic reach, and scaled down in business (Rogers, 1999, p. 35). Standard Chartered basically did the same but to a lesser extent. Capital freed from foreign activities was reinvested in domestic activities from the mid-1980s, with Lloyds as a forerunner. Barclays, Lloyds, National Westminster and HSBC shared an increased domestic focus on cross selling and acquired insurers to this purpose.<sup>48</sup>

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<sup>47</sup> In the Netherlands, a similar approach was developed by Dutch ING in 2000.

<sup>48</sup> By the end of the 1990s, cross selling was a broad felt strategic issue among banks in the sample: "Citigroup, Credit Suisse, Allianz are all trying to get retail bankers to pitch insurance policies and mutual funds". Baker-Said, S. & Giles, T. (2002 April). HSBC: still not the champion. Bloomberg markets, pp. 38-45.

## 14 Internationalization of German banks

Internationalization is strongly intertwined with the largest German banks. They have a historical legacy: for example, Deutsche bank entered London in 1873 and the United States in 1870. After the Second World War, the largest banks (re-)entered internationalization activities first through consortium banks, but soon switched to developing their own branch network in financial and economic centers. A special characteristic is the development of activities in Luxembourg, where in the 1970s large subsidiaries were active, partly to avoid German taxation.

Also, internationalization of German banks was not limited to commercial banks only. Westdeutsche Landesbank, a savings bank, increased its internationalization activities substantially, eventually prompting other commercial banks to lodge a complaint for unfair competition in the 1990s. In the 1980s and 1990s, German banks embraced Europe: Commerzbank remained active in the Europartner consortium, Dresdner Bank agreed to an alliance with French BNP, considering a some time merger, while Westdeutsche Landesbank set up a European branch network and Deutsche Bank actively acquired branch networks throughout Europe. German banks also embraced capital markets: two of the largest investment banking acquisitions in the United Kingdom were done by Deutsche Bank (1989) and Dresdner Bank (1995).

At the end of the 1990s, the banks returned to their domestic market. The German banking market can be characterized as fragmented, where the state owned Landesbanken between 1980 and 2000 were strong (and subsidized) competitors for German commercial banks. Declining profitability in the capital markets and a renewed expectation of upcoming consolidation in the German banking market created a wave of merger talks and eventually the takeover of Dresdner Bank by insurer Allianz.

German banks are attributed a special role in the financial systems discussion; where German banks have closer links to industrial companies than their British or American counterparts. The special role of German banks within the economy has influenced at least one bank outside Germany: the expansion strategy of Crédit Lyonnais was modeled after the breadth and size of Deutsche Bank's activities.

Table 14.1. *Incentives for German banks to internationalize*

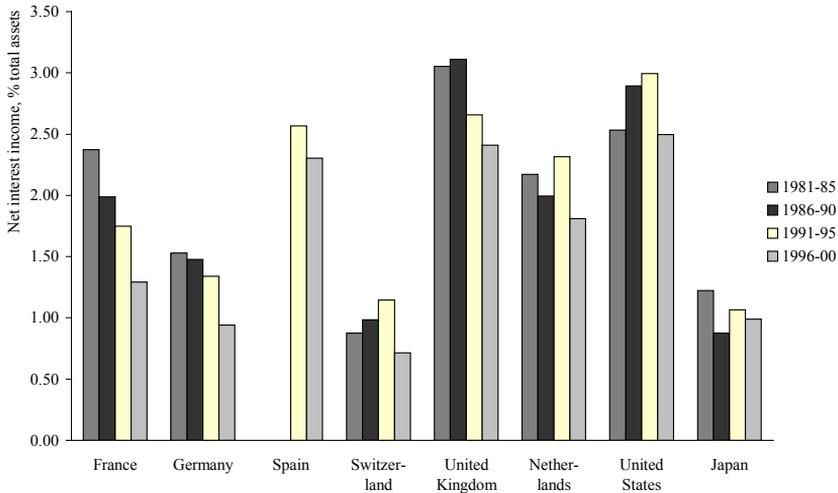
Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Net interest margins and profitability were higher outside Germany between 1980-2000</li> <li>• Economic structure: Home market expanded with German unification in 1989.</li> <li>• Regulation: No strict regulation for banks; but separation and financing Landesbanken upheld for most of the decades. End 1990s abolishment taxation of sale shareholdings, making it easier for German banks to restructure their balance sheets</li> <li>• Client: German clients were traditionally in manufacturing (capital intensive), German banks followed to meet financing demands.</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: internationalization banks in 1980s similar for capital markets/financial centers, for 1990s action-reaction pattern between Dresdner - Deutsche Bank</li> <li>• Market power and concentration: large market share co-operative and Landesbanken, opportunities to expand domestically in (retail) banking limited Guarantee structure Landesbanken challenged</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies of scale and scope: perception has been that economies were difficult to achieve domestically. In 1999/2000 domestic reorganization took off by combining retail branch networks (failed), mortgage operations (succeeded)</li> <li>• Cost of capital: domestic subsidization by state governments for WestLB</li> <li>• Shareholder return: Relative low valuations compared to United Kingdom, United States.</li> </ul>

### 14.1. Incentives to internationalize

#### *Spreads, profitability*

Between 1980 and 2000, net interest income remained relatively low compared to other countries, as well as profitability. Therefore, differences in net interest margin and profitability could be considered strong motives for German banks to internationalize. As will be discussed further on, the German banking structure, creating a high degree of competition between commercial banks and subsidized banks, may have driven down net interest income. On the other hand, the monetary regime of the Bundesbank has in general steered on only keeping down inflation, while central banks in other countries (the United States, Britain, France) also had considered to stimulate economic growth, simultaneously helping net interest income of banks.

Table 14.2. *Net interest margin banks in sample, 1981-2000*



### *Clients, markets*

German banks have in general been inclined to set up foreign activities with a pace comparable to their clients. Nolle and Seth (1996) investigated foreign bank activities in the United States between 1981 and 1992 and found that if German banks in the United States were to extend all their loans to German owned companies in the United States, there still would have been a funding need. In other words, the growth of German banking assets during the 1980s did not outpace the funding needs of German banks operating in the United States.

The pattern of German banks activities followed the country's business and industry in Eastern Europe since the 1990s. By the mid 1990s, the Central and East European economies were already more important as an export market than the United States when Germany became the largest foreign trading partner in terms of exports and imports. German export growth has mainly been concentrated in Poland, the Czech Republic and Hungary, accounting for more than half of Germany's exports to that region.<sup>1</sup> The banks have been most active in these three countries where (economic) reform has been greatest, although they also increasingly became involved in the Baltic States, Slovenia and Slovakia. The German banks adopted different strategies to enter that market. Deutsche Bank and Dresdner adopted a strategy of opening new subsidiaries in the region, while Commerzbank had tended to buy existing operations.<sup>2</sup>

<sup>1</sup> Bowley, G. (1997, June 9). Survey - German Banking & Finance: Eastern Europe: Move to the east pays off. *Financial Times*.

<sup>2</sup> Bowley, G. (1997, June 9). Survey - German Banking & Finance: Eastern Europe: Move to the east pays off. *Financial Times*. In the same article, a Commerzbank manager responsible for Eastern Europe banking observed

### *Regulation*

The German banking structure remained stable between 1980 and 2000. This stability has had positive effects - during this period Germany has been one of the few countries without a major banking crisis and/or bank failure. On the other hand, it also limited the opportunities for banks to expand domestically and (in their view) restructure the domestic branch more profitably in what is generally considered as an over-banked country. The debate has centered around two issues: Landesbanken and cross shareholdings.

The first one addressed how a level playing field should be created between the commercial banks and the Landesbanks, and was especially addressed by commercial banks who stood most to gain. In 1992 German banks filed a complaint with the European Commission that the (re)capitalization of WestLB was in fact a subsidization by the state government, creating unfair competition. The 1999 ruling by the European Commission that WestLB's capitalization in 1992 was in fact an illegal subsidy caused a stir among politicians. The German government sought compromise, putting forward plans under which the state banks would separate their commercial banking activities from their public sector functions. Any such move might serve as a catalyst for reform in the German banking industry: stripped from their guarantees, the Landesbanken would need new sources of capital for support their balance sheets, leading to shedding businesses and stop offering services.<sup>3</sup> In May 2001 the European Commission also announced that the existence of such guarantees distorted competition and should be removed. After considerable debate with the savings banks, it proposed that the liability guarantee should not be extended beyond 2005 (grandfathering maturing liabilities until 2015). The process of phasing out the guarantees should begin in 2005, shifting the credit rating of these banks to general criteria as financial strength of the bank itself (McDonald and Keasey, 2002, pp. 64-65).

Another distinctive feature of the German banking industry has been the distinctive levels of shareholdings in industrial companies and banks (Zysman, 1983, pp. 261-265). Although there has been no conclusive evidence to suggest that this characteristic hampered or stimulated economic growth, a consensus began to form that it at least hampered the restructuring of German banks, which were tied together by cross shareholdings, and prevented them from allocating capital more efficiently. The German parliament passed a set of tax reforms in July 2000, abolishing capital gains tax (averaging 50%) on companies that sell their shareholding in other joint stock companies, if they have held them more than a year. This was expected to encourage foreign investment, raise the attractiveness of the stock market and increase the pace of restructuring of German companies. The principal motive behind the change was to free immobile capital so that

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that "in the Czech Republic, you can reach the rest of the country from Prague. But Poland has a lot of important regional markets. We have clients in five or six different cities, so we needed a branch network in Poland".

<sup>3</sup> Major, T. (2000, October 23). Survey - German banking and finance: Profile Westdeutsche Landesbank, *Financial Times*.

the German industry could consolidate itself and enhance its competitiveness in the euro-zone.<sup>4</sup>

Deutsche Bank, as well as insurer Allianz, had already set up a separate company holding these investments, to create more transparency. Any significant restructuring has been slow: the stock market peaked in 2000, declining the next years. Selling holding has been mainly to shore up capital. The expected increase in mergers and acquisitions did not materialize (the tax measure only came into effect in 2002), affecting the banks who had significantly increased their activities in Germany (and London) to profit from this.

### *Market power and concentration*

For historic reasons, connected mainly with the need to reconstruct Germany after the Second World War, the public sector has played a prominent role in the German sector<sup>5</sup>. There are three kinds of banks in the German banking system – the private banks, co-operative banks and the public banks. The private banks are mainly universal banks, like Deutsche Bank or Dresdner Bank. The co-operative banks are private member-owned banks, which belong to the bank's customers, who provide the equity capital the bank needs<sup>6</sup> (Sinn, 1999, p. 6). The public banks are owned by the German government at various levels, such as federal government, the state governments and the local government authorities. The large share of the public sector is exceptional in international terms. Sinn found for 1993 that the public share in Germany was 48%, compared to 40% in Spain, 29% in Switzerland, 17% in France, and 5% in the Netherlands. In the United Kingdom and the United States, public banks have been absent (Sinn, 1999, p. 7).

Landesbanks, the most important of public banks, are owned and supervised by their own state governments, whose business operations are independent of political influence. They act like private banks, operating in the same areas as private banks do. In addition, they also act as house banks for the states and the local government authorities, for whom they are important providers of loans (Sinn, 1999, p. 11).<sup>7</sup> A crucial difference between the private banks and the Landesbanks has been the institutional guarantee (*Anstaltslast*) and the liability guarantee (*Gewährtrager haftung*), where the government takes on unlimited responsibilities. Any loss that exceeds the Landesbank's equity is taken over by the government authority responsible, virtually eliminating default risk for the bank's creditors (Sinn, 1999, p. 27). The Landesbanks took advantage of this, extending riskier loans than private banks, and it enabled them to refinance more cheaply (Sinn, 1999, p. 29). Also, the capital needed for Landesbanks was lower than for private banks.

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<sup>4</sup> Barber, T. (2000, October 23). Survey - German Banking & Finance: A cure for the 'German Disease'. *Financial Times*.

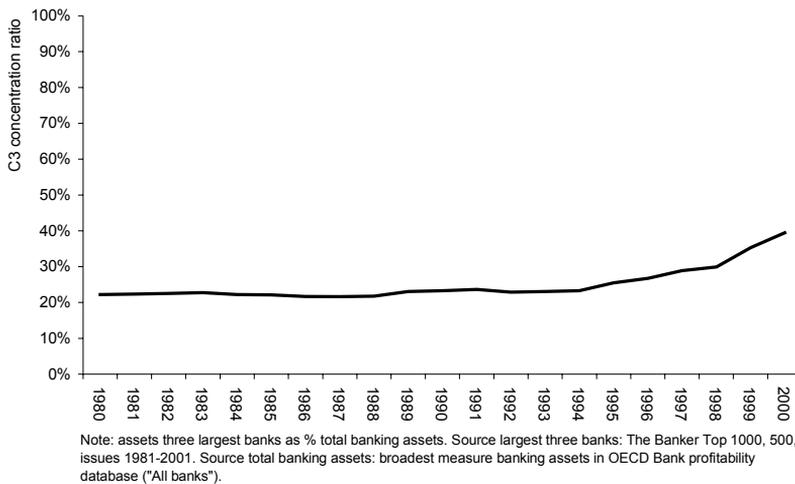
<sup>5</sup> Hargreaves, D. & Barber, T. (1999, October 22). EU attack on German support for banks to create a furore. *Financial Times*, p. 3.

<sup>6</sup> The top-level institution of the German co-operative banks is the Deutsche Genossenschaftsbank (DG Bank), who played an important role in the internationalization strategies of Rabobank, a Dutch co-operative bank. It is a public organization but does not enjoy the same privileges as the public banks.

<sup>7</sup> Landesbanks are also the clearing banks processing the payments transactions between the saving banks.

One of the consequences has been that, despite a process of gradual consolidation since the 1960s, Germany has had the highest banking density in Europe: there were more than 3,200 banks in Germany in 1998 compared with 1,200 in France and 500 in the United Kingdom.<sup>8</sup> The dominance of the public sectors made it difficult to make what the commercial banks considered as a reasonable profit, being unable to generate more business to alleviate the high costs of maintaining extensive branch networks. The failed talks between Dresdner Bank and Deutsche Bank in 1999 to merge their domestic retail operations into one bank were triggered by this.<sup>9</sup>

Figure 14.1. Share of largest three banks in Germany, percentage total assets



By the end of 2000 the role of Landesbanks seemed under scrutiny. After the European Commission penalized Westdeutsche Landesbank in 1999 for receiving direct state aid, the Commission had been preparing to take a closer look at the whole state-guaranteed system of bank funding. Also technological developments, notably online-banking, which allowed private banks to offer a whole range of products at relatively low costs, rendered obsolete the public banks' biggest advantage - their dense network. The second development was accentuated by the lagging efforts of public banks in their online efforts, not posing any real threats by 2000.<sup>10</sup>

<sup>8</sup> Hargreaves, D. & Barber, T. (1999, October 22). EU attack on German support for banks to create a furore. *Financial Times*, p. 3.

<sup>9</sup> Grant, J. (1999, August 23). German banks in link-up talks. *Financial Times*, p. 1.

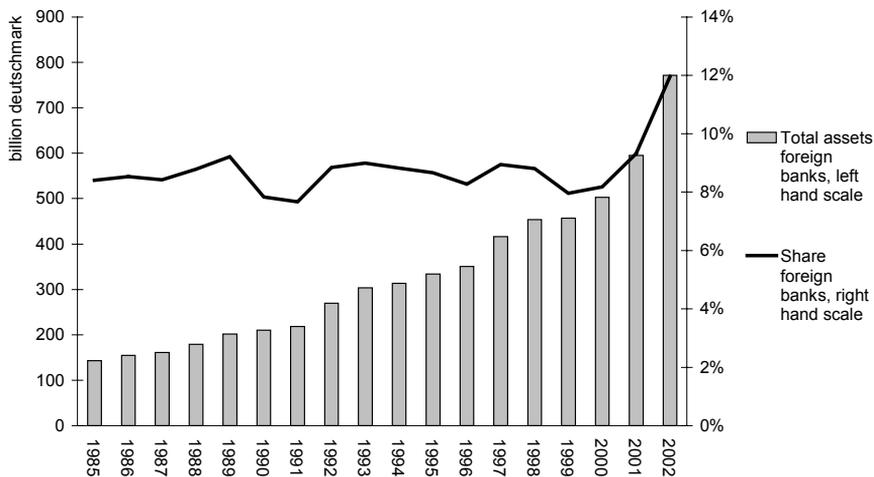
<sup>10</sup> Harnischfeger, U. (2000, October 23). Survey - German banking and finance: Life still tough for private sector.. *Financial Times*.

## 14.2. Role of foreign banks

German authorities applied no special restrictions for the opening of branches and the establishment of subsidiaries by foreign banks at the beginning of the 1980s. Besides the required submission of information to the supervisory bodies, transactions with the parent bank had to be submitted (Pecchioli, 1983, p. 185).

In Germany, market shares of foreign banks in the retail banking segment have been minor although the country has been fairly open to foreign competition. Underlying cause might be that the markets served by foreign banks and domestic banks are segmented.<sup>11</sup> Buch and Golder (2001, p. 349) found that market share in terms of assets might be low; off-balance sheet business however led to different conclusions. For one, foreign banks have occupied substantial market shares in investment banking as well as mergers and acquisitions, accounting for 17% of the turnover on the Frankfurt Stock Exchange and 42% German Futures and Options Exchange in 1998. Also, they held a market share of 42% in issuing securities, and controlling 77% of the M&A market in 1996.

Figure 14.2. Share of foreign banks in Germany



Source: Bundesbank. Total assets: 'Alle bankengruppen'. Foreign assets: sum of 1) 'Zweigstellen auslandischer banken', 2) 'Tochter auslandischer banken', and 3) 'Auslands banken'.

Dutch banks started in the 1970s and early 1980s to expand in Germany.<sup>12</sup> After having set up branches and acquired small banks, ABN and Amro operated under their own name since the early 1980s, steadily increasing their networks. Expansion sometimes took place by divestitures from other foreign banks, such as Royal Bank of Canada's German securities activities to Amro in 1989 and the sale of the German branch of Dutch

<sup>11</sup> In their study, the segmentation of domestic and foreign banks is analysed for German and United States banks between 1986 and 1999.

<sup>12</sup> The paragraph on Dutch banks in Germany is based on van der Lugt (2000).

bank NCB to NMB in 1985. The Rabobank<sup>13</sup> bought in 1983 ADCA bank, who had a branch network and a weak financial position. Rabobank reorganized the bank in 1988, to serve Dutch customers and focus on agricultural and food related finance activities. In 1994, ABN Amro, having built a network of 34 branches, reorganized activities to improve the lagging performance. ING on the other hand acquired market share in 1998 by taking a 49% stake in the Allgemeine Deutsche Direktbank, but the main purchase took place later that year when it took a 39% stake in BHF Bank<sup>14</sup>, taking full control in August 1999. Rabobank approached the German market in the 1990s forging an alliance in 1992 with co-operative DG bank. In 1998 both banks were to bring their corporate finance and investment banking activities under one joint venture, but this plan never materialized.

By the end of the 1990s, the expected imminent restructuring of corporate Germany was viewed as a huge opportunity for investment banking activities. German banks retained strong positions in equity and debt, but in the most important area, advising on mergers and acquisitions, foreign investment banks (Goldman Sachs, J.P. Morgan and Lehman Brothers) already held dominating positions. Foreign banks increased their activities in Frankfurt, where banks like Goldman Sachs and J.P. Morgan could build on their long presence in the German market (Goldman since the 1990s, J.P. Morgan since the 1960s) and their large share of domestic staff.<sup>15</sup>

### 14.3. Case studies

Five German case studies are examined: Deutsche Bank (1980-2000), Dresdner Bank (1980-2000), Commerzbank (1980-2000), Westdeutsche Landesbank (1980-2000), Bayerische Vereinsbank (1980-1997), Bayerische Hypobank (1980-1997), and the latter two bank's merger combination, Hypovereinsbank (1998-2000). Dresdner bank was acquired in 2000 by insurer Allianz, with whom it had a long standing alliance. Westdeutsche Landesbank, Bayerische Vereinsbank and Bayerische Hypobank are banks that have been created in the late 1960s or early 1970s; the latter two merged in 1997 in a reaction to strengthen their domestic home base.

#### 14.3.1. Deutsche Bank

Deutsche Bank "fits the stereotype of the European bank in search of a truly global strategy" (Canals, 1993, p. 97). Founded as a bank primarily for financing German foreign trade in 1870, it had established offices in Shanghai, Yokohama and London by 1873. The bank had been internationally active from its beginning, also being confronted with two

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<sup>13</sup> The bank operated within the UNICO group, having DG Bank as its German partner, but became convinced that companies would in the near future not be prepared to handle their domestic and foreign financing through different banks.

<sup>14</sup> ING already had a 4.5% stake in BHF Bank when both banks participated in Inter Alpha in the 1970s.

<sup>15</sup> Pretzlik, C. (2000, October 23). Survey - German banking and finance: Foreign institutions gobble up the goodies. *Financial Times*.

seizures of activities during the first and the Second World War. Post-war internationalization was resumed in 1957, after Deutsche bank had been re-merged (Gall et al., 1995, p. 741). In the 1960s there was a growing interest in international alliances with a view to promoting foreign business. In 1963, Deutsche Bank was the first German bank to enter a loose cooperation (EAC), that evolved into EBIC. Deutsche Bank integrated its Asian activities into a joint venture of the EBIC group in 1972, until 1978 when the 14 branches were renamed Deutsche Bank (Asia). In 1970, a subsidiary was established in Luxembourg. The expansion and restructuring of the foreign branch network continued in the 1970s and 1980s (Gall et al., 1995, p. 386).

Throughout the 1970s, Deutsche Bank systematically set up its branch network world wide. Although it seemed that this development was largely over in the early 1980s, Deutsche Bank continued to open branches, or convert representative offices to branches. While this might represent an assets seeking strategy, it did not have the intensity of the “flag-planting competition” of British Banks. The bank’s lack of representation in the Scandinavian countries may be explained that business there can be easily conducted from Germany and London, even abstaining from purchasing possibilities during the Swedish banking crisis in 1992 (Gall et al., 1995, p. 775). In 1986, Deutsche Bank started a reorganization to increase efficiency, formulating the following corporate objectives (Canals, 1993, p. 97):

- Increase market position in securities trading, expanding the services offered.
- Continue development of commercial bank activities, increasing the bank’s presence in other high-growth international markets.
- Strengthen the bank’s position in retail banking, developing new distribution channels and services.

The strengthening of retail banking took place in the same years, when the 100 Italian branches of Bank of America were acquired. The Italian subsidiary would further expand in 1993 with a majority stake in Banca Popolare di Lecco, a profitable northern regional bank also with 100 branches.<sup>16</sup> In 1988 the partner in Dutch bank Albert de Bary was bought out, and the bank began building up its branch networks in Argentina and Brazil. It also acquired a further 100 branches in Spain (Gall et al., 1995, p. 386). In 1993 it acquired Banco de Madrid from Banesto, adding another 300 branches in Madrid and Central Spain while overtaking Crédit Lyonnais as the largest foreign retail bank in Spain, and challenging the growth strategy of National Westminster and Barclays in the country.<sup>17</sup>

In 1998, Deutsche Bank paid 1 billion deutschmark for Crédit Lyonnais Belgium. While Crédit Lyonnais achieved more than half the asset sale amount imposed by the

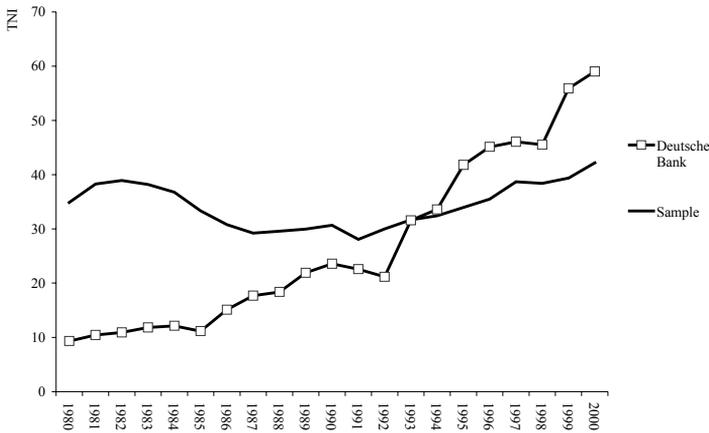
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<sup>16</sup> Simonian, H. (1993 November 25). International Company News: Deutsche Bank offshoot in L470bn Italian deal. Financial Times, p. 27.

<sup>17</sup> Burns, T. (1993 March 30). International Company News: Banks look for warmer climates - Deutsche Bank’s latest foray into Spain. Financial Times, p. 29.

European Commission in exchange for state aid<sup>18</sup>, Deutsche bank established its third substantial retail branch network outside Germany, besides Spain and Italy. It was unsuccessful in acquiring a retail network in France, and decided in 1999 to set up 15 branches for wealthy customers.<sup>19</sup>

Figure 14.3. *TNI Deutsche Bank, 1980-2000*



The growth in the capital markets was primarily accomplished in two large steps: the acquisition of Morgan Grenfell in 1989, and the acquisition of Bankers Trust in 1998. In the 1970s and 1980s, Deutsche Bank established subsidiaries in the major financial centers for capital market activities.<sup>20</sup> The major shift to investment banking started in the 1980s, when it acquired a 4.99% stake<sup>21</sup> in British investment bank Morgan Grenfell, aiming to gain access to London investment banking know-how (Gall et al., 1995, p. 771). In 1989 the situation changed when French financial group Indosuez bought a 14.9% stake from a British insurer, with an option to buy another 10%. Deutsche Bank seized the opportunity, to present itself as white knight, and by the end of 1989 Deutsche Bank had acquired a controlling share of the bank. The full acquisition amounted to 2.7 billion deutschmark, the bank's biggest post war investment (Gall & et al., 1995, p. 771). The bank integrated existing capital market activities in Morgan Grenfell, a process that took several years to complete.<sup>22</sup> Subsequently, the bank's headquarters for its investment

<sup>18</sup> Barber, T., Harros, C. & Iskander, S. (1998 December 3). Companies & Finance: Europe: Deutsche Bank in Belgian buy. *Financial Times*, p. 28.

<sup>19</sup> Harnischfeger, U. (1999 July 5). Deutsche Bank treads gently in Europe. *Financial Times*, p. 22.

<sup>20</sup> For example, besides EBIC bank EAB, where Deutsche Bank participated, the bank set up a New York based joint venture with UBS, which in ended in 1978 with Deutsche Bank taking full control (Gall & et al., 1995, p. 768).

<sup>21</sup> Which was below mandatory approval limit (Gall & et al., 1995, p. 770).

<sup>22</sup> Waters, R. (1992, July 22). International Capital Markets: Deutsche Bank to merge businesses. *Financial Times*, p. 25.

banking activities were transferred to London, “emphasizing London’s pre-eminence over Frankfurt as an international financial center”<sup>23</sup>

In 1992, Deutsche Bank announced the restructuring of its capital market and private banking operations, creating a holding company to bring together its North American activities. Employing 1,200 people in that region, Deutsche Bank’s aim was to become sizeable participant in the wholesale banking activities, focusing on corporate finance, securities and derivatives trading, foreign exchange and asset management.<sup>24</sup> This was achieved with the sale of Bankers Trust to Deutsche Bank in 1998, the eight largest bank in the United States, and at the time the largest acquisition of an American bank by a foreign bank, valued at 9.7 billion US dollar. Bankers Trust had been trying to build a medium-sized investment banking business in the United States, having shed its retail banking activities some years earlier. Where the termination of BZW, the investment banking unit of Barclays, was triggered by the merger of Salomon Brothers and Smith Barney (part of Travelers group), the sale of Bankers Trust was probably triggered by the merger of Citicorp and Travelers, raising the amount of capital needed in investment banking to achieve the same kind of business.<sup>25</sup> Other capital market activities included the building of wholesale banking operations in Australia, and asset management activities in Japan.

Increasing its German market share was a permanent issue in the 1990s for Deutsche bank. With German unification, the bank increased its activities in the new states, as did the other banks. Domestic diversification into insurance took place with the purchase of a majority stake in Herold Versicherungs company in 1992.<sup>26</sup> In 1996 Deutsche Bank created a stir when it took a 5% stake in Bayerische Vereinsbank. With the German economy recovering from a recession, banks were concentrating on low-risk, and thus low profit, loans, striving to cut costs and gain business from wealthy customers. The prospect of an acquisition launched speculation about a restructuring of the German banking scene, and the stake might have signaled that Deutsche Bank intended to be a major participant in that process.<sup>27</sup> In the end however, Bayerische Vereinsbank ended up merging with Bayerische Vereinsbank the next year.<sup>28</sup>

Playing down prospects for a merger of its retail banking operations with Dresdner bank at the launch of its retail operation Deutsche Bank 24 late 1999<sup>29</sup>, a few months later the bank announced that a merger of its domestic retail activities with Dresdner was discussed. Although the banks agreed on the domestic approach of the merger, talks eventually failed because Deutsche Bank’s plan intended to fold Dresdner Kleinwort

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<sup>23</sup> Fisher, A. & Cohen, N. (1994, October 29). Deutsche Bank puts its money on London. *Financial Times*, p. 24.

<sup>24</sup> Friedman, A. (1995, May 6). Deutsche Bank to expand in US. *Financial Times*, p. 21.

<sup>25</sup> Corrigan, T. (1998, December 2). Comment & Analysis: Shrinking middle ground: Now that Deutsche Bank has taken over Bankers Trust. *Financial Times*, p. 20.

<sup>26</sup> Fisher, A. (1992, September 2). International Company News: Deutsche Bank purchase. *Financial Times*, p. 14.

<sup>27</sup> Fisher, A. (1996, September 6). Comment & Analysis: Cat set among the pigeons. *Financial Times*, p. 15.

<sup>28</sup> Fisher, A. (1997, November 18). Survey - German banking: Shake-up sharpens focus. *Financial Times*.

<sup>29</sup> Grant, J. (1999, September 1). No merger for Deutsche bank, *Financial Times*.

Benson (the investment banking unit of Dresdner) into its own investment banking operation. Combined with the proposed restructuring to save costs, it would have effectively closed down Dresdner Kleinwort Benson, a consequence which met considerable resistance at Dresdner's board.

Table 14.3. *Activities Deutsche Bank*

Period	Phase	Objective	Arena	Client	Product	Organizational form															
						Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
'80-'85	Entry	1. Build worldwide network to service client	Major financial and economic centers																		
		2. Maintain commercial bank network	Domestic																		
		3. Expand capital market activities	United Kingdom, United States																		
'86-'98	Broad expansion	1. Increase domestic market position	Domestic																		
		2. Expand worldwide network to service large corporations	Major financial and economic centers																		
		3. Growth in retail banking	Spain, Italy, Belgium, France																		
		4. Increase capital market activities	United Kingdom, United States																		
'99-'00	Restructure, refocus	1. Increase domestic market position and profitability	Domestic																		
		2. Restructure foreign activities	Whole organization																		
		3. Divest strategic industrial shareholdings	Domestic																		

The restructuring of domestic operations had to be done alone, and Deutsche Bank created "Deutsche Bank 24", its retail banking unit, by combining retail and direct bank activities (clicks and bricks) in 1999. The direct banking activities had already been set up in 1995, reacting to the start of the direct bank of Commerzbank (Comdirect).<sup>30</sup> After restructuring, profitability increased in 2000, and the bank moved away from the concept that retail banking was a costly but necessary burden for the bank. With its domestic presence established, Deutsche Bank planned to venture it online brokerage in seven European countries.<sup>31</sup>

### 14.3.2. Dresdner Bank

The internationalization of Dresdner Bank has its roots in the late 1960s, when it established a cooperative agreement with BNP in 1966.<sup>32</sup> Being a co-founder of ABECOR in 1972, it renamed its existing securities operation in New York, and let other

<sup>30</sup> Fisher, A. (1995, March 30). International Company News: Deutsche Bank sets up 24-hour operation. *Financial Times*, p. 26.

<sup>31</sup> Harnischfeger, U. (2000, October 23). Survey - German banking and finance: Life still tough for private sector. *Financial Times*.

<sup>32</sup> *History of Dresdner Bank*. (n.d.) Retrieved April 27, 2003, from www.hoovers.com.

shareholders of ABECOR participate.<sup>33</sup> From 1979 the bank opened foreign branches at a greater pace, opening one in Madrid and Hong Kong (1979), Milan (1980), Barcelona and Toronto (1981). The 1980s did not start off well for the bank. Considerable losses accumulated in 1980 and 1982, suffering from narrowing interest margins, LDC write offs, bad loans due to the worst recession since the Second World War, and extraordinary charges resulting from the restructuring of AEG, a large German industrial firm.

Internationalization activities were also used to set up finance companies: in 1983, a Dutch based (re)financing company was founded, similar companies were established in New York (1983), Milan (1986) and Dublin (1989). Divestitures were few during the 1980s: in 1985, it sold the Landerbank to Credit Suisse.<sup>34</sup> Being the first German bank to list its shares on the Tokyo stock exchange in 1985, its asset management activities were broadened by setting up asset management subsidiaries in Luxembourg (1988) and Dublin (1989).

In the period 1988-90, Dresdner shaped its most of its strategy for the next decade: the alliance with BNP was intensified, and insurer Allianz and Dresdner formed an alliance. BNP and Dresdner signed an agreement to intensify the long standing cooperation with BNP. Over the next years, the banks would become jointly active in Eastern Europe. The banks announced in 1991 that they were on the verge of a wide-ranging collaboration agreement which would include cross-shareholdings of around 10%. The shareholdings eventually never fully materialized.<sup>35</sup> In 1990, Hungarian BDK bank was founded together as a joint venture with a state owned bank. In 1993, the banks opened a joint subsidiary in St. Petersburg.

Also in 1989, Dresdner and German insurer Allianz announced a cross selling agreement. Under this, about half of the bank's branches sell Allianz insurance products and the insurer's salesmen sell those of Dresdner.<sup>36</sup> With the fall of communist regimes in Eastern Europe from 1989 onwards, Dresdner acted upon the enlarged home market and new Eastern European markets. Early 1990, it opened seven new branches and acquires 107 branches throughout Eastern Germany, holding its annual shareholders meeting in Dresdner for the first time since 1941. Also in 1990, representative offices were opened in Warsaw, Prague and Budapest.<sup>37</sup>

Dresdner intensified its asset management activities when it bought UK based Thornton & Co. In 1996 the bank acquired the Californian asset manager RCM Capital Management, and formed an asset management joint venture with Allianz in 1998.<sup>38</sup>

In 1995, Dresdner significantly increased its investment banking activities by purchasing Kleinwort Benson, one of London's few remaining independent investment

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<sup>33</sup> German-American Securities Corp. was renamed ABD Securities Corporation, the other shareholders were ABN, Banque de Bruxelles and Bayerische Hypotheken- und Wechselbank, each with a 25% stake.

<sup>34</sup> *Financial Times*. (1991, May 31), p. 27.

<sup>35</sup> *Financial Times*. (1991, September 4), p. 25. The cross shareholdings have been less than 1%. Source: Dresdner, BNP end some ventures. (2000, September 25). *Wall Street Journal Europe*, p. 18.

<sup>36</sup> *Financial Times* (1991, July 30), p. 17.

<sup>37</sup> In 1973 Dresdner was the first German bank to open a representative office in Moscow.

<sup>38</sup> *History of Dresdner Bank*. (n.d.). Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com).

banks. The purchase of Warburg by SBC, the failure of Barings in February 1995 and the fears that the bank might not successfully complete the transformation from a merchant bank to an investment bank, made management decide to sell out to a large bank (Augar, 2000, p. 243).<sup>39</sup> The acquisition was announced in June, where Kleinwort Benson had negotiated a large degree of autonomy within the Dresdner bank, being responsible for all investment banking activities and (non-German) securities, operating as an autonomous entity within the Dresdner Bank group. This triggered criticism that Dresdner had been more concerned about keeping up with the strong growth of Deutsche bank in that area, than with investment banking (Augar, 2000, p. 244).

Table 14.4. *Co-operation BNP and Dresdner*

Year	Activity
1989	Co-operation agreement.
1990	Joint venture with Hungarian bank to set up BDK bank. <sup>40</sup>
1991	Opening of a joint subsidiary in Prague. <sup>41</sup>
1993	Joint subsidiary in St. Petersburg. <sup>42</sup>
1995	BNP and Dresdner merge their Spanish operations, focussing on corporate clients. <sup>43</sup>
1995	BNP and Dresdner set up a joint subsidiary in Bulgaria, with the ERBD as minority stakeholder (20%). <sup>44</sup>
1996	BNP and Dresdner buy Crédit Lyonnais 55% stake in Chilean brokerage firm Crédit Lyonnais Valores.
1997	BNP and Dresdner announce the opening of a Ukrainian subsidiary in 1998. <sup>45</sup>
1997	BNP and Dresdner announce the opening of a Romanian subsidiary. <sup>46</sup>
1999	BNP and Dresdner talk about a further co-operation, even full merger. Talks resume after BNP acquires Paribas. <sup>47</sup>
2000	The co-operation agreement is ended, the joint venture banks are to be sold.

From 1997, Dresdner actively searched for another bank to merge with, when it held talks with the Bayerische Hypotheken- und Wechsel-bank.<sup>48</sup> The Bavarian bank merged with Vereinsbank, incidentally also leaving Deutsche bank by the sideline, who

<sup>39</sup> BNP already held a 4.8% stake in Kleinwort in 1991, presenting itself as a white knight in case of an unwanted takeover after the investment bank suffered heavy losses in 1989.

<sup>40</sup> *Financial Times* (1996, January 24), p. 18.

<sup>41</sup> *Financial Times* (1991, September 4), p. 25.

<sup>42</sup> *Financial Times* (1993, September 13), p. 22.

<sup>43</sup> *Financial Times* (1994, October 3), p. 21.

<sup>44</sup> *Financial Times* (1995, September 18), p. 21.

<sup>45</sup> *Financial Times* (1997, November 25), p. 22.

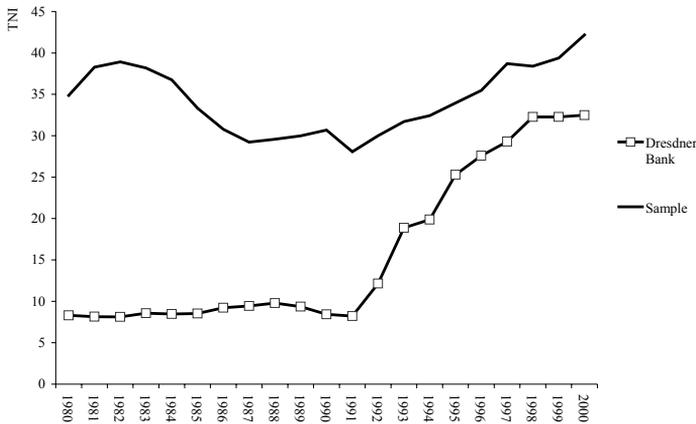
<sup>46</sup> *Financial Times* (1997, November 25), p. 22.

<sup>47</sup> *Financial Times* (1999, September 9), p. 21.

<sup>48</sup> Fisher, A. (1997, November 18). Survey - German Banking: Shake-up sharpens focus. *Financial Times*.

had acquired a stake in the latter bank. Merger discussions were initiated with long standing merger candidate BNP in 1999, but the bank became involved in a domestic takeover battle to take over Société Générale and Paribas.<sup>49</sup> In the same year, Dresdner held exploratory talks with HypoVereinsbank to merge its retail operations, without any results.<sup>50</sup>

Figure 14.4. *TNI Dresdner Bank, 1980-2000*



Then at the beginning of 2000, Dresdner and Deutsche initiated merger talks. Both Deutsche and Dresdner had long been unsatisfied with their inability to generate adequate profits from their domestic retail banking activities, and felt the need to restructure their operations. Dresdner and Deutsche would merge their retail operations, enabling them to cut costs and concentrate on more profitable business. Of the merger bank's 2,500 branches, 700 would be closed. To enable this, Allianz would take a 32% stake in the merged retail bank, acquire Deutsche's insurance activities and other asset management activities.<sup>51</sup> The role of Allianz in the merger talks was an important one, owning 5% of Deutsche and 21.7% in Dresdner.

While doubts mounted about the soundness of the deal - Deutsche simply eliminated a long time domestic competitor in exchange of undervalued assets transferred to Allianz<sup>52</sup> - the merger would fall through on Kleinwort Benson. The domestic dimension apparently was agreed on, but large differences existed on the international consequences of the merger. So soon after the acquisition of Banker's Trust in 1998, Deutsche was not willing to fold Kleinwort into its investment banking activities. After

<sup>49</sup> Mogelijke Frans-Duitse bankfusie. (1999, September 9). *NRC Handelsblad*.

<sup>50</sup> Grant, J. (1999, September 1). No merger for Deutsche bank. *Financial Times*.

<sup>51</sup> Barber, T., Major, T. & Lewis, W. (2000, April 12). Torch that sent a deal down in flames. *Financial Times*, p. 22.

<sup>52</sup> Major, T. (2000, March 17). First the deal - and now the doubts. *Financial Times*, p. 22.

first considering sale, new plans indicated a virtual closure of Kleinwort, shedding 90% of its staff, proving too much for Dresdner management who ended the talks.<sup>53</sup>

Table 14.5. *Activities Dresdner Bank*

Period	Phase	Objective	Arena	Client	Product	Organizational form															
						Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
80-90	Entry	1. Maintain domestic position, diversification activities	Domestic																		
		2. Build international network	Major financial and economic centers																		
		3. Expand in asset management	Europe																		
91-98	Broad expansion	1. Expand investment banking and asset management	United Kingdom, United States, Domestic																		
		2. Expand in Eastern Europe through alliance with BNP	Eastern Europe																		
		3. Increase cross selling through alliance with Allianz	Domestic																		
99-00	Restructuring, refocus	1. Restructure domestic branch network (alone or by merger) to increase profitability	Domestic																		
		2. Refocus investment banking activities	United Kingdom, United States																		
		3. Develop stand alone activities in Eastern Europe	Eastern Europe																		

After presenting its go-alone strategy in May 2000, putting Kleinwort Benson at the center of its strategy<sup>54</sup>, the bank held exploratory merger talks with Commerzbank in June. The same merger rationale for domestic cost cutting remained<sup>55</sup>, but both parties could not agree on the share they would have in the new bank, and the deal also fell through.<sup>56</sup> The go-alone strategy was accentuated when BNP-Paribas and Dresdner announced the end of the Eastern European ventures, where the chairman of BNP commented that the two banks' joint projects did not increase profitability for the banks.<sup>57</sup> In the same year, a New York based investment bank, Wasserstein Perrella, was acquired and merged with Dresdner Kleinwort Benson, as a demonstration of Dresdner's commitment to build its investment banking activities. In July 2001, Dresdner gave up its independence, being bought by Allianz, twelve years after both companies agreed to a cross-selling agreement.

<sup>53</sup> Barber, T., Major, T., Lewis, W. (2000, April 12). Torch that sent a deal down in flames. *Financial Times*, p. 22.

<sup>54</sup> William, J. (2000, May 22). Dresdner Bank sets out strategy for the single life. *Financial Times*, p. 34.

<sup>55</sup> Walker, M. & Portanger, E. (2000, June 16). Dresdner and Commerzbank begin talks to explore merger. *Wall Street Journal Europe*, p. 1.

<sup>56</sup> Commerzbank insisted on a nearly 50% stake in the to be merged bank, while Dresdner insisted on a stake close to 60%, in accordance with the estimates of most analysts. Source: Major, T. & William, J. (2000, July 27). Final moments when a breakdown became inevitable. *Financial Times*, p. 20.

<sup>57</sup> Harnischfeger, U. (2000, September 11). Dresdner ends search for deal. *Financial Times*, p. 26.

### 14.3.3. Commerzbank

A significant part of the international network was created in the 1970s. Here it followed a two way approach: the build up of an own network and the build up of a co-operative network. In 1969 it founded its Luxembourg subsidiary, and after establishing branches in the major financial centers (New York in 1971, London in 1973), other financial centers in Europe, United States and Japan were opened.<sup>58</sup> This continued into the 1980s. Commerzbank also actively co-operated with other banks, forming Europartners with Crédit Lyonnais in 1970.<sup>59</sup> Three Europartner subsidiaries, in New York and Amsterdam, were ultimately fully controlled by Commerzbank in the 1980s.<sup>60</sup>

In 1973, Commerzbank took a 10% stake in Spanish Banco Hispano Americano, which was raised to 20% in 1984. The cross shareholding structure became an essential part of Commerzbank's strategy. In 1990, it began talks with Banco Hispano Americano and Banco di Roma, all members of Europartners, to exchange equity holdings, aiming at a better access of each others networks, and a joint development of new products.<sup>61</sup> Four years later, the bank bought a 3.2% stake in the newly-privatised Italian Banco Commerciale Italiana.<sup>62</sup> This stake was raised to 5% in 1998, following the announcement that Deutsche Bank also acquired a 4.5% stake in the Italian bank. Moreover, at the end of 1998 Italian insurer Generali and Commerzbank announced a cross shareholding alliance, aimed in large part at strengthening their grip on Banca Commerciale Italiana; together they would own 10% of the bank.<sup>63</sup>

The bank's expansion, the bad loans accumulated in South America<sup>64</sup>, and losses resulting from interest rate mismatches took a heavy toll on the financial position of Commerzbank, even forcing the bank to pass on dividend payments in 1982. A restructuring plan coached the bank back to profitability in 1984 and the bank focused on becoming a bankassurance group, expanding into mortgages, insurances and financial services. In 1988, it bought into savings with a 40% stake in Leonberger Sparkasse, while in 1989 it agreed to an alliance with insurer DBV and took a stake in a financial advisory

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<sup>58</sup> Also from the 1960s, Commerzbank held a 5% stake in Brazilian Unibanco, which was raised to 19.4% in 1988, and consequently diluted to 10% (Krause et al., 1995, p. 281).

<sup>59</sup> Banco di Roma joined in 1971, and Banco Hispano Americano in 1973.

<sup>60</sup> EuroPartners Securities Corporation, New York. The bank was established in 1970 and fully controlled by Commerzbank in 1988, its name changed to Commerzbank Capital Markets Corporation. Europartners Bank (Nederland) N.V., Amsterdam was established in 1973 and fully controlled by Commerzbank in 1984, renamed Commerzbank (Nederland) N.V. Commerz-Credit Bank, a joint venture in Saarbrücken where Crédit Lyonnais held 35% and Commerzbank 65%, was fully controlled in 1993 when Commerzbank acquired the Crédit Lyonnais stake.

<sup>61</sup> *Financial Times* (1990, February 19), p. 23.

<sup>62</sup> *Financial Times* (1994, March 19), p. 11.

<sup>63</sup> The shareholding alliance meant that Generali would take a 5% stake in Commerzbank, while Commerzbank would take a 2.5% stake in Generali. *Financial Times* (1998, November 10), p. 29.

<sup>64</sup> At a seminar in 1980 (Brützel, 1981, p. 77), Wolfgang Jahn, board member of Commerzbank, presented figures showing that close to 10% of Commerzbank's assets, amounting to 3.5 billion deutschmark, were located in other overseas countries, "with the greatest proportion of this figure related to Latin-America Newly Industrialised Countries". The other geographical allocation of assets were as follows: industrialized world (76%), socialist economies (7%), OPEC states (5%) and other European nations (2%).

firm (Krause et al., 1995, p. 329). When German unification took place, it decided not to take over any of the state banks in the former German Democratic Republic, but to set up its own branch network. By 1993, the bank had opened 113 branches in the new States (Krause et al., 1995, p. 281).

Figure 14.5. *TNI Commerzbank, 1980-2000*



German imports in the Comecon countries grew from the mid-1980s. To facilitate the trade settlement, Commerzbank set up joint ventures with Russian, Bulgarian and Czech banking cooperatives. When the change to market oriented economies began to take place, Commerzbank ensured a presence in the new markets opening up in Eastern Europe, establishing between 1991 and 1993 presence in Budapest, Prague and Warsaw. Also in Poland, Commerzbank took a 20% stake in the Bank Rozwoju Eksportu (BRE). Being present in Moscow since 1976, Commerzbank added in 1993-94 five additional representative offices in Russia (Krause et al., 1995, p. 295). In 1995, celebrating its 125th anniversary, the chairman of Commerzbank, Martin Kohlhausen formulated its strategy (Krause et al., 1995, p. 316-318):

- Commerzbank remained deeply committed to the German banking market, focussing on firms, retail clients and private banking clients.
- Commerzbank was a universal bank: it saw strong growth opportunities in mortgage activities as well as insurance.
- Internationally, the bank especially targeted Europe - including Eastern Europe - for trade, institutional and private banking, establishing presence in the main financial centers. Outside Europe, activities in North America (mainly States) and South East Asia (14 operations in 8 countries) were developed.

Compared to the other large German banks, Commerzbank remained aloof from large investment banking acquisitions in the early 1990s. As the bank was relatively hard hit in the early 1980s, the depletion of hidden reserves compared to other German banks might have led to a cautious approach to higher risk activities. But from 1995, the bank targeted asset management, and expanded into investment banking. In 1995, the bank bought 75% of Jupiter Tyndall, a British fund management group. Jupiter aimed its equity based fund management products mainly at institutional investors. In the same year, the bank acquired a minority stake in a new Taiwanese fund management company, targeting institutional and wealthy private Taiwanese investors. Also, a controlling stake was bought in a specialized United States investment bank. A larger acquisition in the United States would take place in 1997, buying Montgomery Asset Management, handling about 8 billion US dollar of funds for retail and institutional clients.<sup>65</sup>

In 1996 the bank continued to expand in Eastern Europe, setting up a joint venture with a local stock-broking firm to trade in the Eastern European bond markets.<sup>66</sup> In 1997, it increased its minority stake in Polish bank BRE. Its Polish ventures were stopped by Citicorp two years later, when the BRE bank merged with Handlowy. Citicorp eventually acquired the majority of the merged bank, and Commerzbank sold out.

Table 14.6. *Activities Commerzbank*

Period	Phase	Objective	Arena	Client				Product				Organizational form						
				Government	Institutional	Corporate	Private	Credit	Asset management	Securities	Insurance	Services	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
80-90	Entry	1. Diversify domestic banking activities	Domestic		■	■		■	■	■		■	■					
		2. Gain access to network	Europe			■					■							
		3. Maintain commercial branch network	Major financial and economic centers		■	■		■	■							■		
91-99	Broad expansion	1. Maintain domestic position, being a universal bank	Domestic		■	■		■	■	■						■		
		2. Increase asset management	United Kingdom, United States, Taiwan		■	■									■			
		3. Increase Asian activities	South Korea, Japan		■	■									■			
		4. Increase Eastern Europe activities	Eastern Europe		■	■		■	■			■	■					
00	Restructuring, refocus	1. Find group of stable shareholders, to fend off acquisition	Domestic															
		2. Restructure domestic branch network to increase profitability	Domestic, Europe		■	■												■
		3. Restructure branch network, integrate corporate finance and investment banking	United Kingdom, Europe		■	■			■	■	■							■

<sup>65</sup> *Financial Times*. (1997, April 8), p. 24.

<sup>66</sup> The partner was bought out in 1998, and the operations renamed Commerzbank Capital Markets (Eastern Europe). *Financial Times*. (1998, June 12), p. 26.

The latter half of the 1990s also presented unexpected challenges for Commerzbank. In 1996, regulators charged that the bank helped clients move assets to Luxembourg to evade taxes. The bank was also hit hard by the Asian crisis of 1998, especially after the crisis spread to Russia in 1998.<sup>67</sup> Investment banking was targeted again in 1998, when Commerzbank raised the importance of its investment banking branch in London, doubling the equities staff to 540 through aggressive recruitment.<sup>68</sup> In the same year, Commerzbank was granted a licence by the Japanese ministry of Finance to sell mutual funds to private investors.<sup>69</sup> The bank also bought a seat on the Tokyo stock exchange, becoming vacant after the merger of Smith Barney and Salomon Brothers.<sup>70</sup> In the same year, Commerzbank agreed to buy a 30% stake in Korea Exchange Bank, South Korea's largest bank in terms of assets. It thereby became the first foreign bank to take a significant stake in a Korean commercial bank.<sup>71</sup>

In 2000, Commerzbank intensified the cross shareholdings once again, as an attempt by management to protect itself from unsolicited takeovers after the failed merger talks with Dresdner Bank.<sup>72</sup> An investment group, Rebon, became Commerzbank's largest shareholder, fuelling speculations about a possible takeover.<sup>73</sup> As a defense, Italian insurer Generali raised its equity stake in Commerzbank from 5.1 to 9.9% while Mediobanca, the Italian investment bank, increased its holdings to 2%. A similar attempt to double the shareholdings by BSCH failed.<sup>74</sup>

A failed merger, pressure by shareholders and disappointing financial results in 2000 forced management to change its strategy. Commerzbank announced that it would concentrate its activities on Europe, and a restructuring plan would be implemented closing down branches and integrating its investment banking activities and corporate finance<sup>75</sup>, similar to the approach of ING.

#### 14.3.4. WestDeutsche Landesbank Girozentrale

In 1969, the Rhineland and Westphalian Landesbanks merged into WestDeutsche Landesbank Girozentrale (WestLB), creating one of the country's largest banks. Unlike a commercial bank, the bank had a public law status, its owners being mutual banks and regional government.<sup>76</sup> The main object of the bank was not to make profit, but to carry

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<sup>67</sup> *History of Commerzbank*. (n.d.). Retrieved April 27, 2003.

<sup>68</sup> *Financial Times* (1998, November 16), p. 26.

<sup>69</sup> *Financial Times* (1998, January 6), p. 22.

<sup>70</sup> *Financial Times* (1998, January 7), p. 28.

<sup>71</sup> *Financial Times* (1998, May 28), p. 26.

<sup>72</sup> William, J. & Barber, T. (2000, October 17). Commerzbank builds cross-shareholdings. *Financial Times*, p. 24

<sup>73</sup> Major, T. (2000, May 17). Rebon raises Commerzbank stake. *Financial Times*.

<sup>74</sup> Commerzbank was to acquire BSCH's consumer credit company in exchange for the equity share, but the bank's could not agree on the valuation. Source: William, J. and Barber, T. (2000, October 17). Commerzbank builds cross-shareholdings. *Financial Times*, p. 24.

<sup>75</sup> Duitse Commerzbank reorganiseert na verlies. (2001, February 6). *Financieel Dagblad*, p. 5.

<sup>76</sup> The State of North Rhine-Westphalia (43.2%), the Regional Associations of the Rhineland and Westphalia (11.7% each), and the Sparkassen Associations of the Rhineland and Westphalia-Lippe (16.7%).

out the tasks of a state and municipal bank, as well as a central bank for the mutual banks. WestLB was permitted to conduct all types of banking transactions (Pohl and Freitag, 1994, p. 479). The bank was one of the founding members of consortium bank Orion in 1970, together with Chase Manhattan, National Westminster and Royal Bank of Canada, being a preferred candidate for the consortium bank because “it was a leader in Deutschemark bond issues for domestic and foreign borrowers and renowned for its aggressive marketing of Deutschemark foreign bonds; it also had access to a wide range of corporate clients drawn from Germany’s foremost industrial region” (Roberts and Arlander, 2001, p. 45).

By 1980, the bank was active in the Eurocurrency markets<sup>77</sup> through a Luxembourg subsidiary, and had set up two (smaller) banks in France, a finance company in the United States and subsidiaries in HongKong.<sup>78</sup> Rising interest rates in the 1980s hit the financial position of WestLB relatively hard<sup>79</sup>; to stabilize the bank and regional economy the North Rhine-Westphalia government subscribed to an additional capital increase raising its stake to over 40%.<sup>80</sup>

After restoring financial health, the bank returned to its international expansion path in the late 1980s: it extended loans to the Soviet Union, invested in the emerging South American economies, and created joint ventures and partnerships worldwide. A London subsidiary was established in 1985.<sup>81</sup> By 1986, it was active in 12 different countries<sup>82</sup>, increasing to 16 in 1990.<sup>83</sup>

Table 14.7. *Activities Westdeutsche Landesbank*

Period	Phase	Objective	Arena	Client					Product			Organizational form						
				Government	Institutional	Corporate	Retail	Private	Credit	Asset management	Securities	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield
’80-’85	Restructuring	1. Regain financial profitability	Domestic															
		2. Maintain foreign network	Major financial and economic centers		■	■	■	■	■	■								
’86-’97	Broad expansion	1. Increase commercial bank network	Europe, South America		■	■				■	■							
		2. Develop investment banking unit	United Kingdom		■	■				■	■							
		3. Diversify in other fee generating financial services	United Kingdom				■	■		■					■			
’98 - ’00	Restructuring, refocus	1. Maintain domestic market position	Domestic	■	■	■				■	■	■						
		2. Restucture organisation to comply with European Commission ruling	Domestic															

<sup>77</sup> WestDeutsche Landesbank (1981). *Geschäftsbericht 1980*, pp. 40-41.

<sup>78</sup> WestDeutsche Landesbank (1982). *Geschäftsbericht 1981*, pp. 103-104.

<sup>79</sup> Profits in 1980 had decreased by 67.5% to 61 million deutschmark; WestLB’s New York operation alone suffered a loss of 47 million deutschmark. The bank’s reputation also suffered because Ludwig Pollain (WestLB’s CEO who engineered the bank’s internationalisation strategy in the 1970s and resigned in 1997) was in 1981 on trail facing charges of fraud, corruption and breaches of trust. Source: Unhappy landesbanks. (1981, July). *The Banker*, pp. 11-12.

<sup>80</sup> *History of West Deutsche Landesbank*. Retrieved April 27, 2003, from www.hoovers.com.

<sup>81</sup> WestDeutsche Landesbank (1982). *Geschäftsbericht 1981*, p. 118.

<sup>82</sup> WestDeutsche Landesbank (1987). *Geschäftsbericht 1986*, p. 43.

<sup>83</sup> WestDeutsche Landesbank (1990). *Geschäftsbericht 1989*, p. 15.

Besides its own network, the bank established in 1989 Chartered WestLB, a joint venture with Standard Chartered, targeting merchant corporate finance services for existing clients, also gaining access to the network of Standard Chartered.<sup>84</sup> In addition, Standard Chartered sold its European branches to WestLB.<sup>85</sup> In 1993, WestLB acquired full control of Chartered WestLB, completely integrating it in its European network.<sup>86</sup> Summarizing, by the late 1980s and early 1990s WestLB pursued a three tier approach in the international banking markets:

- WestLB offered its clients the range of products and services from its subsidiary WestLB Merchant Bank Ltd.
- WestLB (Europe) set up in 1989, maintained branches, subsidiaries and representative offices in a total of 16 European countries.
- In addition, WestLB serviced its clients through branches set up financial centres outside Europe (except London). It established subsidiaries in Luxembourg (1972), Switzerland (1986). Since 1991, it had also been represented in 7 South American countries through its subsidiary (Pohl and Freitag, 1994, p. 480).

Figure 14.6. *TNI Westdeutsche Landesbank, 1980-2000*



The position of Landesbanks was challenged after 1992, when the implementation of the capital adequacy regulation<sup>87</sup> triggered a capital increase funded by the state North Rhine-Westphalia. The increase in WestLB's equity capital by 4 billion deutschmark was disputed by the *Bundesverband Deutscher Banken*, the trade association of German private

<sup>84</sup> WestDeutsche Landesbank (1990). *Geschäftsbericht 1989*, pp. 15-16.

<sup>85</sup> WestDeutsche Landesbank (1991). *Geschäftsbericht 1990*, p. 16.

<sup>86</sup> Which was set up as a separate subsidiary, WestLB Europe.

<sup>87</sup> European Council Directive of April 1989 concerning the capital resources of banks and the Council Directive of December 1989 for a solvency coefficient of banks (Sinn, 1999, p. 47). See also chapter 8.

banks, lodging an appeal with the European Commission arguing that this was a grant which violated the subsidy rules.<sup>88</sup>

In 1995, WestLB fully acquired the Thomas Cook tourist group, becoming a major building block in the tourist concept of the WestLB which has concentrated on the business of "leisure travel" and "foreign currency/travellers cheques". WestLB increased its foreign presence by opening new offices, particularly in Central and Eastern Europe, and in Asia. In London, it increased its investment banking activities, building around the acquisition of the British brokerage firm Panmure Gordon from Nationsbank in 1996.<sup>89</sup> In 1999, the European Commission ruled on the capital injection of 1992, concluding that WestLB had received illegal state aid of 808 million euro<sup>90</sup>, giving the bank two months to reimburse the illegal subsidies. A year later, all suggested repayment plans were rejected by the European Commission.

Besides the disputed capital injection, the European Commissions was not willing to tolerate the special status of German state-owned banks, arguing that the state guarantee for its liabilities was an unfair competitive unadvantage compared to other commercial banks. In 2001, the German government agreed to dismantle the special status of state-owned by 2005. During 2000, the supervisory committee of WestLB moved towards a proposal that would partially privatize WestLB. In December 2001, shareholders approved a new structure for WestLB. The commercial activities were to be spun off as WestLB AG; the state owned parent company was to be remaned Landesbank NRW and would take on all public interest activities.<sup>91</sup>

#### 14.3.5. Bayerische Vereinsbank

Just as the Hypo-Bank, Bayerische Vereinsbank could be considered a regional bank in Bavaria. In the 1950s the bank began to expand beyond its regional base; its first foreign representative office was opened in Beirut in 1958 but eventually closed. A renewed attempt was undertaken in 1970 when offices were opened in Tokyo and Rio de Janeiro. The next year, the bank opened a New York office, adding offices in Los Angeles, Cleveland and Atlanta throughout the decade. Other economic and financial centers were targeted, opening branches in Tehran (1971), Paris (1973), Johannesburg (1974), London (1976), Bahrain (1979) and Hong Kong (1979). Internationalization has mainly been to serve existing clients, and gain access to the capital markets. Activities to optimize financing possibilities were also set up for tax advantageous funding such as in the Netherlands Antillen. The bank worked towards a nationwide presence, opening branches and acquiring banks in the 1970s and 1980s, the largest being a majority stake in Vereins- und Westbank in 1990, creating a nationwide presence.

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<sup>88</sup> The Federal Association of German Banks lodged the complaint.

<sup>89</sup> Harris, C. (2004, January 8). WestLB Disposal - US groups among four BoxClever contenders. *Financial Times*, 22.

<sup>90</sup> The aid consisted of the value of a housing agency which was transferred as capital plus accrued interest.

<sup>91</sup> Westdeutsche Landesbank Girozentrale (2002). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol 35, pp. 458-461.

International activities expanded at a similar rate as domestic activities, its foreign strategy was mainly influenced by the developments in international financial markets. In 1971 it opened a subsidiary in Luxembourg in view of the strong growth of the Euromarkets. The bank realized that it was necessary to have a presence of its own in local markets, and established branches and representative office in all major financial centers in Europe, North and South America, Asia and Africa. In the late 1980s Vereinsbank continued to expand its international activities. A Beijing branch was opened in 1986, and in 1988 the bank acquired First National Bank of Chicago's branches in Milan and Rome. In Russia, the bank participated in an international joint venture to set up the International Bank of Moscow, intended to finance foreign trade and provide financial advice.<sup>92</sup>

Table 14.8. *Activities Bayerische Vereinsbank*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Private	Credit	Securities	Asset mgmt	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Diversure
'80 - '89	Entry	1. Maintain strong regional position	Domestic																
		2. Build nation wide network	Domestic																
		3. Expand international branch network	Major financial and economic centers																
'90 - '97	Broad expansion	1. Build branch network in new German states	Domestic																
		2. Set up new distribution channels	Domestic																
		3. Set up activities in Eastern Europe	Eastern Europe																

The fall of the Berlin Wall in 1989 forced a re-orientation of strategy. The bank began to systematically expand its branch network in the new states in which – in contrast of competitors like Deutsche Bank or Dresdner Bank – it had no historic roots. Existing business contacts in Eastern Europe were intensified. The bank opened offices in Hungary, Bulgaria, the Czech Republic and Russia (Pohl and Freitag, 1994, p. 360). In 1996 the bank set up Advance Bank, an online bank.

#### 14.3.6. Bayerische Hypobank

Bayerische Hypotheken- und Wechsel-Bank (Hypo-Bank) was created as a universal bank, with deep roots in the home region Bavaria. The bank changed in two ways: scope and arena. While continuing to be a deposit bank for the general public in the home region, it transformed itself from a regional bank into an institution operating on a nationwide scale. The bank also became more active on the international market, to attract funding for the

<sup>92</sup> Bayerische Vereinsbank A.G.. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 242.

economy's demand for capital that was rapidly expanding and to support clients' structural reorientation to export markets of the European community.

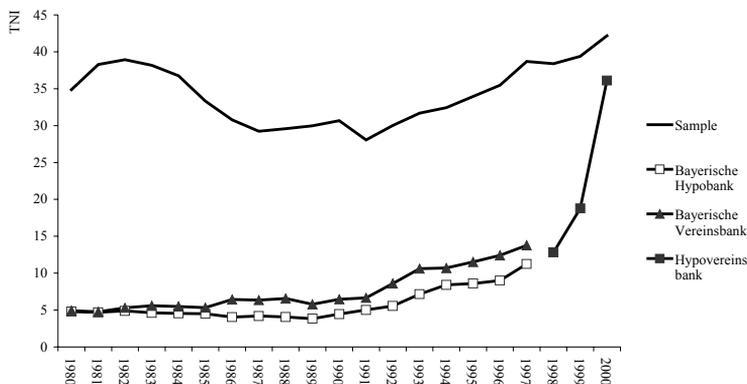
The internationalization strategy was two-fold: the creation of a foreign network, and (controlling) financial participations in foreign banks (Pohl and Freitag, 1994, pp. 350-351). Hypo-Bank announced that it would expand internationally and diversify to keep up with its competitors. Between 1969 and 1975, the bank internationalized its securities operations, entered the foreign exchange business and increasing its foreign loans. In 1972, together with Dresdner Bank, Algemene Bank Nederland and Banque de Bruxelles, it founded ABD Securities Corporation in New York to offer securities and investment banking services to European investors active in the United States. It also joined ABECOR in 1972, and was a co-founder of the Euro-Latin American Bank in 1974.

Table 14.9. *Activities Bayerische Hypobank*

Period	Phase	Objective	Arena	Client				Product			Organizational form							
				Government	Institutional	Corporate	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
'80 - '89	Entry, broad expansion	1. Maintain strong regional position	Domestic															
		2. Build nation wide network	Domestic															
		3. Expand in asset management	United Kingdom															
		4. Expand international branch network	Major financial and economic centers															
'90 - '97	Broad expansion	1. Build branch network in new German states	Domestic															
		2. Set up new distribution channels	Domestic															
		3. Set up activities in Eastern Europe	Eastern Europe															

From 1982, the bank further increased its foreign activities. In 1987 Hypo-Bank bought a 15% equity stake in Italy's Banco Trento & Bolzano. Asset management was enhanced when Hypo-Bank bought a stake in UK based Foreign & Colonial, an asset management firm. Hypo-Bank eventually took full control of Foreign Colonial, actively selling the investment funds through its own branch network. By 1993, the bank held branches in London, New York, the Cayman Islands and Hong Kong. Representative offices were held in Italy, South Africa, Russia, Spain. Also, subsidiaries were established in Austria, Czech Republic, Great Britain, Hungary, Ireland, Luxemburg and Switzerland. In 1994, Hypobank formed Direkt Anlage Bank, Germany's first discount brokerage.

Figure 14.7. TNI Bayerische Hypo-Bank (1980-1997), Vereinsbank (1980-1997) and HypoVereinsbank (1998-2000)



#### 14.3.7. HypoVereinsbank

Throughout the 1990s, the largest three German banks became more active in the regional markets vital to Vereinsbank and Hypobank. In an attempt to regain lost ground, the Bavarian banks merged in 1998, creating Europe's largest real estate lender. The merger started off on the wrong foot though. In October 1998 the bank announced that it would raise its loan provisions by 3.5 billion deutschemark to cover overvaluations of real estate projects, principally located in former communist Eastern Germany.<sup>93</sup> The losses originated in two former Hypo-Bank subsidiaries for real estate projects, after expectations of a booming German mortgage market after the unification in 1990 failed to live up to expectations. The incident was generally regarded as an embarrassment, not only because HypoVereinsbank had been generally regarded as one of the more cautious banks in Europe but also because a public row between former chairmen developed.<sup>94</sup>

The crisis at HypoVereinsbank eventually subsided; similar to a super-regional bank in the United States, HypoVereinsbank stayed regionally focused leaving foreign expansion to Deutsche Bank or Dresdner Bank.<sup>95</sup> HypoVereinsbank sold Advance bank to Dresdner after the merger, when Direkt Anlage became the merged bank's online unit. Direkt Anlage, who became by 2000 Germany's third largest broker, itself began to internationalize, offering proprietary access to the broking platform of Goldman Sachs in 2000. In the same year, it acquired France's third largest broker, Self Trade, creating Europe's third largest discount broker with more than 325,000 accounts and operations in

<sup>93</sup> Companies & Finance: Europe, Shake-up looms at German bank: HypoVereinsbank personnel changes still likely. (1998, November 17). *Financial Times*.

<sup>94</sup> Companies & Finance: Europe, HypoVereinsbank provisions up DM 3.5bn (1998, October 29). *Financial Times*.

<sup>95</sup> History of Commerzbank. (n.d.). Retrieved April 27, 2003, from www.hoovers.com.

five European countries outside Germany. The online bank followed a move into foreign markets by market leader Comdirect, the internet banking subsidiary of Commerzbank.<sup>96</sup>

Table 14.10. *Activities HypoVereinsbank*

Period	Phase	Objective	Arena	Client				Product			Organizational form			
				Government	Institutional	Corporate	Private	Securities	Asset management	Insurance	Joint venture	Acquisition	Merger	Divestiture
98 - 99	Restructuring, refocus	1. Merge organizations	Domestic											
		2. Restructure mortgage portfolios	Domestic											
99 - 00	Focused expansion	1. Restructure organisation	Domestic											
		2. Gain sizeable presence in Central/Eastern Europe	Austria, Eastern Europe			■	■						■	
		3. Expand direct distribution channels	Continental Europe				■	■	■					■
		4. Divest asset management activities	United Kingdom	■		■			■					■

From 1999, the bank restructured its organization and acquired a strong foothold in Central and Eastern Europe. In that year HypoVereinsbank held talks with competitors about merging the retail units; the bank also decided to take its Direkt Anlage Bank unit public that year. The bank acquired in 2000 Bank Austria. Although analysts were not enthusiastic about the efficiency and profitability of that bank, the main attractions were to gain a strong presence in Austria and Eastern Europe. When its fund management unit decided to sell third-party funds, the business of its British asset management firm Foreign & Colonial became redundant. HypoVereinsbank sold Foreign & Colonial to Eureko, an European insurance consortium on co-operative basis.<sup>97</sup>

#### 14.4. Commonalities and differences

German bank internationalization started relatively late compared to American, British, Swiss or French banks. In that regard, they are comparable to Spanish banks. After a decade of gradual increasing foreign banking activities in capital markets, the pace increased from the late 1980s with large foreign acquisitions within a short period of time. In the 1980s, German banks had in common that they built up internationalization activities that were to a large degree supportive of domestic activities. Branches in economic centers assisted German clients. Subsidiaries in financial centers generated additional fee income and corporate finance services for domestic clients (London, New York, Tokyo) and subsidiaries were set up to create tax advantageous financing (Luxembourg, Netherlands, the United States).

<sup>96</sup> Major, T. (2000, October 23). Survey - German banking and finance: Profile Direkt Anlage Bank. *Financial Times*.

<sup>97</sup> *History of Hypovereinsbank*. (n.d.). Retrieved April 27, 2003, from www.hoovers.com.

Domestic growth centered mainly around further diversification of financial services, broadening the "Allfinanz" concept, to a limited degree establishing new branches and most importantly the market enlargement of Germany itself in 1989 when the country was reunited with East Germany. Liberalization of Eastern Europe meant that German banks could expand in new and growing markets, where they had the advantage of having maintained trade links throughout the decades before.

By the end of the 1980s, differences in internationalization strategies appeared. Deutsche Bank wanted to be a prominent player in European retail banking, and acquired to that end retail banks in Belgium, Italy and Spain. It also aimed for a large market share in investment banking, and acquired investment bank Morgan Grenfell to that end. Dresdner Bank followed Deutsche Bank five years later with the acquisition of Kleinwort Benson. Deutsche Bank kept on buying capital market activities outside Germany throughout the 1990s, notably Bankers Trust in 1998. Dresdner Bank did (and could not) follow the scale enlargement with the same pace, but otherwise its strategy appeared similar to Deutsche Bank. Dresdner Bank also looked for domestic cross selling to increase its activities with insurer Allianz, who in turn owned a large stake in Dresdner Bank

Westdeutsche Landesbank probably stretched the definition of diversification somewhat. From its original role of central banker for the "Sparkassen" it had expanded significantly in capital market activities in Europe, the United States and Asia, eventually even owning branches in Brazil. Travel activities were acquired in 1995 with the acquisition of Thomas Cook. The bank was on its way in the 1990s to emulate Dresdner Bank and Deutsche Bank in foreign capital market and corporate finance presence, but the ambition was eventually checked by the European Commission's ruling that its funding structure was illegal and, a separation between the public and commercial activities of the bank should be set up.

For the 1980s and the first half of the 1990s, Bayerische Hypobank, Bayerische Vereinsbank and Commerzbank took a more gradual approach to internationalization. However, by 1995 felt Commerzbank its relative market position weakened. The bank, traditionally European oriented, acquired foreign banking activities in countries like South Korea, probably only to acquire assets to increase the balance sheet. In 1997 Bayerische Hypobank and Bayerische Vereinsbank felt that their domestic home market was under threat by the other large German banks and merged. Internationalization increased substantially with the Austrian bank's acquisition after two years, a delay caused by internal merger problems.

By 2000, the German banks revisited their domestic banking market, realizing that a significant restructuring of the domestic retail market would not take place in the near future. After several not-materialized mergers (Deutsche Bank and Dresdner Bank, Commerzbank and Dresdner Bank), the aborted talks seem to have the effect that the banks were forced to develop strong strategic concepts.

HypoVereinsbank announced it would focus on retail banking, and mortgage financing, expanding its successful online-brokerage, Direkt Anlage Bank, and broadening its product range to non-HypoVereinsbank funds. On the other hand, Deutsche Bank

created "Deutsche Bank 24", its retail banking unit, by combining retail and online activities (clicks and bricks) in 1999. After restructuring, profitability increased in 2000, moving away from the concept that retail banking was a costly but necessary burden for the bank. Commerzbank in 2000 announced that it would develop an independent strategy, limiting the geographic reach of its foreign activities to Europe.



## 15 Internationalization of French banks

The French banks in the sample differ from the other banks in major aspect: most of them were owned and managed by the French government for part of the period between 1980 and 2000: Banque Nationale Paris (BNP) was privatized in 1992, Crédit Lyonnais in 1998, and Société Générale in 1987. Paribas was nationalized for a short period, between 1982 and 1986. At the heyday of nationalization in 1983, Zysman wrote that “the French government has intervened continuously in the affairs of the public and private companies since the Second World War. [...] since 1945 it has more often had to act as an entrepreneur, organizing and promoting industry” (Zysman, 1983, p. 146). Controlling the financial system would be an instrumental tool in this process, although not explicitly: Haberer proudly noted that during the nationalization of Paribas, “at no time [...] did the State ask for anything to be done or not to be done” (Bussière, 1992, p. 208). This was not the case with Crédit Lyonnais however, who - also from the testimony of Haberer - was stimulated to pursue an aggressive growth strategy to create a national financial champion.

The French government changed its attitude towards bank intervention between 1980 and 2000. By 1999, the final decision in the takeover battle between Société Générale, BNP and Paribas was left to the shareholders, most of them foreign based, and not the Central Bank or the Trésor. With the exception of Crédit Lyonnais, getting itself into financial trouble from 1991 onwards when it turned out that business controls were not in place throughout the organization and its acquired subsidiaries, French banks were quite similar to the other European banks. They also were formulating their response to the growing size of the capital markets, and the expected effects of European regional integration, operating in a banking environment comparable to Germany when the size of the mutual and co-operative banks is considered.

Table 15.1. *Incentives for internationalization of French banks*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Relatively low net interest margins in the 1990s averaging 1%; an incentive to internationalize to United States, Spain, Netherlands, Germany, United Kingdom (and even Japan). Similar for profitability.</li> <li>• Regulation: Nationalization between 1982-1986, privatization from 1986 onwards. Developed internationalization strategies of BNP, Crédit Lyonnais, Société Générale, Paribas have been directed by government in the 1980s. In the 1990s state support for Crédit Lyonnais in return for ending its internationalization strategy. In the late 1980s, deregulation of mutual banks took place</li> <li>• Historic and cultural determinants: Inclination towards branch network in (North) Africa, South East Asia</li> <li>• Client: strong relationship between clients and internationalizing banks, trade companies were specifically set up.</li> <li>• Perception of the market: Deregulation financial markets in 1986: shift to universal banking</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: Development European asset growth strategies in the 1980s as a response to Deutsche Bank and position Japanese banks</li> <li>• Market power and concentration: Merger 1999 of BNP and Paribas motivated by creating large European bank</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Cost of capital: interest rate controls until the early 1990s</li> <li>• Shareholder return: most banks were not publicly listed in the 1980s, valuation of banks was relatively low in the 1990s compared to European and American banks.</li> </ul>

## 15.1. Incentives

### *Regulation*

The French banking sector has been characterized by the strong presence of the public sector. Until 1986, when the nationalization of 1982 was reversed, 63% of assets, 73% of loans and 83% of deposits were concentrated in public hands (Canals, 1993, p. 130). Banks changed between private and public ownership at regular intervals since 1945, when the four largest banks were nationalized. At the end of the 1960s, competition between banks was liberalized to some extent (the Debre Laws of 1966-67). Compared to other OECD countries, a strict market segmentation was applied where commercial banks operated under different rules than did merchant banks, savings banks and financial co-operatives (Coleman, 2001, p. 329). In 1982, a new wave of nationalism arose after the election of Socialist president Mitterand, brought about by Pierre Mauroy. Commercial banks with deposits larger than one billion francs were nationalized, resulting in a banking sector divided in either public or mutual sector. In 1987 the Chirac government privatized a few banks, among them Société Générale, Crédit Commercial de France, Suez and Paribas (Pohl and Freitag, 1994, p. 193).

Banking operations changed significantly in the 1980s. In 1983, the Tresor initiated a series of changes to the savings banks, anticipating their diversification moves. Specific market privileges enjoyed by groups of banks were ended, such as subsidized lending to agriculture by Crédit Agricole, or subsidized lending to small businesses by other banks (Coleman, 2001, p. 333). The 1984 Law on Banking tended to unify the status of all credit institutions. The government rationalized the number of regulators, and the new legislation allowed for closer equity ties between banks and industrial firms along the lines of the (German) universal banking model, as well as securities underwriting and investment banking activities (Coleman, 2001, p. 333). The early centralization of regulators brought French banks some success in the negotiations of the Second Credit Directive at the EC, where the approach taken came close to the 1984 banking law (Coleman, 2001, p. 333).

Following the victory of the right in the 1986 elections, moves began to privatize BNP and Société Générale, leaving Crédit Lyonnais the principal commercial bank in government hands (Coleman, 2001, p. 333). Worried about the expansion of Germany's large banks such as Deutsche bank, Francois Mitterrand, the French president, urged Crédit Lyonnais to expand similar to its German competitors, made possible by the changes in banking law (Coleman, 2001, p. 337).

The supervisory organization created by the banking reforms of the 1980s, the Commission Bancaire (CB), played a passive role during the demise of Crédit Lyonnais. The Dutch Central Bank informed both the CB and the French central bank of the dangerous lending practices by Crédit Lyonnais' Dutch subsidiary in 1989, after a letter to Crédit Lyonnais' bank president had gone unanswered. There is no evidence that the both regulators took any steps while the problems increased from 1990 onwards; the regulators only issued a statement on its role in 1995 when the crisis was full-blown. Coleman observes that "this silence stands in sharp contrast to the inquiries commissioned by the Bank of England and the British government following the failures of both BCCI and Barings Bank, and of congressional investigation of the savings and loans fiasco in the United States" (Coleman, 2001, p. 338).

The role of the French government changed during the 1990s in the three way banking merger struggle in 1999 between BNP, Société Générale and Paribas. The Bank of France did not prevent the take over struggle and encouraged the process of letting ultimately the shareholders decide. This attitude is all the more remarkable given the fact that the banks were privatized less than a decade ago: "letting the market make the final choice was tantamount to turning one's back on France's entire post-war philosophy" (Moisi, 1999).<sup>1</sup> More pragmatically, the financial markets were difficult to ignore with foreign investors owning 51% of Paribas, 48% in Société Générale and 45% in BNP at the time of the merger battle.<sup>2</sup>

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<sup>1</sup> Moisi, D. (1999, August 23). France's quiet revolution. *Financial Times*, p. 12

<sup>2</sup> Graham, R. (1999, July 2). The state bows out. *Financial Times*.

Table 15.2. *Major regulatory events in France, 1982 - 2000*

Year	Regulatory event	Effect on internationalization	Effect on entry foreign banks
1982	Nationalization all banks with deposits larger than 1 billion francs	None	None
1983	Ending of lending privileges for different types of banks	None	None
1984	Deregulation financial activities, allowing universal banking activities centralising financial supervisors	None	Increasing establishment branches foreign banks in Paris
1986-87	Privatization Paribas (1986), Société Générale (1987), CCF (1987)	None	None
1992	Privatization BNP	None	None
1994-98	State aid to Crédit Lyonnais	End of internationalization Crédit Lyonnais	None, effect on internationalization activities banks outside France with divestiture foreign activities Crédit Lyonnais
1999	Non intervention take over battle Paribas, Société Générale, BNP	None	None
2000	Privatisation Crédit Lyonnais	None	None

### *Market power and concentration*

After the first phase of privatization in 1986-87 (Société Générale, CCF, Paribas) and the second phase in 1993-94 (BNP) there were relatively few large mergers or acquisitions that changed the structure of French banking, such as the acquisition of Credit du Nord by Société Générale. From 1996, public sector banks became active in the acquisition process, initiated by the purchase of Indosuez by Crédit Agricole (Table 15.3).

The biggest competitive challenge for French retail banks have been the powerful mutual banks. By their status, mutuals like Crédit Agricole, France's largest bank, are all but immune to takeover bids, while they also dominate regional banking in France. This has made it difficult for commercial banks to build up a critical mass for domestic banking activities that banks like BNP believed they needed to compete globally. Together, mutuals accounted in 1999 for more than 40% of loans and more than 56% of deposits in France.<sup>3</sup>

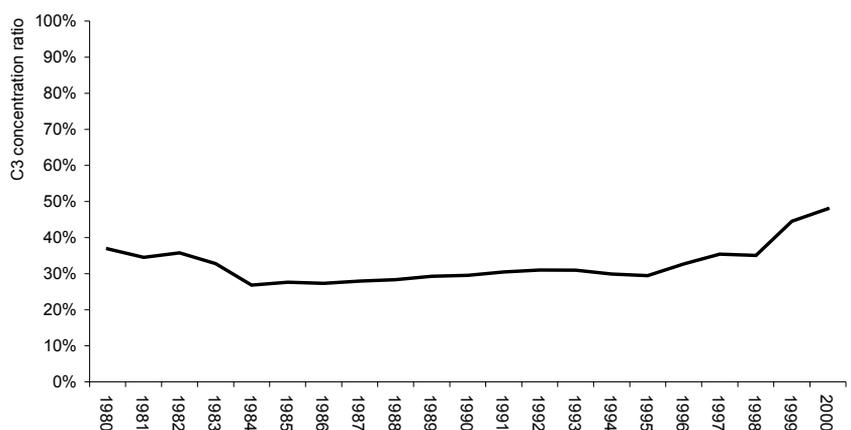
<sup>3</sup> Clow, S. (1999 September 22). French Banks' Restructuring Is on Hold. *Wall Street Journal Europe*.

Table 15.3. Major mergers and acquisitions involving French banks and banks in sample

Year	Corporate activity	Domestic	Cross-border	Foreign acquisition
1992	Acquisition Europeenne de Banque by Barclays			•
1993	Acquisition CCR by Commerzbank			•
1996	Strategic partnership BNP-Dresdner Bank		•	
1996	Acquisition of Indosuez by Crédit Agricole	•		
1997	Acquisition of Credit du Nord by Société Générale	•		
1997	Merger of Compagnie Bancaire and Paribas	•		
1999	Acquisition of Paribas by BNP	•		
1999	Strategic partnership Société Générale-BSCH		•	
2000	Acquisition CCF by HSBC			•

Source : Taken from Credit Suisse First Boston, Equity Research: French Banks, 28 September 2000, p. 31

Figure 15.1. Share of largest three banks in France, percentage total assets



Note: assets three largest banks as % total banking assets. Source largest three banks: The Banker Top 1000, 500, issues 1981-2001. Source total banking assets: broadest measure banking assets in OECD Bank profitability database ("All banks"). Banking assets prior to 1984 missing, weighted growth rate of French banks in Top 1000, 500 taken as proxy for change in total banking assets.

At the end of the privatization process, the structure of the French banking sector had converged to the other European banking markets, in terms of concentration with the three largest banks commanding nearly 50% of total banking assets, or measured by branches per capita (440 branches per capita compared to 470 for the European average). The French banking sector has historically also been similar to the German banking market: the French banking sector has been split into two major groups with the private

commercial banks accounting for about half of the market, and the public institutions. Just as in Germany, the branch network of the commercial banks has had a minor share in total branches throughout the country, (39% in France compared to 19% in Germany 19% in 1998).<sup>4</sup> As a consequence France and Germany are the European banking markets with some of the highest price competition, which over time has led domestic banks to diversify into international expansion and investment banking.

## 15.2. Foreign banks

At the end of 1979, 100 foreign banks were operating in France. Among them were 12 Arab banks who opened offices in Paris in 1979, and Midland bank who had chosen Paris as its base for European expansion. The foreign banking market was dominated by the American, British and Canadian banks ("the ABC club"). Some Canadian banks used Paris as a regional office, being more oriented to Paris than London because of their French-speaking roots. Chase was the only North American bank with provincial branches: "branching, in fact, tends to be a British specialty", with Lloyds and Barclays well positioned in the branches, and Midland just starting. The American banks set up investment banking subsidiaries to draw clients to services ranging from merger and acquisition advice to Euro-issuing from a Paris base.<sup>5</sup>

In the early 1980s, the French government had no special restrictions for foreign banks, applying rules equally for foreign and domestic branches. The opening of a branch or subsidiary however implied an inflow of foreign capital, which was subject to the exchange controls for foreign direct investment, and had to be authorized by the Direction du Trésor. Foreign participations in domestic banks exceeding 20% required prior authorization, also applicable to French banks (Pecchioli, 1983, p. 184).

Due to the large size mutual banks, foreign banks found it difficult to gain a sizeable presence in France when wanting to acquire one. At the end of 1990, Barclays negotiated the sale of *Europeenne de Banque*<sup>6</sup> from Credit Commercial de France (CCF), after negotiations between National Westminster and CCF were broken off. Barclays paid over an estimated twice the book value to gain 70 branches.<sup>7</sup> Other banks had more difficulty entering the French banking market. Deutsche Bank, after some years of unsuccessful talks with banks to acquire them, eventually decided in 1999 to set up a branch network itself.<sup>8</sup>

Foreign banks saw the opportunity to acquire a retail bank in Credit Commercial de France, one of the ten largest banks in France (albeit considerably smaller in terms of asset share). Early 1999 speculation arose that the bank was about to be taken over. By the third quarter of 1999, more than 50 percent of the equity was controlled by foreign investors, the

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<sup>4</sup> *Equity Research: French Banks* (2000, September 28). Credit Suisse First Boston, p. 24.

<sup>5</sup> Lewis, V. (1980, March). A hard road to profitability for France's ABC club. *The Banker*, pp. 41-47

<sup>6</sup> Formerly known as *Banque Rothschild*

<sup>7</sup> Barclays leads expansion abroad. (1990, December 13). *Financial Times*, p. 23

<sup>8</sup> Harnischfeger, U. (1999, July 5). Deutsche Bank treads gently in Europe. *Financial Times*, p. 22

three largest being ING, Belgian KBC and Swiss Life.<sup>9</sup> ING and CCF had been acquainted in an earlier stage through Inter Alpha, the banking club. In the takeover battle that ensued between ING, HSBC finally acquired control over CCF for 11 billion euro, gaining 1 million French customers and completing Europe's largest ever cross-border banking acquisition.<sup>10</sup>

### 15.3. Case studies

The following case studies are discussed: BNP, Paribas, Société Générale, Crédit Lyonnais and Crédit Agricole. BNP (1980-2000) acquired Paribas in 1998 which substantially increased BNP's degree of internationalization. Crédit Lyonnais is one of the banks in the sample that has shown the largest fluctuations in internationalization activities between 1985 and 1995. On the other hand, Crédit Agricole became especially internationally active in the 1990, while Société Générale has maintained an active international involvement throughout the whole period of investigation.

#### 15.3.1. BNP

Banque Nationale de Paris (BNP) is the result of a merger between two financial institutions, the Comptoir d'Escompte de Paris (CNEP) and the Banque pour le Commerce et l'Industrie (BNCI), prompted by the French Treasury in 1966. CNEP had concentrated its banking activities in the Paris region, while BNCI was active in the main financial and economic centers. In 1972, BNP opened a branch in Tokyo, and was allowed in California to establish the French Bank of California. By that time, BNP was the second largest bank in Europe.

Between 1974 and 1977, it opened branches in over 10 countries, while activities in the United States were strengthened. Over the next years, the bank continued to strengthen BNP's status as the most internationally oriented of the French nationalized banks.<sup>11</sup> In 1985, part of the bank's international finance operations were moved to London. In 1986, the bank increased its capital through a share offering by almost 50 percent. Since the mid-1980s, BNP concentrated itself on three areas of activity (Canals, 1993, p. 142):

- Commercial banking in France, Europe and Africa.
- Financial market operations, participation on its own account as well as for clients.
- Investment banking, directly or through subsidiaries.

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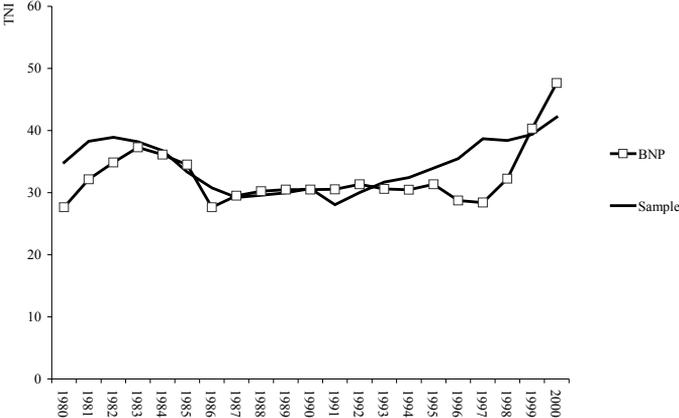
<sup>9</sup> Owning 18.6, 18.2 and 14.6% respectively. Iskander, S. (1999, September 10). Majority of CCF bank held by non-French. *Financial Times*.

<sup>10</sup> Baker-Said, S. & Giles, T. (2002 April). HSBC: still not the champion. *Bloomberg markets*, pp. 38-45.

<sup>11</sup> BNP Paribas Group. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. x, p. 96

Central to BNP's strategy was the concentration of activities in the EU member countries. In Southern Europe, BNP introduced a wide range of products and services, while in Northern Europe it followed a product-by-product strategy (Canals, 1993, p. 143). In 1991, it struck an alliance with Dresdner to collaborate in international markets and to exchange 10% equity stakes in one another. BNP hoped that Dresdner would offer access to Eastern Europe and expertise in the securities markets, while Dresdner would draw on BNP's larger foreign network and its strong ties to medium-sized companies (The Economist, 1991).<sup>12</sup>

Figure 15.2. *TNI BNP, 1980-2000*



The presence in the United States was firmly established after BNP acquired Californian Bank of the West in 1979, through the French Bank of California it had set up in 1979. The Bank of the West was further used for expansion, several banks and branches were added to it between 1987 and 1997. In 1998, BNP merged Bank of the West with First Hawaiian, a bank in the Pacific Northwest. The new holding company took on the name of Bank of the West, in which BNP held a 44% stake, agreeing not to increase its stake for some time (Tschoegl, 2000).

International activities intensified in 1997, when BNP got a licence to operate in New Zealand, bought a bank in the Bahamas, bought out its joint venture partner in Egyptian Banque du Caire, and opened a subsidiary in Brazil. The high acquisition pace was upheld in 1998, buying the Chinese operations of failing investment bank Peregrine. Offices were opened in emerging markets (Peru, Algeria, Uzbekistan, India) and the Australian brokerage operation of Prudential were bought.<sup>13</sup>

In the following year, 1999, BNP returned to its domestic base and forced a long drawn takeover battle. The launch of the euro had initiated a series of (largely) domestic mergers to achieve sufficient size in the Eurozone market. BNP's reaction had been to

<sup>12</sup> The co-operation activities between BNP and Dresdner are listed in Table 14.4 on page 318.

<sup>13</sup> *History of BNP Paribas* (n.d.). Retrieved April 27, 2003, from www.hoovers.com.

enter secret merge talks with Société Générale, in which BNP already held a large equity stake. Société Générale abruptly broke off talks and announced a merger with Paribas.<sup>14</sup> BNP decided it would acquire both banks, thereby also getting a larger share of the to be privatized Crédit Lyonnais, and creating a French banking champion in the wake of increasing competition in the European banking market. BNP tried to raise controlling stakes in the two banks. The French central bank unsuccessfully negotiated a deal, favoring the tri-partite merger itself. In the end, BNP took control of Paribas, but could not acquire Société Générale.

Table 15.4. *Activities BNP*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80-'85	Broad expansion (1)	1. Build worldwide network to service clients	Major financial and economic centers																	
		2. Maintain commercial bank network	Domestic																	
		3. Expand capital market activities	United Kingdom, United States																	
'86-'99	Broad expansion (2)	1. Expand commercial banking	France, Europe, Africa, the United States																	
		2. Increase investment banking activities	United Kingdom																	
		3. Expand in Eastern Europe through alliance with Dresdner (from 1989)	Eastern Europe																	
		4. Expand in emerging markets	South America, North Africa, China																	
99-'00	Focused expansion	1. Increase domestic market share by acquiring Paribas	Domestic																	
		2. Develop European network	Belgium																	
		3. End alliance with Dresdner, set up activities independently	Eastern Europe																	

The acquisition of Paribas changed the composition of BNP from a successful domestic oriented retail banking operation into a European oriented banking group, where besides the retail bank corporate and investment banking dominated the activities. BNP Paribas intended to further improve the profitability of the domestic retail branch network and to develop in Europe, mainly through specialized financial services companies. In asset management, it planned to become a worldwide active asset manager, developing operations in Asia organically and in the United States by acquiring companies. In corporate banking and investment banking, although BNP Paribas started to reduce the capital allocated, it planned to have a leading position in securities in Europe and Asia.<sup>15</sup>

<sup>14</sup> BNP Paribas Group. In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. x, p. 97

<sup>15</sup> Equity Research: French Banks (2000 September 28). *Credit Suisse First Boston*, p. 115.

The newly merged bank, BNP Paribas, was ordered by regulators to sell its shares in Société Générale.<sup>16</sup> In 2000, BNP Paris took full control of its Belgian investment firm subsidiary Cobepa. Also, in 2000 the alliance with Dresdner was ended. The profitability of the Eastern European joint ventures did not contribute relatively much, and with the acquisition of Paribas the bank itself had reached the network and size to go without foreign partners.

### 15.3.2. Paribas

In 1980, Paribas<sup>17</sup> was one of the French banks with extensive international activities. It had escaped nationalization after the Second World War, out of consideration for its foreign shareholders (Born, 1983, p. 310). The bank evolved into a company with interests in the banking, financial and industrial activities. A worldwide network of banking subsidiaries and branches was built up during the 1970s. First came the Middle East, followed by the Far East, the United States and Canada. The European network centered around the Brussels and Geneva branches, and expansion went well into the 1980s with the opening of new offices in Germany, Italy, Spain and the Scandinavian countries. (Pohl and Freitag, 1994, pp. 249-250).

Paribas was also involved in three London consortium banks, Banque Ameribas, European Brazilian bank and International Mexican bank (founded more than a century ago). After the Bank of England required a letter of comfort in the wake of the secondary banking crisis and the Herstatt failure, the potential disadvantages were considered to outweigh the advantages, and Paribas withdrew its shareholding (Roberts and Arlander, 2001, p. 179).

Its capital market activities grew steadily from the 1980s. Investment banking activities were established in all major centers, as was asset management. In 1973 Paribas formed an alliance with SG Warburg, in which it held a 25% stake<sup>18</sup>, and the next year they had set up the Warburg Paribas Becker investment bank in the United States. Not living up to expectations, the activity was taken over by Merrill Lynch in 1984, in which Paribas acquired a financial participation (Pohl and Freitag, 1994, p. 250).

Paribas was nationalized between February 1982 and March 1987. Jean Yves Haberer, the state appointed chairman during this period, observed that Paribas “had acquired something of a red blooded, predatory image, which contributed to the political image making that resulted in nationalisation” (Bussièrè, 1992, p. 213). In the wake of change of ownership, Paribas reduced the share in its Swiss and Belgian subsidiaries to 35% and 37% respectively (Bussièrè, 1992, p. 292), selling to a befriended party.

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<sup>16</sup> History of BNP Paribas (n.d.). Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com).

<sup>17</sup> The Bank started out in 1872 as Banque de Paris et de Pays-Bas, and its holding company as Compagnie de Financiere de Paris et de Pays-Bas. The name was changed to Paribas in 1982. Haberer related that he became convinced to change the corporate name after a visit to China, where an official informed him about the rumours that the Dutch Government intended to nationalise the Dutch bank half as well (Bussièrè, 1992, p. 209).

<sup>18</sup> In return SG Warburg held a 25% stake in the Belgian, Dutch and Swiss subsidiaries of Paribas (Bussièrè, 1992, p. 289).

Organizationally, the bank started to introduce more coherence in its organization structure, being a financial group consisting of independent companies where the holding company (Compagnie de Financière) held significant stakes, but not total ownership. For the international strategy for the 1980s, the bank continued the path set out by its predecessors (Bussière, 1992, pp. 214-215):

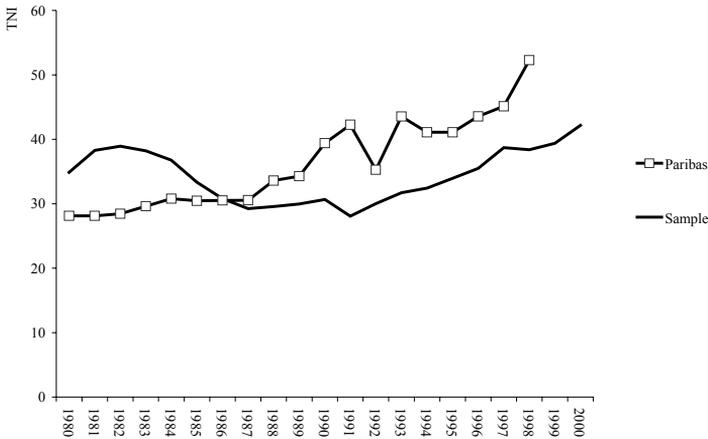
- Domestically, Paribas had to compete with the large retail banks, through the smaller Crédit du Nord and Compagnie Bancaire. The relatively modest branch network expanded in the inner cities, targeting small and medium sized businesses. Paribas also took over an industrial holding company Nord-Est, and a specialized bank (Bussière, 1992, p. 214).
- Outside France, priority was given to Europe, North America and the Far East, setting up new activities “in line with new markets and customers’ expectations”. Branches and offices were opened, (where compared to other banks Scandinavia was targeted between 1984 and 1986), and China.
- An aggressive approach to acquire market share was taken in capital market activities. In 1984, Banque Paribas Capital Markets was set up in London, to increase activities in the Euromarkets (Bussière, 1992, p. 212).
- International private banking activities were targeted with the creation of Paribas Asset Management (PAM), in New York, Geneva and Paris. Over the next years, further offices are opened in Tokyo and Luxembourg.

Branches continued to be opened in major cities over the next years. Most of its activities were greenfield related. Otherwise, it accumulated a series of financial participations in a host of countries. For example, it acquired minority shares in an Ecuador bank (1982), a Nigerian Bank (1982), an Australian and Italian bank (1984) and a Tunesian Bank (1986).

Internationalization not only took place through Banque Paribas, but also through Credit du Nord set up branches and offices in New York and Milan (1979, 1982), London and Singapore (1981), Brussels (1988). From a decade earlier stemmed cooperation agreements with National Westminster Bank and Bayerische Vereinsbanks, who acquired a stake in Credit du Nord in 1974 (Bussière, 1992, p. 290).

After the privatization in 1987, Paribas made further steps to consolidated the (domestic) organization structure. In the same year the holding company became a 48% shareholder in Banque Paribas; a year later Paribas acquired the remaining shares of Credit du Nord from the French States gaining full control.

Figure 15.3. *TNI Paribas, 1980-1998*



In 1989, Paribas was set to undergo a drastic transformation, launching an ultimately unsuccessful hostile bid for Navigation Mixte, a French conglomerate. The bank was almost taken over by Navigation Mixte in a counter move. The internal turmoil led to a change in management in 1990.<sup>19</sup> In the same year, a change in management structure took place in 1990, when Compagnie Financiere introduced a two tier management structure<sup>20</sup> and reorganized its banking activities into two new departments: the European Banking Department and the International Banking Department. into a company.

Over the next years, Paribas would attempt to evolve from a diversified holding company of (financial) participations to an integrated universal investment bank. In 1990 Paribas regained full control of its Swiss subsidiary, set up to evade nationalization in 1982, in exchange for its stake in Belgian Groupe Bruxelles Lambert.<sup>21</sup> A similar exercise was performed in 1994 with the Swiss subsidiary.<sup>22</sup> In 1993, it sold its asset management firm, CCR, to Commerzbank.<sup>23</sup> The major divestiture however would be the sale of Credit du Nord to Société Générale in 1997, making Société Générale the largest commercial bank in France.<sup>24</sup> In the same year, it would reduce its controlling stake in its Belgian retail banking activities to a minority stake, retaining only an investment banking subsidiary there.<sup>25</sup>

<sup>19</sup> Half a revolution (1991, October 12). *The Economist*, pp. 103-104.

<sup>20</sup> Changing from one board of directors to a supervisory board and board of management (Bussière, 1992, p. 298).

<sup>21</sup> *Financial Times* (1990, April 27), p. 34.

<sup>22</sup> *Financial Times* (1994, October 18), p. 20.

<sup>23</sup> *Financial Times* (1993, June 30), p. 28.

<sup>24</sup> *Financial Times* (1997, January 10), p. 1.

<sup>25</sup> *Financial Times* (1997, May 26), p. 24.

Table 15.5. *Activities Paribas*

Period	Phase	Objective	Arena	Client				Product			Organizational form								
				Government	Institutional	Corporate	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80-89	Broad expansion	1. Increase domestic market share, opening branches in cities	Domestic			■	■	■	■								■		
		2. Expand branch network outside France to service current clients	Europe, North America, South East Asia		■	■		■	■	■							■	■	
		3. Expand in capital market activities	London, New York		■	■		■	■	■								■	
		4. Expand in private banking activities	New York, Geneva, Paris				■		■	■								■	
'90-99	Restructuring, refocus	1. Divest retail branch network	Europe, Belgium			■	■											■	
		2. Expand in capital market activities	Europe		■	■											■	■	
		3. Acquire full control of subsidiaries	Domestic, Belgium, Switzerland			■	■		■		■						■		

The bank simultaneously worked on expanding its fee generating business. In 1995, Paribas bought the European custody activities from J.P. Morgan, adding 299 billion US dollar custody assets, and making Paribas one of the leading custodians in Europe. Two years later, it announced a 25% increase in its US investment banking workforce in a move to strengthen its position in the capital markets.<sup>26</sup> In 1997, the bank also moved to gain full control in two of its most profitable subsidiaries: Compagnie Bancaire, its consumer finance subsidiary, and Cetelem, the specialist financial services group.<sup>27</sup>

Paribas, similar to Bankers Trust in the United States, felt that its medium sized investment banking operations would need a larger scale in the near future, and decided on a merger. In February 1999, Société Générale announced the takeover of Paribas in an agreed 10 billion US dollar share deal, in anticipation of a restructuring of the overcrowded French banking sector.<sup>28</sup> The takeover battle was joined by BNP, who - threatened by the prospect of a powerful competitor, launched a counter bid to acquire both Paribas and Société Générale. After a public relations war where each bank tried to acquire shares in the other banks, the monopolies and mergers commission decided that Paribas could be taken over by BNP, but not Société Générale.

### 15.3.3. Crédit Lyonnais

The internationalization of Crédit Lyonnais was well underway in the 1970s, already having established a network in Latin America, Africa and for a short while the Middle East. In 1970 UBAF (Union des Banques Arabes et Françaises) was created and the Europartners alliance was formed between 1970 and 1973. With Europartner members,

<sup>26</sup> *Financial Times* (1997, March 6), p. 37.

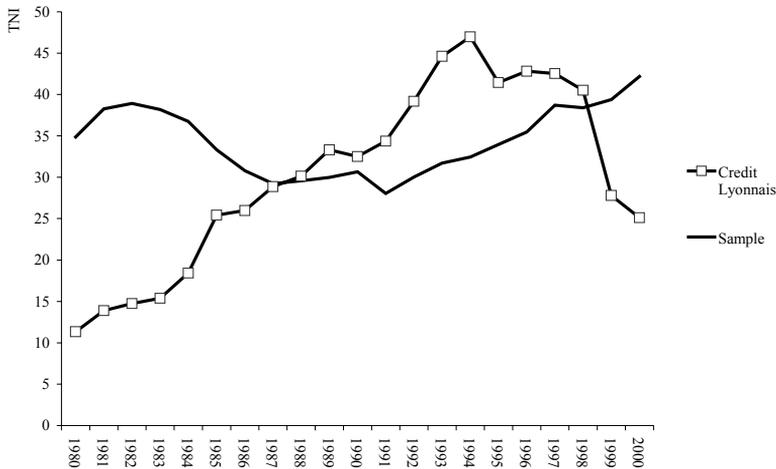
<sup>27</sup> *Financial Times* (1997, May 14), p. 18; see also *Financial Times* (1997, November 27), p. 26.

<sup>28</sup> *Financial Times* (1999, February 2), p. 1.

joint ventures were set up, such as the Credit-Commerz Bank in Saarbrucken in 1973 with Commerzbank. Branches in the major financial centers were created during the next years.

Crédit Lyonnais undertook the most ambitious growth strategy in the 1980s and the early 1990s. It embraced a universal banking concept: while the bank must play an important role in the financing as well as control of industrial companies, it believed in the need to be present in European countries, either through internal growth or by buying foreign banks (Canals, 1997, p. 57). Between 1986 and 1993 this presence is developed, mainly by acquiring a score of banks between 1989 and 1992: Chase Banque de Commerce in Belgium (1989), Credito Bergamasco and Banco San Marco in Italy, Banca Jover (1991) and Banco Comercial Espanol (1990) in Spain, and particularly BfG Bank in Germany. During the same period, major stakes were acquired in companies via the Clinvest and Clindus subsidiaries.<sup>29</sup> In 1991, Crédit Lyonnais acquired Irish Woodchester (Marois, 1997).

Figure 15.4. *TNI Crédit Lyonnais, 1980-2000*



The expansion of Crédit Lyonnais was directed by government. Haberer, bank president in the late 1980s, declared in parliamentary hearing that the government had asked him to expand Crédit Lyonnais' investment abroad and to assist state-owned industrial firms as they sought to compete outside France (Coleman, 2001, p. 337). Also, by pursuing an aggressive growth strategy prudent banking was not always followed, and bank management was actively involved in fraudulent activities (when finalizing the purchase of MGM by Paretti in 1990).

By 1993, Crédit Lyonnais owned 850 offices and branches in Europe outside France (Marois, 1997). This aggressive strategy proved to be a risky one after the economic slowdown in 1992. Industrial holding weighed down the bank's working capital

<sup>29</sup> *Crédit Lyonnais over years* (n.d.). Retrieved on April 17, 2003, from [www.credit-lyonnais.com](http://www.credit-lyonnais.com).

while property loans generated heavy losses. Finally, insufficiently controlled subsidiaries caused serious setbacks both in France (SASEA) and abroad (MGM). After a change of management, staff was cut, operations streamlined and assets sold, including 48% in insurer Union des Assurances Fédérales. This was to little avail, and the heavy losses forced the French government to rescue the bank, first in early 1994 and then in April 1995. Low quality of bank management, an inadequate investment and loan monitoring process, and the bank's slowness to pull out of the investments in time when a company reached a point of no return all attributed to the bank's troubles (Canals, 1997, pp. 58-59).

Between 1993 and 1995, the government provided financial assistance which probably worsened the situation (Coleman, 2001, p. 336). A "bad" bank (Consortium de Realisation, CDR) was created in 1995 to hold the worst assets of Crédit Lyonnais, but Crédit Lyonnais itself also had to make a substantial loan below market rates to CDR and provide CDR with good assets to ensure that CDR would be viable to carry out the required sell-offs. These decisions tied Crédit Lyonnais' hands, and the bank ran into further trouble in 1996. By 1998, total losses had reached 31.8 billion US dollar, the single largest commercial bank failure in the post war period in the OECD and costing the taxpayer at least 20 billion US dollar (Coleman, 2001, p. 336).

The French government now also had to negotiate with the European Commission, realizing that substantial financial assistance would be needed to salvage the bank. A financial restructuring plan was finally agreed on with French government and approved by the EC in 1998, scheduling major sales of foreign assets (reducing its international network by 30% and halving its European assets) as well as the privatization of the bank by October 1999. The sale of German subsidiary BfG in 1999 completed the divestment of the foreign banking division. The bank refocused on three areas: retail banking in France, investment and corporate banking, and asset management and private banking. The public offering of shares took place in 1999, reducing the state's stake to 10% and creating a core shareholder group holding 33% with Crédit Agricole controlling a 10% stake.<sup>30,31</sup>

Crédit Lyonnais stated that it would pursue a strategy based on a number of partnerships with domestic and foreign financial institutions, mainly the members of its core shareholder group. The bank set up a series of joint ventures: two with Crédit Agricole in consumer lending and leasing, one with BBVA in cross border mergers and acquisitions, another with CDC in global custody, and one with Allianz-AGF for non-life insurance products.<sup>32</sup>

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<sup>30</sup> *Crédit Lyonnais over years* (n.d.). Retrieved April 17, 2003, from [www.credit-lyonnais.com](http://www.credit-lyonnais.com).

<sup>31</sup> The core shareholders were obliged to hold their equity stakes for a 24-month period ending in June 2001. In this period, they also held a right of first refusal when other strategic shareholders would offer their shares for sale. Source: Equity Research French Banks (2000 September 28). *Credit Suisse First Boston*, p. 132.

<sup>32</sup> Equity Research: French Banks (2000 September 28). *Credit Suisse First Boston*, pp. 130-131.

Table 15.6. *Activities Crédit Lyonnais*

Period	Phase	Objective	Arena	Client				Product				Organizational form						
				Government	Institutional	Corporate	Private	Securities	Asset management	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture	
80-84	Broad expansion	1. Maintain domestic position	Domestic															
		2. Build international network	Major financial and economic centers															
		3. Set up joint ventures with Europartners	Europe															
85-93	Focused expansion	1. Build European branch network	Continental Europe															
		2. Diversify in other financial services	Domestic, Europe															
		3. Build up industrial shareholdings	Domestic															
		4. Expand in investment banking	Major financial centers															
94-00	Restructuring, refocus and exit	1. Sale of European branch network	Spain, Belgium, Netherlands, Germany															
		2. Refocus on retail banking, investment and corporate banking, asset management	Domestic															
		3. Develop activities with core shareholders (from 1999)	Domestic															

#### 15.3.4. Société Générale

During the 1970s, Société Générale had been active in the euromarket loans, but its international expansion increased substantially from 1978 onwards. In that year a New York branch was opened; the next year branches in South America and Asia were established, and a new banking group was set up with the National Bank of Egypt while expansion in the Middle East was also targeted. By the end of 1979, the bank had set up 200 foreign branches in 60 countries.<sup>33</sup> Société Générale set out its strategy on two lines: servicing the (retail) customers with expanding its branch network in France, acquiring specialized financial advisory activities. It also targeted capital market activities, with France as the dominant market and seeking presence in major financial centers (Pohl and Freitag, 1994, p. 288). The bank acquired a controlling interest in the London stockbrokers Strauss Turnbull and Company in 1980, also acquiring its Eurobanks operations. The bank was domestically successful but not internationally, suffering a loss of 2.4 million US dollar on international operations. As a result, the bank refocused its international operations by concentrating more on wholesale and specialized banking activities.<sup>34</sup> When Conservatives gained power in the French government in 1986, Société Générale was fully privatized in July 1987. At the end of the 1980s, a change in activities was discernible:

- The bank further intensified its capital market activities by acquiring smaller securities activities.
- It restructured its foreign activities where the bank had no significant market shares.
- It diversified and increased its domestic activities.

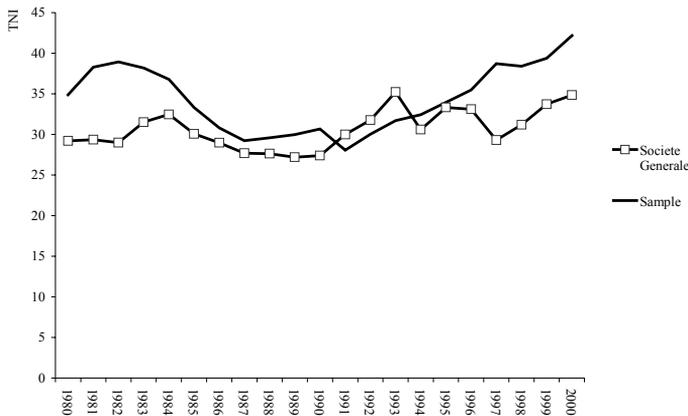
<sup>33</sup> Société Générale. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 355.

<sup>34</sup> Société Générale. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 355.

In 1989, the bank and Credit Frontier set up a joint venture in the United Kingdom, aimed at the residential mortgage market. Within three years, Société Générale backed out of the joint venture.<sup>35</sup> Longer lasting was the full control of Strauss Turnbull in 1993, the London based securities house which had been trying to transform itself into a broad based trading firm.<sup>36</sup> Securities activities were also targeted in 1996 with the majority stake in Hong Kong based investment bank Crosby securities to form a new brokerage and corporate finance institution<sup>37</sup>, and a controlling stake in a South African broker in that year.<sup>38</sup> In May 1991, Société Générale was the first bank to return to South Africa after the European Community lifted the bank on new investments, buying International Bank of Johannesburg to develop its corporate banking business.

In 1993, Spain's Banco Central Hispano and Société Générale reached an agreement allowing the two banks to pool their marketing resources outside the domestic markets. It also enabled them to use each other's branch networks.<sup>39</sup> New branches or offices were set up sparingly during the early 1990s. A Mexican representative office is upgraded to branch in 1994<sup>40</sup>, and a branch was opened in Shanghai, Société Générale's fourth activity in China.<sup>41</sup> In the early 1990s the bank also remained active domestically. After wooing Assurances Generales de France (AGF) in 1994 to forge closer links with the bank after its privatization<sup>42</sup>, it planned to sell non-life insurance through its domestic network, competing more directly with insurance companies.

Figure 15.5. *TNI Société Générale, 1980-2000*



<sup>35</sup> *Financial Times* (1992, September 2), p. 16.

<sup>36</sup> *Financial Times* (1993, February 3), p. 30.

<sup>37</sup> *Financial Times* (1996, August 9), p. 19.

<sup>38</sup> *Financial Times* (1996, October 14), p. 26.

<sup>39</sup> *Financial Times* (1993, April 15), p. 18.

<sup>40</sup> *Financial Times* (1994, November 8), p. 26.

<sup>41</sup> *Financial Times* (1995, September 16), p. 9.

<sup>42</sup> Competing against Crédit Lyonnais. (1994, May 10). *Financial Times*, p. 24.

From 1997 activities intensified, internationally as well as domestically. Early 1997 Société Générale bought Credit du Nord from Paribas for 2.2 billion French Francs, enhancing its position as France's largest commercial bank. Société Générale recapitalized the bank, buying 61% immediately, and the remainder over three years.<sup>43</sup> At the end of that year, the banking business of Hambros in the United Kingdom was bought, ending its 160-year old history as an independent merchant bank.<sup>44</sup> A few months later, the bank acquired United States based investment banker Barr Devlin, and the collapsed Yamaichi International Capital management, one of Japan's largest fund management companies.<sup>45</sup> Contacts with Yamaichi dated from 1991, when both banks took a minority stake in Lodestar, a Wall Street takeover specialist.<sup>46</sup> In the United States it bought Cowen and Company, a boutique investment bank specializing in healthcare and technology companies.<sup>47</sup>

Table 15.7. *Activities Société Générale*

Period	Phase	Objective	Arena	Client	Product			Organizational form					
					Asset mgmt	Securities	Insurance	Joint venture	Acquisition	Greenfield	Merger	Divestiture	
'80-'88	Entry	1. Expand retail branch network	Domestic										
		2. Expand branch network	Major financial centers										
		2. Develop capital market activities	Major financial and economic centres, worldwide										
'89-'98	Broad expansion	1. Expand capital market activities, asset management	United Kingdom, United States, Japan										
		2. Develop alliances with Banco Central Hispano	Spain										
		3. Increase domestic market share, acquiring Credit du Nord	Domestic										
'99 - '00	Restructuring, refocus	1. Revive alliance with BSCH	Spain										
		2. Further develop investment banking and asset management	United States										
		3. Maintain domestic retail market position	Domestic										

The bank did not only acquire activities over the years, it also restructured. In 1996, it divested part of its car finance subsidiary to National Westminster.<sup>48</sup> The banks did meet again two years later, when Société Générale bought the Bahama branch of private bank Coutts from National Westminster.<sup>49</sup> Also in 1994, management announced that it was considering possible reductions in its (23 billion French francs large) industrial and

<sup>43</sup> *Financial Times* (1997, January 10), p. 20.

<sup>44</sup> *Financial Times* (1997, December 20), p. 18.

<sup>45</sup> *Financial Times* (1998, January 23), p. 26.

<sup>46</sup> *Financial Times* (1991, May 7), p. 23.

<sup>47</sup> *Financial Times* (1998, February 21), p. 20.

<sup>48</sup> *Financial Times* (1996, January 26), p. 20.

<sup>49</sup> *Financial Times* (1999, August 22), p. 17.

property investments portfolio as a response to Anglo-Saxon investors' concerns that the portfolio was becoming too large for the bank to handle.<sup>50</sup>

After the failed merger with Paribas in 1999, Société Générale had to reconsider its strategy. Its business consisted of a profitable and growing domestic retail banking operation, and a domestic asset management business. Third, it had a large corporate and investment banking division, taking up 42% of group capital. To compensate the lack of critical mass in asset management, with 150 billion Euro assets under management, Société Générale set up a partnership with Frank Russell in 2000.<sup>51</sup> Also, the bank planned to develop its investment banking and asset management organically.<sup>52</sup>

Its European strategy was based on an ambitious alliance with BSCH they had set up in 2000, reviving the 1993 agreement with Banc Central Hispano, one of BSCH's predecessors. This involved Société Générale taking a 3% stake in BSCH, and the latter taking a 6% stake in Société Générale. A number of joint ventures were set up in asset management, specialized financial services, investment banking and trading services. These joint ventures should lead to external growth outside the core markets, and the sharing of IT and product development costs.<sup>53</sup> The bank also took a 30% share in Italian insurer Società Assicuratrice Industriale's Banca SAI subsidiary, gaining access to SAI's three million customers.

### 15.3.5. Crédit Agricole

In 1980, Crédit Agricole was the second largest bank in the world in terms of assets. Its origins are co-operative, when regional mutual banks established an interregional clearing system, the Caisse Nationale de Crédit Agricole (CNCA).<sup>54</sup> Contrary to other banks, the CNCA had to deal with additional restrictions due to this co-operative status. Beginning in 1971, legislation was broadened until in 1991 Crédit Agricole was allowed to finance all types of business throughout France. During this process, the bank set up specialized subsidiaries to carry out investment banking, commercial lending, leasing and insurance. From 1976 Crédit Agricole became internationally active, offering mainly agricultural loans and funds to exporting firms.<sup>55</sup> To finance the foreign operations of the regional banks, it created a foreign network, starting with a Chicago branch in 1979.

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<sup>50</sup> *Financial Times* (1996, October 28), p. 21.

<sup>51</sup> Société Générale (2000). *Annual report 2000*, p. 6.

<sup>52</sup> Equity Research: French Banks (2000, September 28). *Credit Suisse First Boston*, p. 123.

<sup>53</sup> Equity Research: French Banks (2000, September 28). *Credit Suisse First Boston*, p. 124.

<sup>54</sup> The organization structure of Crédit Agricole is based on a three tier structure: local banks, regional banks and Caisse Nationale de Crédit Agricole (CNCA). The local banks, in practice co-operative holding companies (with individuals, farmers and co-operatives), do not have branches and hold the controlling stakes in the regional banks. The regional banks are co-operative and represent the retail branch network of the group. The regional banks in turn control CNCA. In CNCA, functions like treasury, international services, investment banking and wholesale banking, asset management and other financial services are carried out. CNCA also controls the group subsidiaries. Source: Equity Research French Banks (2000, September 28). *Credit Suisse First Boston*, p. 29.

<sup>55</sup> History of Crédit Agricole (n.d.) Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com).

Table 15.8. *Activities Crédit Agricole*

Period	Phase	Objective	Arena	Client	Product			Organizational form					
					Credit	Asset management	Insurance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80-91	Entry	1. Expand foreign network	Major financial and economic centers		■	■	■			■	■	■	
		2. Diversify banking activities	Domestic		■	■	■			■	■	■	
92-98	Broad expansion	1. Expansion of foreign network, buying Indosuez (1996)	Major financial and economic centers, Europe		■	■	■			■	■	■	
		2. Develop alliance with Northern European banks through UNICO	Northern Europe										
		3. Take financial participations in Southern European banks	Southern Europe				■			■			
		4. Change into universal bank	Domestic		■	■	■	■					
99 - 00	Restructuring, refocus	1. Form alliances with Southern European banks	Spain, Greece				■						
		2. Change mutual status to prepare public listing	Domestic										

In the early 1980s Crédit Agricole was allowed to diversify its banking activities, and had to give up its tax exempt status as well when the Financial Liberalization Law of 1983-4 was enacted. It continued to diversify, establishing life insurance subsidiary Predica in 1986, and bought stakes in two brokerage firms in 1988.<sup>56</sup> In January 1988, under the Mutualization Law, Crédit Agricole, which until then had been a government agency, became a mutual company when the government sold 90% of the bank to the regional banks (Pohl and Freitag, 1994, p. 257). After the last restrictions on lending were removed in 1991, the bank began transforming itself into a financial services firm. It expanded its lending operations around the world and diversified further by adding new subsidiaries to the group.

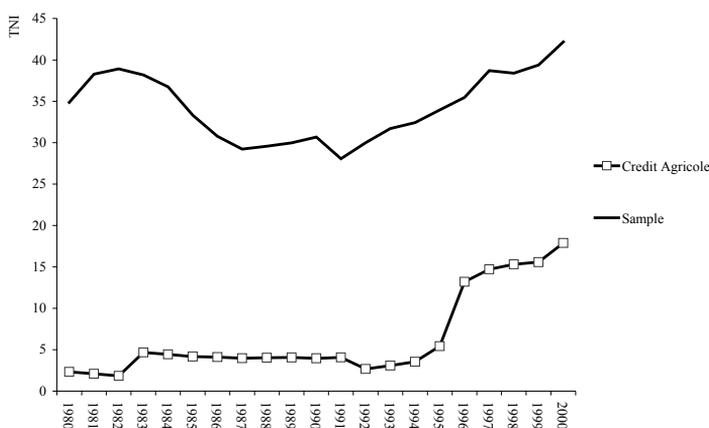
The surge in international lending was unbalanced and in December 1990 Crédit Agricole was forced to take a 1.5 billion French Francs provision for bad loans after an audit uncovered severe international corporate and property loan losses, mostly in the United Kingdom and Ireland.<sup>57</sup> By 1993 Crédit Agricole was present in 17 countries. In Europe, Crédit Agricole had acquired direct equity stakes in banks in Southern Europe (Italian Ambroveneto in 1989 and 1995, and Esprito Santo in Portugal). For Northern Europe, alliances with other co-operative banks through UNICO created a correspondent banking network (Pohl and Freitag, 1994, p. 256). In 1991 the banks signed an agreement to allow their customers to link into each other's branches.<sup>58</sup>

<sup>56</sup> History of Crédit Agricole (n.d.) Retrieved April 27, 2003, from www.hoovers.com.

<sup>57</sup> *Financial Times* (1990, December 3), p. 25

<sup>58</sup> *Financial Times* (1991, March 16), p. 6

Figure 15.6. *TNI Crédit Agricole, 1980-2000*



The degree of internationalization was increased significantly with the purchase of Banque Indosuez from Suez in 1996, an internationally oriented wholesale bank. Indosuez fit the modest international presence of Crédit Agricole well, offering an extended network in Europe and Asia.<sup>59</sup> Crédit Agricole and Suez had a partnership with Sofinco, a consumer finance subsidiary of Suez, and in 1997 Crédit Agricole lifted its stake in Suez to 10%.<sup>60</sup> When Suez restructured its activities in 1998, Sofinco was bought by Crédit Agricole.<sup>61</sup> Crédit Agricole’s international expansion was slowed by the Asian and Russia crises, forcing the bank to close down its emerging markets business. The next year Crédit Agricole formed alliances with BBVA and Commercial Bank of Greece, as part of its plans to expand its presence in the Mediterranean and southern Europe. By 2000, the bank indicated that it would forfeit its mutual status and list on a stock exchange. With the privatization of Crédit Lyonnais, the bank was invited by the French government to be one of the long term shareholders by the government, acquiring 10% of Crédit Lyonnais.

#### 15.4. Commonalities and differences

Compared to the other banks in the sample, many of France’s largest banks were nationalized banks, especially in the 1980s. The commonality in single shareholder did not hinder internationalization, perhaps the opposite. Paribas and BNP had a long history in international banking, while Crédit Lyonnais and Société Générale increased their international banking activities in a relatively short time span. French banks also shared with German banks the relatively large role of non-commercial banks; the relatively low market share led to a high degree of consolidation among commercial banks and stimulated internationalization, especially capital market activities.

<sup>59</sup> *Financial Times* (1996, May 6), p. 18.

<sup>60</sup> *Financial Times* (1997, March 27), p. 34.

<sup>61</sup> *Financial Times* (1998, April 15), p. 30.

BNP, Crédit Lyonnais and Société Générale, three state owned banks, began to increase expansion abroad, revived by the new banking alliances in the 1970s. Although these operations did not contribute to profitability, the international activities created “a base for profits for future years, and is a good way of scoring against each other as well”.<sup>62</sup> At the beginning of the 1990s, the French banks developed different European strategies (Marois, 1997). Crédit Lyonnais, and partly BNP, developed into a Europe-wide universal bank. This strategy was not successful. Crédit Lyonnais accumulated domestic problem loans, and had not installed a control structure for its foreign subsidiaries that largely operated unchecked. The losses forced Crédit Lyonnais to sell its foreign subsidiaries. BNP also abandoned its universal banking ambitions, leaving Belgium and Italy.

On the other hand, Société Générale and Crédit Agricole remained domestic universal banks but developed specialized activities outside France. The internationalization of Crédit Agricole was boosted with the acquisition of Indosuez in 1996, an internationally oriented wholesale bank. Finally, Paribas (more specifically Compagnie Bancaire, a subsidiary of Paribas) developed the specialized financial services in the domestic market and applied it to the other European markets. Compagnie Bancaire sold two British subsidiaries, and halted its European expansion.

During the 1980s and 1990s, the French banks were in general oriented towards European banking markets. An unsuccessful orientation was Crédit Lyonnais who modeled itself after Deutsche bank, but French banks were also active in the initiation of more successful and long lasting banking alliances. Crédit Lyonnais participated in Europartners in the 1980s, Société Générale entered into an alliance with Spanish Banco Central Hispanoamericano and its successor Banco Santander. BNP and Dresdner co-operated closely in the 1990s, even building up a shared branch network in Eastern Europe.

Crédit Agricole was an active member in the mainly co-operative banking alliance UNICO, making the alliance part of its strategy. Crédit Agricole declared that Northern European banking activities would be served by its UNICO partners, and active acquisitions would be sought after in Southern Europe where no UNICO partner existed. Other European banks have participated in banking alliance also; the distinguishing feature for French banks is that European alliances as a strategic option to internationalize have recurred regularly throughout 1980 and 2000, while other European banks abandoned this form of internationalization.

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<sup>62</sup> Lewis, V. (1980, July). France’s nationalised banks - a whiff of re-privatisation. *The Banker*, pp. 43-48.

# 16 Internationalization of Spanish banks

Compared to the other investigated countries, Spanish banks perhaps have gone through the largest changes between 1980 and 2000. Having a highly regulated banking industry in the early 1980s, the country underwent political liberalization when Franco died in 1975 and subsequent economic liberalization from 1985 onwards. These economic changes were volatile, and the lessons learned by banks were considered to be a competitive advantage, when banks entered South American banking markets in the 1990s, coping with similar transition processes as Spain had a decade earlier.

Table 16.1. *Incentives for Spanish banks to internationalize*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Net interest margins relatively high in the 1980s, declining to European averages in the 1990s</li> <li>• Economic structure: More stable economic growth outside Spain until the early 1990s</li> <li>• Regulation: After strong regulation, fast pace of deregulation in the 1980s, in preparation of European integration. Acquisition of failed Banesto by Santander in 1994</li> <li>• Historic and cultural determinants: Re-acquaintance with Spanish speaking markets in South America</li> <li>• Client: historic trade relationships with Spanish speaking markets, Portugal and France.</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: BBV(A) and Santander have similar realized domestic and foreign strategies</li> <li>• Market power and concentration: Relatively stable market. Increase in concentration in the 1990s, due to liberalization and consolidation in Spanish banking market.</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies of scale and scope: scale enlargement in the 1990s to position banks for expected consolidation in the European banking market. Alliances with non banks</li> <li>• Shareholder return: relative high stock market valuations compared to European and American banks in the 1990s.</li> </ul>

From the outset, a number of Spanish banks had a strong drive to internationalize, not to be left out in the ongoing and future expected increase of scale in European banking.

As with the French banks, there seemed to be a need to create one or more national champions, who could cope within a liberalized banking market in Europe. Spanish banks are special for two reasons: first, their internationalization activities have centered around South and Central America, and second, the activities of the two largest banks reflect to a large extent an action-reaction chronology: similar international acquisition or domestic activities within a short period of time.

## 16.1. Incentives

### *Spreads, profitability*

Net interest margin has been relatively high during the 1980s compared to other countries. To offset the decline in interest income, related to the EMU convergence process in the 1990s, Spanish banks turned to South America as a strategic market, offering comparable opportunities in Spain before the decline set in (Sebastian, 2000).

### *Clients, markets*

Expansion of Spanish banks in Latin America slowly grew until 1995, before increasing sharply in 1996-99. The process of privatizations and the withdrawal of American banks from that region contributed to the timing of the Spanish bank's entry. The expansion of Spanish banks in South America seems to be unconnected with following or leading its domestic clients. International asset growth of banks accelerated in 1992 and 1993, as the result of the complete liberalization of capital flows. Outward foreign direct investment began to increase in 1994, but this has concentrated in only a few companies, such as telecommunications and energy sectors (Sebastian, 2000, p. 9, 13, 21).

Spanish banks targeted the South American banking market relatively more than banks from other countries. Spanish banks, compared to other foreign banks entering South American banking markets, had some competitive advantages (Sebastian, 2000):

- They were more familiar than banks from other countries with building a democratic state.
- They had experienced similar surges and downturns in economic growth as South American economies.
- Were familiar with the effects of volatile home currency, and with the exception of Brazil.
- Shared a common language with most South American countries.

These reasons might have influenced the mindset of Spanish banks, finding themselves more comfortable taking larger risks in the South American banking market. Besides commercial banking, asset management of private pension funds became an important market to target. Private pension funds were first introduced in Latin America in Chile in 1981, when the government changed from the public "pas-as-you-go" system to

one that was privately managed. Low dependency ratios and concerns about the inefficient management of the pension funds triggered the reform. The successful implementation in Chile during the 1980s led to its introduction in most Latin American countries (Credit Suisse First Boston, 2000, p. 13). The two Spanish banks, BSCH and BBVA, with 14.6 and 30.7% of all the assets under management by mid-2000, have been the key players in this area. Other sizeable competitors were Citibank (14.4%) and ING through its United States insurance subsidiary Aetna with 8.3% (Credit Suisse First Boston, 2000, p. 25).

Table 16.2. *Private pension funds in South America, 30 June 2000*

Country	Year of reform	Funds under management, million US dollar	Funds under management, % GDP	Number of pension fund firms	Market share Funds, two largest companies (%)
Chile	1981	36,313	53.3	8	54
Peru	1992	2,612	4.1	4	61
Argentina	1994	18,714	5.9	12	44
Colombia	1994	3,101	5.3	6	48
Uruguay	1995	703	2.7	6	66
Bolivia	1996	2,306	7.0	2	100
Mexico	1996	13,441	2.3	13	39
El Salvador	1997	270	1.7	3	98
Total		77,460	7.1	7.3	65

Source: taken from Credit Suisse First Boston, 2000, p. 13, figure 9, key statistics private pension funds; p. 14, figure 11, market concentration.

### *Regulation*

Financial liberalization in Spain was marked by two periods of banking crises (Perez, 2001, p. 383). The first, spanning from 1978 to 1985, involved a large number of failing industrial banks, controlling a significant amount of deposits. The second crisis took place in 1993 when Banco Espanol de Credito (Banesto), one of Spain's largest commercial banks, failed in 1993.

In 1977 a reform package was introduced, dismantling the selective credit allocation by the ministry of finance, deregulating interest rates and creating a control mechanism for the central bank to steer liquidity growth. The oligopoly structure of the Spanish market was kept intact though, and the opening of the Spanish banking market to foreign banks was restricted severely, preventing any real price competition or financial innovation. Foreign banks were prevented from competing with domestic banks for deposits by being limited to operate three branches, and had to rely on the interbank market controlled by the big Spanish banks for their funding.

Between 1977 and 1985, 51 out of 102 industrial banks, accounting for 20% of total bank deposits, failed. The crisis led to a wave of concentration in the banking sector as the

large commercial banks eventually took over most of the relatively profitable banks rescued by the Deposit Guarantee Fund set up by the Central bank (Perez, 2001, p. 392).

Emphasis on reforming the structure of the financial system began to change after the accession of Spain to the EC in 1986, when the central bank began to prepare the banking sector for the Single European market after 1992. In 1988, legislation was passed ending the privileges of brokerage firms, allowing banks to seize the market. Also, the accession to the EC led the central bank to actively promote a series of mergers (Perez, 2001, p. 393). The banks were allowed to operate as universal banks, holding significant equity stakes in Spanish industry, and holding dominant positions in other financial markets, including insurance, pension products and mutual funds.

Spain witnessed a major bank failure in the 1990s when Banesto, one of the largest banks, defaulted in 1994. The bank incurred large losses as a result of a surge in bad loans and a particularly vulnerable position in its equity holdings, and was nationalized in 1994. Eventually, after an auction, the bank was bought by Santander.

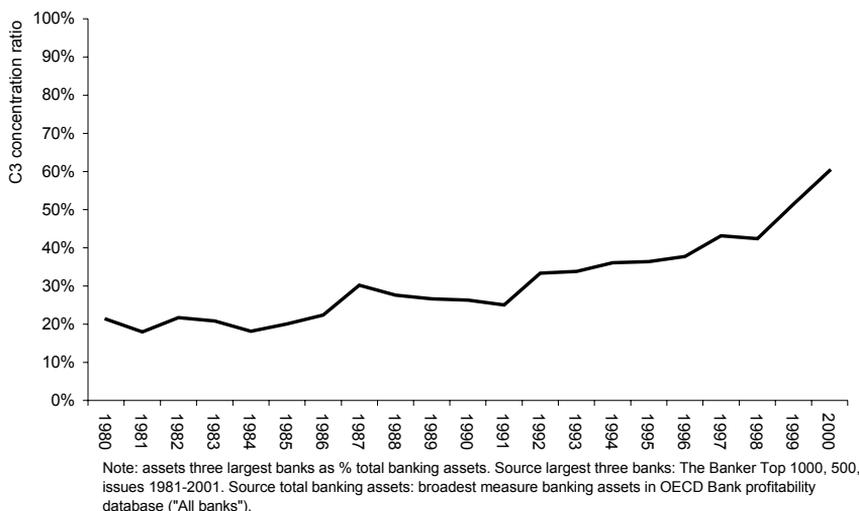
Table 16.3. *Major regulatory events in Spain, 1978 -1994*

Year	Regulatory Event	Effect on internationalization	Effect on entry foreign banks
1978	Foreign banks are allowed to enter Spain		Initial establishment representative offices and single branches
1987	Deregulation interest rate controls		Expansion of foreign branch networks
1991	Privatization, creation Argenta		
1988	Financial deregulation	Diversification, increase of capital market activities	
1994	Failure Banesto, acquired by Santander		

### *Market power and concentration*

The Spanish banking market has traditionally been dominated by a small number of large commercial banks. Seven banks (Banesto, Banco Central, Hispano-Americano, Banco de Bilbao, de Vizcaya, Santander and Popular) operated as a cartel from the 1920s through the Franco regime, and during most of the 1980s after the regime transition (Perez, 2001, p. 384). The relative absence of competition in the Spanish financial sector was reflected in the high profit margins of Spanish banks during the 1980s (Perez, 2001, p. 383).

Figure 16.1. *Share of largest three banks in Spain, percentage total assets*

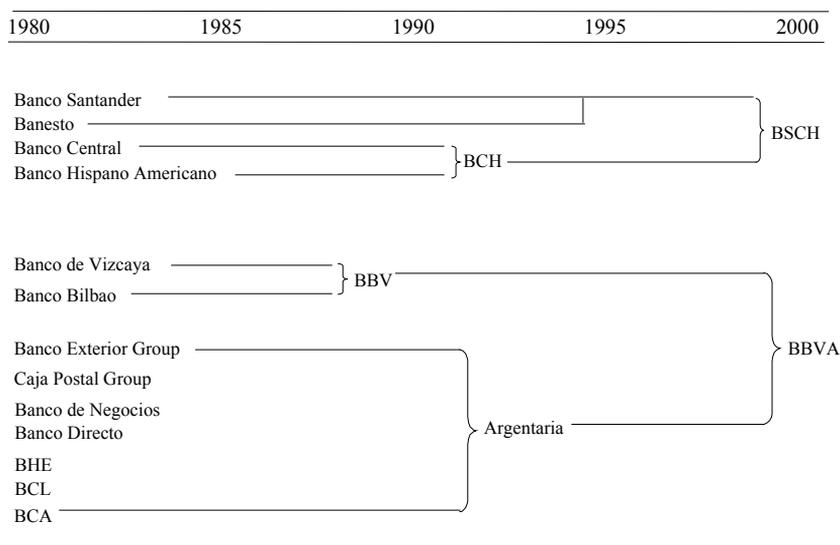


From the late 1980s onwards, the banks entered in a series of mergers and acquisitions, reducing the number of banks to three, controlling more than 60 percent of the commercial bank's assets in 2000 (Figure 16.2). The merger in 1989 between Banco of Bilbao Bank of Vizcaya created BBV, followed by the merger of Banco Central and Banco Central Hispano to form BCH in 1991, at the time the Spanish bank with the largest deposit base (McDonald and Keasey, 2002, p. 94).

In 1994 the Bank of Spain intervened in Banco Español, the fifth largest bank, and mounted a rescue operation. The bank was auctioned to Banco Santander. Privatization created another bank in 1991, by merging seven state owned banks into a new entity, Argentaria, in which the state retained a 50% holding until 1998 when the state sold its shares. In January 1999 Banco Santander and Banco Central Hispano agreed to merge into Banco Santander Central Hispano (BSCH), followed by the merger announcement in October 1999 of Banco Bilbao Vizcaya and Argentaria into BBVA.

Another sector of importance is the savings banks, which are non-profit institutions held by the regional authorities, and have since the 1960s controlled almost half of the retail deposit market (Perez, 2001, p. 385). Their fragmented concentration has not made them an important competitor for commercial banks though.

Figure 16.2. *Mergers and acquisitions Spanish banks, 1980-2000*



## 16.2. Foreign banks

Following the death of General Franco, and the elections of 1977, the Spanish government modernized the economy, including the financial sector.<sup>1</sup> Foreign bank entry was substantially liberalized in 1978, after a 40-year period where no foreign bank was allowed to enter Spain. Depending on the approval of the Ministry of Economy (weighing interests of the Spanish economy and the application of reciprocity), foreign banks could set up subsidiaries or branches, and own up to 50 percent of Spanish bank's equity, needing government approval for higher stakes (Pecchioli, 1983, pp. 185-6). The Spanish government permitted foreign banks to acquire failing domestic banks, thus encouraging competition and preventing concentration from increasing (Tschoegl, 1987, p. 76). Barclays was the first foreign bank in 1981 to acquire a Spanish bank (in receivership), Banco de Valladolid. Other banks followed, with BNP buying Banco Lopeze Quesada six months later, Citibank acquiring Banco de Levante and Deutsche Bank buying Banco Madrid.<sup>2</sup> Banks such as Citibank and BNP then further expanded their Spanish banking activities organically, while another group decided to limit their banking activities focusing on large corporate clients, such as ABN Amro or Bank of America (Canals, 1997, p. 215).

<sup>1</sup> “[The government’s] willingness to inflict some losses on the banking sector may reflect the fact that this long-lived and cosiest of cartels was particularly associated with the France regime” (Tschoegl, 1987, p. 76).

<sup>2</sup> Levitt, J. (2003, October 8). How to make gains in Spain. In Special Report: Banking in Europe. *Financial Times*, p. 3.

However, foreign banks have had limited success in gaining market share in the Spanish financial market in the 1980s, even after restrictive conditions to operate had been lifted further in compliance with European legislation (Perez, 2001, p. 385). The presence of foreign banks did not increase domestic competition; their market share remained below 10% of total loans and deposits. The share of foreign banks in the Spanish retail banking market accounted for 14% in the mid-1980s, and fell to less than 5% by the end of the 1990s (Perez, 2001, p. 385). The main contribution of foreign banks probably has been to introduce new financial innovations to the Spanish banking market (Canals, 1997, p. 215). Chase and Chemical withdrew from Spain by the end of the 1980s, but some European banks, notably Barclays and Deutsche Bank, proved to have greater staying power.

### 16.3. Case studies

The internationalization of four Spanish banks are discussed: Santander (1980-2000), Banco Central Hispano Americano (1980-1998), Banco Bilbao Vizcaya (1980-2000) and Argentaria (1991-1999). These banks were clustered in two groups: Santander acquired BCH in 1999, while BBV acquired Argentaria in 1999. Argentaria itself was a merger combination of state owned banks in 1991.

#### 16.3.1. Santander

In the early 1980s, Banco Santander had branches in six countries and representative offices in another eight. Expansion in South America started as early as 1983, when the former colonies of Spain and Portugal began to privatize and open their banking system to foreigners. The expansion in South America was lasting; in Asia the bank moved too fast. In the 1980s the bank opened offices in East Asia, these were closed soon afterwards for lack of business.<sup>3</sup> Until 1987, its international growth was modest, spurred by internal loan growth. The pace changed in the late 1980s Santander prepared to compete in deregulated Spain and single European market; the bank purchased two German organizations in 1987: CC-bank, a consumer finance bank, and Visa Card Services. In 1988, the bank established an alliance with Royal Bank of Scotland, encompassing the joint development of products but also a share swap between banks giving Banco de Santander a 9.88% stake in Royal Bank of Scotland at the end of 1994.<sup>4</sup> Also, in the late 1980s alliances were formed with Kemper and Metropolitan Life Insurance.<sup>5</sup> Santander focused on the home market in the 1990s. In 1994, Santander acquired a 60% stake in financially distressed Banco Español de Crédito (Banesto), taking full control in 1998. Banco Santander swiftly began to reduce Banesto's international exposure in Argentina, Chile and Mexico, as well as its real estate

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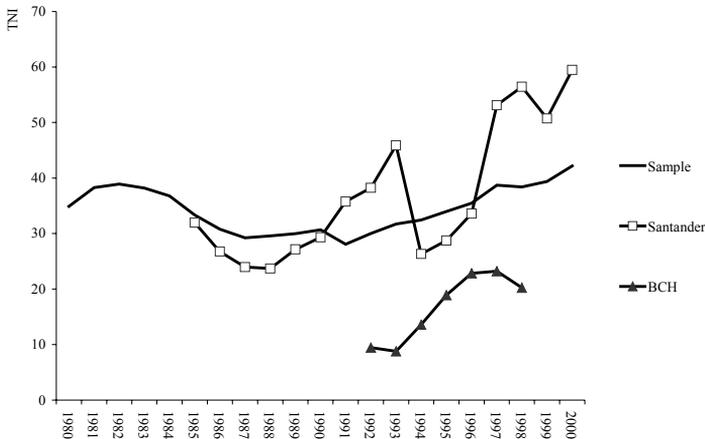
<sup>3</sup> Edmondson, G., & Fairlamb, D. (2001, April 23). The Super Banks of Spain. *Business Week Online*. Retrieved November 3, 2003, from [http://www.businessweek.com/print/magazine/content/01\\_17/b3729023.htm?mz](http://www.businessweek.com/print/magazine/content/01_17/b3729023.htm?mz).

<sup>4</sup> The share stake became an issue in 1999 with the acquisition of National Westminster. The share swap was not unique in European banking, cf. BNP-Dresdner.

<sup>5</sup> History of Santander. (n.d.). Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com)

holdings. Industrial holdings were reduced to a minimum level, as a necessity for maintaining client relationships (McDonald and Keasey, 2002, pp. 94-95).<sup>6</sup>

Figure 16.3. *TNI Santander, Banco Central Hispano Americano*



Regional expansion took place in 1990, when Portuguese Banco de Comercio e Industria was acquired, "the Portuguese market [...] already being considered a natural extension of the Spanish market" (Canals, 1997, p. 245). In 1991 the bank ventured into the United States with a 10% equity participation in First Fidelity, a large commercial bank in the North-East of the United States.<sup>7</sup> The American continent became the center focus of international expansion. In 1994, Santander was licensed as a broker on the United States stock market, and it expanded its presence in Puerto Rico, owning the second largest bank at the end of 1994.<sup>8</sup>

In the same year, several branches were opened in Mexico. Santander first opened representative offices in 1955 in Mexico, gradually increasing its presence in that region with offices in Argentina, Brazil, Chile and Venezuela. In 1978 the first subsidiary of Santander was set up in Chile. From there on, Santander would mostly expand by making acquisitions in the region. In the early 1990s, South America was selectively targeted with the Chilean acquisitions of Fincard (1993) and Financiera FUSA (1995), merging it with Banco Osborne (1996). Banco Santander was actively engaged in investment fund and pension fund business, such as Chile and Argentina, establishing leading market positions in those countries (Canals, 1997, p. 245). Following the acquisition of Banco Totta and Acores in 1999, BSCH obtained a 12% of the Portuguese banking market (McDonald and Keasey, 2002, p. 96).

<sup>6</sup> Banesto kept its separate brand name.

<sup>7</sup> This changed into an 11% equity stake in First Union in 1995, when First Union acquired First Fidelity.

<sup>8</sup> And a smaller bank operating in cities in the country.

Table 16.4. *Activities Santander*

Period	Phase	Objective	Arena	Client					Product			Organizational form							
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
'80-'86	Entry	1. Expand foreign branch network	Major financial and economic centers		■	■			■	■							■		
		2. Maintain domestic position	Domestic		■	■			■		■								
'87-'93	Broad expansion	1. Form alliances for specialized banking activities	Europe, United States		■	■			■	■	■		■	■					
		2. Diversify domestic banking	Domestic		■	■	■		■	■	■								
		3. Expand capital market activities	Major financial and economic centers		■	■			■	■	■				■	■			
94-'00	Focused expansion	1. Increase domestic market position (1994, 1999)	Domestic		■	■	■		■	■	■						■		
		2. Expand in South and Central America	South, Central America		■		■		■		■						■		
		3. Create European alliances (2000 onwards)	Europe		■				■		■			■	■				
		4. Expand in home region	Portugal		■	■											■		

The year 1998 proved to be difficult for Santander who had built up extensive holdings in South America, 51% of the bank's income in 1998 originated in that region. In that year, most South and Central American economies slipped into economic recession and Santander saw its profitability slip. Expecting its future further threatened by the coming transition to the Euro, Santander approached its smaller domestic rival, Banco Central Hispanoamericano, for a merger. Banco Santander merged in 1999 with Banco Central Hispanoamericano to form BSCH, eventually renamed SCH.<sup>9</sup>

In 2000 BSCH focused on expanding in Europe and Latin America. In Europe it formed an alliance with Société Générale to buy investment fund management firms, targeting the United States.<sup>10</sup> In the same year Santander purchased a controlling share in Banespa, the largest of Brazil's privatized banks, for 3.7 billion US dollar, almost four times the minimum asking price. Until this purchase, Spanish banks had been less aggressive in entering the Brazilian market than they had been elsewhere in Latin America (McQuerry, 2001). BSCH also bought Banco Meridional, the leading bank in the state of Rio Grande du Sol, as part of its strategy to concentrate on the seven richest states in the south east of Brazil. BSCH aimed to achieve a 10% market share there, and was halfway with the acquisition of Banco Meridional. BSCH also purchased banks in Peru and Columbia for the same reason (McDonald and Keasey, 2002, p. 97). Also in 2000, BSCH bought Gruppo Financiero Serfin, Mexico's third largest bank, controlling 30% of the Mexican banking market.

<sup>9</sup> Banco Santander Central Hispano S.A. (19xx). In Grant, E.T. (Ed.), *International Directory of Company Histories*, volume x, pp. 63.

<sup>10</sup> Hoovers online, history of Santander, consulted on 2003, April 27, www.hoovers.com

### 16.3.2. Banco Central Hispanoamericano

Banco Central has a long history of financing Spanish industry. Over time it had built up a network of branches in 23 countries, especially in South America.<sup>11</sup> By 1980, Banco Central was the largest Spanish bank. In the 1970s, the bank grew by concentrating on failing banks, buying them up and making them part of the Banco Central. The bank doubled its number of branches in the early 1970s, and increased its influence in Spain's industry through loans. In the 1980s the banks reacted slowly to the financial liberalization and did not reduce its operating costs. Eventually, two businessmen built up an equity stake of 12% in Banco Central to force changes in the bank; Banco Central refused to give the stakeholders seats on the bank's board. As an alternative, the businessmen also acquired shares in Banco Espanol de Credito and proposed to merge the two banks, which would at the time have been one of the top 25 banks in Europe. Both plans fell through. In 1991, Banco Central merged with Banco Hispano Americano (BHA) instead. BHA had long been a leading Spanish bank, but it had undertaken several costly acquisitions in the 1980s that had weakened its profitability at a time that the Spanish banking market liberalized and focused towards European integration.<sup>12</sup>

Central bought BHA in 1991 to remain competitive as Spain entered the European Economic Community in 1992. Following the merger, Banco Central Hispanoamericano closed 20 percent of its branches, shed 10,000 employees, and divested unprofitable holdings. The bank remained focused on Latin America, taking stakes in small banks from 1993.<sup>13</sup> In that year, Banco Santiago in Chile was acquired, and merged into its local bank O'Higgins.

### 16.3.3. Banco Bilbao Vizcaya

Banco Bilbao-Vizcaya (BBV) was formed in 1988, merging Banco de Bilbao and its regional competitor Banco de Vizcaya after Banco de Bilbao failed to take over Banco Español de Crédito in 1987.<sup>14</sup> Both banks originated from Bilbao, growing through corporate financing, and merged to assure continued profitability after the integration of the EEC in 1992.<sup>15</sup> The merger made BBV one of the largest Spanish banks in terms of total assets of capital. On a worldwide level BBV remained a medium-sized bank, ranking 68th in terms of assets. Canals finds that the main strategic issues of BBV are similar to those of the individual banks before the merger (Canals, 1993, p. 124):

- Strong presence in retail banking, increasing the use of electronic banking services.
- Strengthening the relationship with large firms, directly or through specialized units.

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<sup>11</sup> Banco Central. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, volume 2, pp. 197-198.

<sup>12</sup> Banco Santander Central Hispano S.A. (19xx). In Grant, E.T. (Ed.), *International Directory of Company Histories*, volume x, pp. 63.

<sup>13</sup> History of Santander. (n.d.). Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com)

<sup>14</sup> The bank was acquired in 1994 by Santander.

<sup>15</sup> Banco Bilbao Vizcaya, S.A., *International Directory of Company Histories*, volume 2, pp. 194

- Participation in (non-financial) Spanish firms considered to be strategic for the economy.
- A growing presence in the capital markets, especially primary securities markets, specialized financing, and financial services.
- A greater presence in the principal international markets. To take greater advantage of economies of scale, BBV created specialized international finance units.

These objectives were ambitious and involved a high degree of risk (Canals, 1993, p. 125). Unlike other European banks however, the investments in non-financial companies did not cause serious problems during the Spanish recession of 1992-94. The success might be attributed to the diversified portfolio, as well as the fact that BBV considered the holdings as investments, not as opportunities to monopolize their banking services (Canals, 1997, pp. 231-233), increasing interdependency.

In 1988 BBV had established a presence in neighboring countries (Portugal, Morocco, Gibraltar, Italy), Central America (Panama, Puerto Rico) and Northern Europe (Germany, Belgium, Luxemburg). A representative office was opened in 1989 in Vienna to gain access to the Eastern European market, and in subsequent years offices were opened in South America (Panama, Brazil, Colombia, Argentina, Venezuela and Chile). The presence in international markets was enhanced by opening an office in Tokyo in 1990.<sup>16</sup> Internationalization of BBV has progress significantly in the 1990s. Although it had already built up an international network (in 1979 Banco de Vizcaya acquired a Puerto Rican bank), it significantly increased its foreign activities from 1992 onwards through a series of acquisitions, building a large franchise in Latin America.

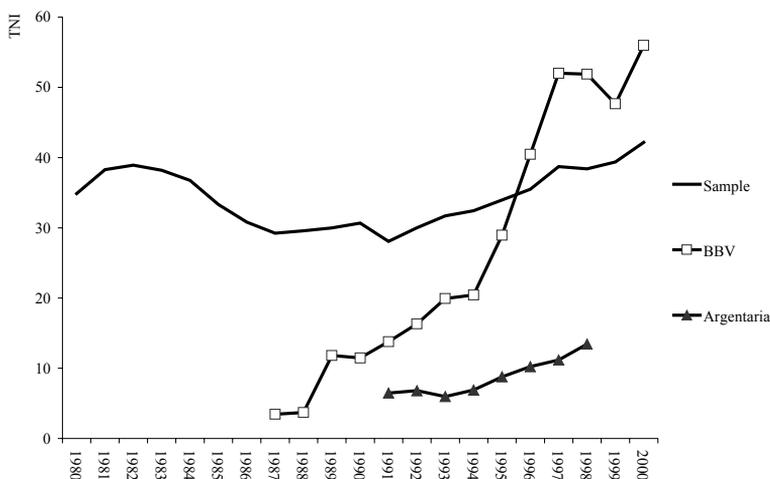
After Spain had entered the European Union in 1993, BBV focused on becoming an international leading bank, implementing a new strategy in 1994 named the "1,000 Day Program", aiming to develop the bank as the preferred financial provider both in Spain and in South America.<sup>17</sup> In 1995 the bank expanded into Peru, with the privatization of Banco Continental, and into Mexico, with Probusa. A year later, banks were acquired in Colombia and Argentina. Venezuela was targeted in 1997, buying Banco Provincial. Operations were set up in Chile in 1998 with Banco BHF.

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<sup>16</sup> The initial formation of BBV also meant that Banco de Bilbao lost interest in British bank Hambros (The Economist, 1991).

<sup>17</sup> Banco Bilbao Vizcaya Argentaria S.A. (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, volume 2, p. 50.

Figure 16.4. *TNI Banco Bilbao Vizcaya, Argentaria*



The merger of domestic competitors Banco Santander and Banco Central Hispanoamericano in 1999 prompted BBV to merge with Argentaria in October 1999, creating a bank with an initial market value of 40.7 billion US dollar, comparable to Deutsche Bank in the Eurozone.<sup>18</sup> The merger had been expected after the creation of BSCH, and the Spanish centre-right government did not persist in its earlier insistence that Argentaria, created from former State-owned banks, should remain independent to stimulate domestic competition.<sup>19</sup>

BBV started to expand its presence in South American pension fund management in 1996 through Consolidar, Argentina’s largest pension fund manager (Credit Suisse First Boston, 2000, p. 27). More significant was the acquisition of Provida, Chile (and South America’s) largest private pension fund manager. Provida had its subsidiaries in various South and Central American countries, providing scope for cost synergies when integrating into BBVA (Credit Suisse First Boston, 2000, p. 27).

Before the Argentaria acquisition, BBV also set out to create a European alliance with Italy’s UniCredito group, meant to be Europe’s first cross-border banking merger. In 1999 the foundations controlling UniCredito took a 1.9% stake in BBV. The talks ended because Italy’s central bank wanted a merger of equals, and the merger with Argentaria nearly doubled BBV’s size. Analysts did not display sorrow at the break up, indicating that BBVA’s internet strategy would probably be a key driver to expand geographically, and BBVA was considered to be an early mover in the internet banking market. It had merged its internet activities with Ireland’s First-e to create an online bank, and agreed to a share-swap agreement with Spanish telecom company Telefonica to develop online banking.<sup>20</sup>

<sup>18</sup> White, D. (1999, October 20). BBV to merge with Argentaria. *Financial Times*, p.1.

<sup>19</sup> White, D. (1999, October 20). Spanish banks settle on their marriage of convenience. *Financial Times*, p. 27.

<sup>20</sup> Johnson, K. & Hall, D. (2000, April 14). Unicredito Halts Proposed Merger With Spain’s BBVA. *Wall Street Journal Europe*, p. 15.

Table 16.5. *Activities BBVA*

Period	Phase	Objective	Arena	Client					Product			Organizational form								
				Government	Institutional	Corporate	Retail	Private	Credit	Asset management	Securities	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'87-93	Broad expansion	1. Build branch network to to service client	Major economic centers			■														
		2. Maintain commercial bank network	Domestic		■	■														
		3. Expand capital market activities	Major financial centers		■	■	■	■							■	■	■			
94-00	Focused expansion	1. Increase domestic market position (1999)	Domestic		■	■	■													
		2. Expand fund management activities	Central, South America		■	■	■									■	■			
		3. Increase capital market activities	Major financial centers		■	■	■	■	■	■	■					■	■	■		
		4. Create alliances with (non) banks	Europe, Domestic		■	■	■	■	■	■	■						■			

The merger was no hindrance for further international expansion. In 2000, Mexican subsidiary Probusa acquired Bancomer<sup>21</sup> for 1.85 billion US dollar, creating Mexico’s largest bank controlling 30 percent of the banking market.<sup>22</sup> To finance this and fund further expansion in Latin America, BBVA raised 3 billion US dollar in capital, the biggest capital increase ever undertaken by a Spanish bank and creating a similar market value as BSCH.<sup>23</sup>

#### 16.3.4. Argentaria

Argentaria was formed in 1991 when six government-owned banks, each with a different area of specialization, merged into the Corporacion Bancaria de Espana, which took on the trade name of Argentaria. Argentaria was created to build a large, financially sound and competitive bank, exploiting synergies and complementarities between the six banks<sup>24</sup>, with Banco Exterior de Espana, a diversified and partly privately held commercial bank, as the largest. Also, the Spanish government wanted to shift future financing needs from the bank to the public.<sup>25</sup>

<sup>21</sup>History BBVA (n.d). Retrieved on April 15, 2003, from [http://ws1.grupobbva.com/TLWA/eng/sala\\_prensa/historia.html](http://ws1.grupobbva.com/TLWA/eng/sala_prensa/historia.html)

<sup>22</sup> Fritsch, P. (2000, June 13). Bancomer Accepts \$1.85 Billion Bid From BBVA. *Wall Street Journal Europe*, p. 18.

<sup>23</sup> White, D. (2000, May 8). BBVA raising €3.3bn in capital. *Financial Times*, p. 27.

<sup>24</sup> Argentaria (1991). *Annual report 1991*

<sup>25</sup> Similar arguments were used for the formation of Dutch Postbank (1986), merged with NMB.

Table 16.6. *Merger banks of Argentaria in 1991*

Merger bank	Activity
Banco Hipotecario de Espana	Real estate finance
Caja Postal	Banking services (current accounts, loans)
Banco Exterior de Espana	Foreign trade finance, insurance and brokerage services
Banco de Credito Agricola	Agricultural finance
Banco de Credito Industrial	Industrial finance
Banco de Credito Local	Public finance

Source: Hoovers online

Between 1991 and 1993, the bank restructured to consolidate management and control of the 7 banks, as well as introducing consistency in each of the banks' businesses (Canals, 1997, p. 297). Argentaria also bought shares in other banks, and the government began to sell its stake from 1993, completing the privatization in 1998. The main focus of Argentaria was on the Spanish banking market, and internationalized to a lesser degree than the other large Spanish banks. After the privatization, Argentaria planned expansion, increasing its pension, insurance, and financial services operations in Central and South America. Banco Exterior de Espana, one of its merger banks, had a network of South American subsidiaries built up in the late 1970s and 1980s, which were unprofitable when Argentaria was created. These were restructured and most of the retail banking activities were closed. In 1996 it set up Banco Exterior de America, based in Montevideo, combining its subsidiaries in Uruguay, Chile and Argentina. Specializing in corporate and foreign trade and banking, it was expected to profit from the trade flows in the Mercosur countries.<sup>26</sup>

Argentaria was also active in the pension fund management through Siembra, the third-largest pension fund company in Argentina.<sup>27</sup> In 1998 it launched private banking services and announced an alliance with Belgian Dexia Group to provide loans to governmental institutions in Spain. In 1999 the bank launched an internet brokerage, and announced a merger with the second largest bank in Spain, Banco Bilbao Vizcaya. At the time of the merger, the bank had built a network of 1,700 branches at home and 60 branches in 23 other countries.<sup>28</sup>

#### 16.4. Commonalities and differences

The deregulation and consolidation in Spain created two major Spanish banks at the end for the 1990s, Santander and BBVA. The two leading banks have strengthened their

<sup>26</sup> Warner, A. (1996, October). New World ventures. *The Banker*, pp. 51-53.

<sup>27</sup> Which BBVA after the merger had to sell back to Citibank (Credit Suisse First Boston, 2000, p. 27).

<sup>28</sup> History of Argentaria. (n.d.). Retrieved April 27, 2003, from www.hoovers.com

position by entering into alliances in Europe, and acquiring activities in South and Central America.

A major incentive for Spanish bank internationalization was the European banking market: Spanish banks sought ways to position themselves in the ongoing and expected consolidation in the European banking market. However, the Spanish banks were relatively late arrivals in European consolidation activities, to position themselves and gain market value (and share) they focused on South American countries instead of European countries. Although profit margins of Spanish banks gradually fell after 1992, they remained well above those of other European banks. The relatively high levels of valuations in the Spanish stock markets allowed the Spanish banks to engage in an active campaign of acquisitions in Latin America (Perez, 2001, p. 394).

By the end of the 1990, two main competitive banks had emerged: BBVA and BSCH. They pursued similar goals but followed different implementation paths: BSCH purchased investment banks and BBVA concentrated on acquiring small shareholdings, gradually increasing the stakes over time. The other goal for the banks was the pension fund business (McDonald and Keasey, 2002, p. 97).

By 1997, Spanish banks, led by BBV and Santander, had gained control of more than 20% of the banking markets in countries such as Chile, Peru, Columbia, Venezuela and Puerto Rico, as well as substantial shares in Brazil and Argentina (Perez, 2001, p. 385). By the end of 1999, BBVA had a 30% market share in the South American pension fund business; BSCH became the largest financial institution in South and Central America in 2000 (McDonald and Keasey, 2002, p. 97).

The Latin American acquisitions have been a means to an end; BSCH and BBVA were "well placed to plan a merger or an acquisition that would put one or other at the center of a pan-European bank. Their strategy has been planned and carefully executed over several years." (McDonald and Keasey, 2002, p. 98). Their efforts to expand in the banking markets outside Spain mirrored each other. BSCH established cross-shareholdings in other banks in the European Union, including Commerzbank, Société Générale, the Royal Bank of Scotland and San Paolo IMI. BBVA on the other hand did not have such extensive links. For example, when BSCH acquired a 5% stake in Société Générale, BBVA acquired a 3.75% stake in Crédit Lyonnais. In Italy, when BBVA took a 10% equity stake in Banca Nazionale del Lavoro, BSCH acquired 7% stake in San Paolo. BBVA also had Telefonica as its industrial partner (McDonald and Keasey, 2002, p. 163).



## 17 Internationalization of Swiss banks

In the course of the twentieth century, as a result of its neutrality in the two world wars, Switzerland emerged as one of the major financial centers in the world. Given the relatively small size of the economy this position has been due to the large extent of its international financial activities (Pohl and Freitag, 1994, p. 1020). In the 1970s Swiss banks exploited the country's position as a low-tax country with no foreign exchange regulations, and gained a substantial market share of the money flows that were being recycled following the sharp rise in world oil prices.

Despite the extent of their international involvement, Swiss banks had very few branches until the late 1960s, partly because the country itself was an exporter of capital and partly because a main activity was the deposits by foreign residents in Switzerland, reducing the need to establish branch offices. When internationalization took off from the 1970s onwards, the banks focused on capital market activities, and opened branches in all the major international financial centers.

When financial deregulation of financial centers commenced in the 1980s, Swiss banks participated in a second wave: increasing scale and market position in private banking, investment banking and asset management in the largest financial centers, particularly London and New York. Foreign growth became even more important when in the early 1990s the consolidation in the domestic market was finished, leading the banks five years later to merge among themselves to keep up with scale enlargement.

Banking secrecy, introduced in the Swiss Banking Law of 1934, has been one of the reasons for the success of Swiss Banking. It has often been associated with scandals, tarnishing the image of Swiss banks in the public opinion. (Pohl and Freitag, 1994, p. 1022). The issue escalated in 1996, and several class action law suits were launched against UBS, SBC and Credit Suisse, even threatening the merger of UBS and SBC at some point.

Table 17.1. *Incentives for internationalization of Swiss banks*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Economic structure: relatively small economy, with capital surplus and financial center</li> <li>• Regulation: relatively liberal regulation compared to other countries, attracting capital flows</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: SBC, Credit Suisse and UBS followed similar internationalization strategies</li> <li>• Market power and concentration: From the 1990s, domestic banking consolidation finished</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies of scale and scope: expansion in capital market activities that were sensitive to scale: securities, asset management, financial advice</li> <li>• Shareholder return: relatively low stock market valuation, from the mid-1990s relatively high stock market valuation</li> </ul>

## 17.1. Incentives to internationalize

### *Regulation*

Traditionally, non-residents could avoid all withholding taxes in their domestic country by setting up fiduciary accounts in Switzerland through which their funds are invested abroad. This is advantageous because Swiss banks do not withhold income tax if its source is non-Swiss, and Swiss bank secrecy, laid down in the constitution, protects the identity of the owner of the account from disclosure to the tax authorities.<sup>1</sup>

Cartel practices in Swiss banking and securities activities came under increased scrutiny in 1989 when the Swiss Cartel Commission published a report on the existing agreement, recommending that 19 of these be terminated (OECD, 1992, p. 89).

In 1996 the Swiss banks came under fire for refusing to relinquish assets from dormant Jewish's customer accounts from the Second World War, and for gold trading with the German National Socialist regime. The investigation for dormant accounts from the Second World War took an unexpected turn for UBS when old documents within UBS, originally planned to be destroyed, were secretly handed over to the Jewish community and published.<sup>2</sup> This prompted US regulators to threaten with the blockage American bank activities by Swiss banks. In 1997 the banks agreed to establish a humanitarian fund for the Holocaust victims, and a stream of lawsuits by American heirs and boycott threats from

<sup>1</sup> Hall, W. (1999, October 27). Switzerland: Banking and Finance: Three factors that lead to tax evasion. *Financial Times*, p. 5.

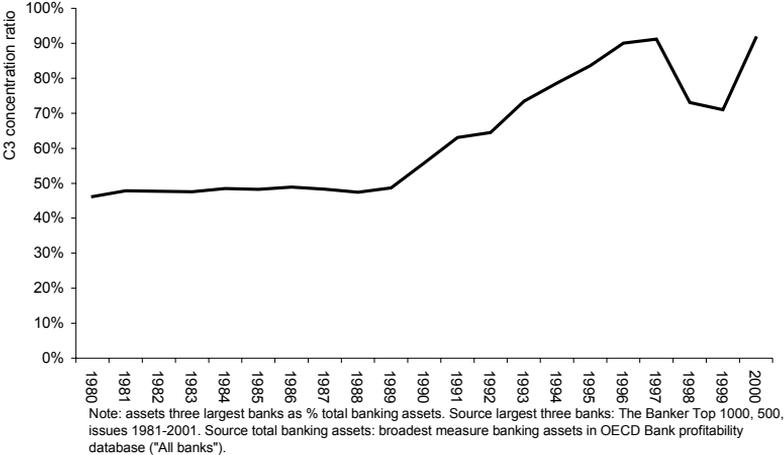
<sup>2</sup> *History of UBS Part 5: 1990 - 2000* (2001). UBS, p. 15.

federal states in the United States led in 1998 to a tentative 1.25 billion US dollar settlement by Swiss banks.<sup>3</sup>

*Market power and concentration*

“Switzerland is a small country of 7 million people with three banks which are disproportional large given the size of the country. It also has a disproportional large share of the private banking market”.<sup>4</sup> Increasing concentration in Swiss banking has been a continuous process since the 1960s, and the three largest banks became UBS, Credit Suisse and SBC. Between 1990 and 1996 the total number of bank branches in Switzerland had been falling with 20%, while the network of the big three banks only declined with 3%. Credit Suisse bought Swiss Volksbank, the fourth biggest bank, in 1993. UBS bought in 1995 a cantonal bank in Appenzell and a local bank in Langenthal, while SBC acquired a number of banks including Solothurn’s cantonal bank.<sup>5</sup>

Figure 17.1. Share of largest three banks in Switzerland, percentage total assets



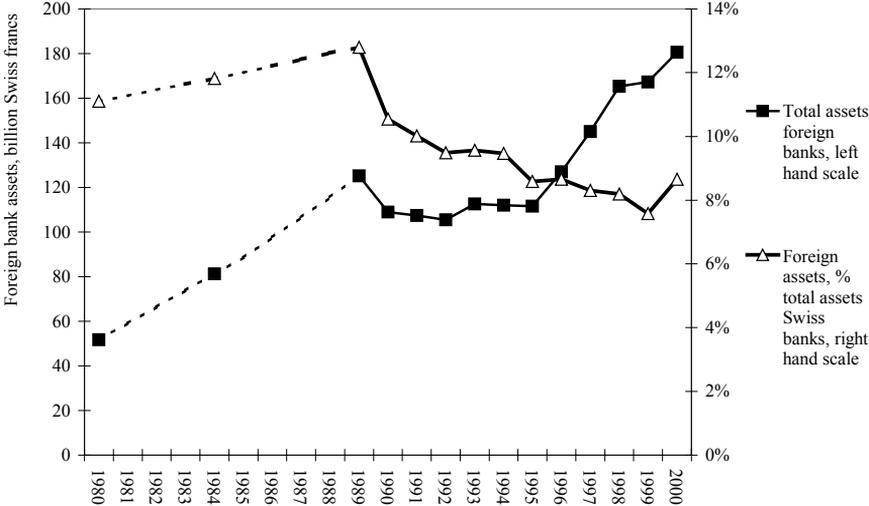
Banking concentration remained initially high after the merger between UBS and SBC in 1997. Because of the terms of the merger agreement by the regulators, branches had to be divested causing the decline in market concentration.

<sup>3</sup> *History of Credit Suisse*. (n.d.). Retrieved April 27, 2003, from www.hoovers.com  
<sup>4</sup> Lukas Muhlemann, chief executive of Credit Suisse, in an interview in 1997. Source: Hall, W. (1997, October 31). Survey: Swiss Banking and Finance: Bancassurers ‘winning the argument’: The group is preparing for a position as a truly international operator. *Financial Times*.  
<sup>5</sup> Hall, W. (1997, October 13). Survey: Swiss Banking and Finance: Retail Banking: A time of domestic restructuring. *Financial Times*.

**17.2. Role of foreign banks**

At the beginning of the 1980s, Swiss regulators allowed foreign bank entry on the basis of reciprocity. Entry provisions applied equally to both domestic and foreign banks, with the provision that the foreign bank's name would not give the impression that it was a Swiss one (Pecchioli, 1983, p. 186). The role of foreign banks steadily increased in Switzerland. In 1987, there were 125 foreign banks in Switzerland and nearly 500 banks. In 1997 there were 157 foreign banks and less than 250 other Swiss banks. In 1997, it was estimated that Switzerland's foreign banks managed nearly 20% of the funds under management.<sup>6</sup>

Figure 17.2. Assets Foreign banks in Switzerland, 1980-2000



Note: dotted line data not available. Source: calculated from Swiss Central Bank. Foreign assets is calculated as "Übrige Banken, Ausländisch beherrscht (Code nr 5.2) + Filialen Ausländischer Banken (Code nr 7).

In the 1980s, Japanese banks settled in Switzerland. Sumitomo took a controlling stake in Lugano based Banca del Gottarda, to boost private banking in that area and to finance loan placements of Japanese companies in Switzerland, with lenient regulation. In the 1990s, they retreated from Switzerland, due to their domestic problems. Paribas, in the wake of its nationalization in 1982, greatly expanded its banking activities there.

**17.3. Case studies**

The internationalization activities of three Swiss banks are investigated: Credit Suisse, SBC and UBS. In 1997, SBC and UBS agreed to a merger under the UBS name.

<sup>6</sup> Hall, W. (1997, October 31). Survey – Swiss Banking and Finance: Foreign Banks: Firm roots in fertile soil. *Financial Times*.

### 17.3.1. SBC

Of the three Swiss banks, Swiss Bank Corporation (SBC) has been the most internationally oriented bank in Switzerland. SBC followed the accelerated growth of international banking in the 1960s, opening offices in the major financial centers, and expanding its US network, where it had opened a New York branch in 1939. The number of foreign branches grew from 9 to 11 between 1975 and 1992 while the representative offices increased from 17 to 28. In the early 1990s, Swiss Bank Corporation operated as an universal bank and was active in all areas of business. Outside Switzerland, it did not engage in retail banking, focusing on large corporate and private clients (Pohl and Freitag, 1994, p. 1119). During the 1970s and 1980s, SBC established its presence in the major financial centers, and off shore facilities such as SBC Finance in the Cayman Islands were set up to handle the international capital market operations of SBC.<sup>7</sup>

In 1989, SBC initiated a partnership with the US derivatives house O'Connor & Associates in Chicago.<sup>8</sup> In 1990 SBC acquired a 49% share in Lugano based Banca della Svizzera Italiana.<sup>9</sup> After taking full control, five private banking subsidiaries of SBC were integrated into Banca della Svizzera in 1992. In the same year, SBC acquired over O'Connor, and set up new subsidiaries in Paris.<sup>10</sup> In 1991, a new organization structure was enforced, integrating foreign wholesale banking into one international and financial group, headquartered in Zürich.<sup>11</sup>

Table 17.2. *Activities SBC*

Period	Phase	Objective	Arena	Client					Product				Organizational form					
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield
'80-'88	Broad expansion	1. Build worldwide network to service client	Major financial centres and economic centers															
		2. Maintain commercial bank network	Domestic															
'89-'97	Focused expansion	1. Maintain domestic market position	Domestic															
		2. Increase capital market activities	United Kingdom, United States															

In 1995, SBC acquired S.G. Warburg, a leading European investment bank, renaming it SBC Warburg.<sup>12</sup> Warburg had a year earlier initiated merger talks with Morgan Stanley, but these were aborted once it became clear that the American investment bank was mainly interested in Warburg's asset management subsidiary, Mercury Asset

<sup>7</sup> *History of UBS Part 4: 1970 - 1989*. (2001). UBS, p. 14.

<sup>8</sup> *Ibid.*, p. 21.

<sup>9</sup> *Ibid.*, p. 3.

<sup>10</sup> *Ibid.*, p. 6.

<sup>11</sup> *Ibid.*, p. 4.

<sup>12</sup> *Ibid.*, p. 10.

Management rather than the parent company. The match with SBC proved to be better, as the latter already had a strong investment management arm (Brinson Partners) and thus did not need Mercury. Also, SBC had created a position in trading activities for primary business without the financial advisory business that would not overlap with Warburg (Augar, 2000).

In 1997, SBC bought Dillon, Read & Co., an old established New York investment bank founded in 1832, integrating it into the SBC Warburg division. In the same year, SBC also acquired Brazilian bank Banco Omega, and entered into strategic alliances with Brunswick in Russia and Long Term Credit Bank (LTCB) in Japan.

Figure 17.3. TMI SBC, 1980 - 1997



On December 8th, UBS and SBC announced their planned merger. There had been speculations after consolidation among UBS, SBC or Credit Suisse, especially when after Credit Suisse had unsuccessfully approached UBS before it acquired Wintherthur.<sup>13</sup> The merger was triggered by American competitors; UBS and SBC acknowledged that they had lost market share over the years, and believed that neither bank would succeed in the long term, especially compared to American investment banking competitors. The announced merger reduced total workforce by 13,000 employees and led to a pre-tax restructuring charge of 7 billion Swiss francs. The new bank, UBS, also became the world's largest global asset manager, managing assets worth almost 1,000 billion US dollar. Even though UBS shareholders owned 60% of the merged bank's shares, with the continuation of the UBS name, the deal was considered a thinly disguised takeover by SBC. The SBC chairman led the new combination, SBC managers headed the main businesses, and the majority of staff lay offs were with the old UBS.<sup>14</sup> Investment banking

<sup>13</sup> Graham, G. & Martinson, J. (1997, December 8). Comment & Analysis: The Dollars 600bn question: Are SBC and UBS set to take one of the few places at the global banking top table. *Financial Times*.

<sup>14</sup> Hall, W. & Harris, C. (1997, December 9). SBC takes seniority in merger with UBS: Deal to cost 13,000 jobs and create leading asset manager. *Financial Times*.

activities were centred on SBC's Warburg Dillon Read subsidiary; and institutional asset management was headed by Gary Brinson of SBC.

### 17.3.2. UBS

Union Bank of Switzerland (UBS) had been a predominantly domestic oriented bank throughout the 1960s, increasing its domestic position by buying Interhandel, a financial company in 1967, and four savings banks in 1968.<sup>15</sup> Founding its first branch office in London in 1967, UBS began to expand the number of offices throughout the world, setting up presences in most major financial centers and establishing several securities underwriting subsidiaries there. Determined to keep up with its domestic peers in international operations<sup>16</sup>, the bank set out to grow significantly in foreign activities and streamline its Swiss consumer banking activities (Schütz, 2000, p. 181). UBS bought almost 30% of the British brokerage house Phillips & Drew in 1984, taking full control two years later.<sup>17</sup> Phillips & Drew's business was hit hard after the 1987 United States stock market crash and when losses continued over the next two years, the subsidiary was restructured.<sup>18</sup>

This move increased UBS's presence in the securities markets, which were then beginning to increase in importance. In 1990 the second overseas purchase after Phillips & Drew was staged with the acquisition of New York based Chase Investors, an asset manager aimed at institutional investors.<sup>19</sup> Comparable to Swiss Bank Corporation, UBS provided a full range of financial services for domestic clients, focusing abroad on wholesale banking services for institutional investors, large corporations, wealthy individuals and governments. In the early 1990s, UBS enjoyed the competitive advantage of being one of four privately owned banks worldwide being awarded a "Triple A" rating (Pohl and Freitag, 1994, p. 1122). During the years, the bank also turned its attention to the Italian banking market, setting up a merchant banking operation in Milan in 1990.<sup>20</sup> Domestic activities went less smoothly when UBS acquired PBZ, a Zurich based private bank in 1989. The acquisition failed and the bank was practically dissolved after two years (Schütz, 2000, p. 181).

In 1991, UBS changed its organizational structure, creating five geographical regions as well as six group divisions.<sup>21</sup> Over the years, UBS had continued to expand in Switzerland as well, buying five more banks to gain market share and complement the

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<sup>15</sup> *History of UBS* (n.d.). Retrieved April 27, 2003, from www.hoovers.com

<sup>16</sup> *History of UBS* (n.d.). Retrieved April 27, 2003, from www.hoovers.com

<sup>17</sup> *History of UBS Part 4: 1970 - 1989* (2001). UBS, p. 14

<sup>18</sup> *History of UBS* (n.d.). Retrieved April 27, 2003, from www.hoovers.com

<sup>19</sup> This acquisition was inadequate for entering the American market, since the company was founded in the 1970s as a petrodollar vehicle, and its clients were mainly from Japan and the Middle East (Schütz, 2000, p. 181).

<sup>20</sup> *History of UBS Part 5: 1990 - 2000*. (2001). UBS, p. 3

<sup>21</sup> Regions: domestic, Europe, North America, Japan, East Asia). Group divisions: corporate lending, corporate finance, trading and risk management, country exposures and general banking in non-regionalized countries, private banking and institutional asset management, resources and management support. Source: *History of UBS Part 5: 1990 - 2000*. (2001). UBS, p. 5

coverage of its branch network. This also left UBS with overlapping operations and a high cost structure when economic recession hit the bank, falling property prices aggravated this by increasing non performing loans.<sup>22</sup> In 1994 profitability had decreased dramatically and a multiyear reorganization was launched to consolidate its consumer operations.

Table 17.3. *Activities UBS*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
80-84	Broad expansion	1. Build worldwide branch network to service clients	Major financial and economic centers		■	■	■													
		2. Maintain commercial bank network	Domestic			■	■	■												
		3. Expand capital market activities	United Kingdom, United States			■	■		■	■	■									
85-91	Focused expansion	1. Increase domestic market position	Domestic		■	■	■													
		2. Expand worldwide network to service large corporations	Major financial and economic centers					■	■	■	■									
		3. Increase capital market activities	United Kingdom, United States			■	■		■	■	■									
92-97	Restructuring	1. Restructure and consolidate domestic branch network	Domestic			■	■													
		2. Maintain market position foreign activities	Europe, United States, major financial centers																	
98-00	Focused expansion	1. Restructure and consolidate domestic branch network, divest part as merger condition	Domestic			■	■		■		■								■	
		2. Divest foreign activities, streamline activities after merger	Italy, Europe			■			■	■										■
		3. Expand in securities and asset management	Europe, United States			■	■			■	■									

In 1996, UBS took a 25% stake in Rententanstalt/Swiss Life, Switzerland's largest life insurance company, offering insurance products through its network. The investigation for dormant accounts from the Second World War took an unexpected turn for UBS when old documents, planned to be destroyed, were secretly handed over to the Jewish community and published.<sup>23</sup> In the end, Swiss banks reached a general settlements with US regulators to stave off court actions. UBS also acquired German private banking house Schroder Munchmeyer Hengst from Lloyds TSB. The pace of reorganization was stepped up in 1996, after declining Credit Suisse's merger proposal. A number of domestic branches were closed, and provisions for bad loans increased, leading to losses in 1996 and 1997.

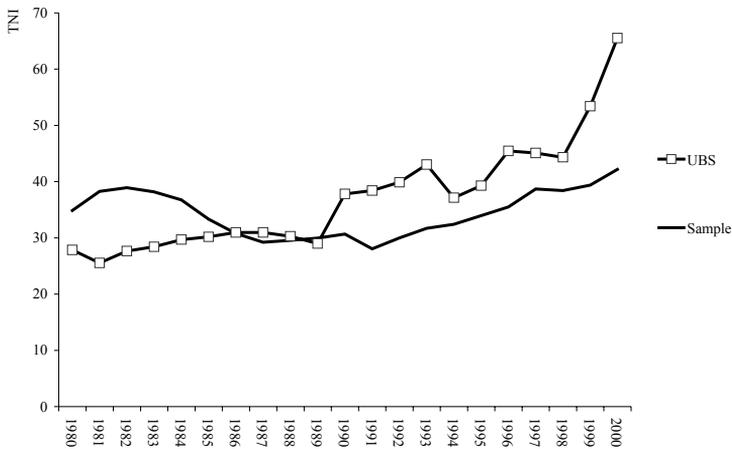
At the time of the merger, total assets of UBS were 577 billion Swiss Francs, employing a staff of 27,661 of which 8,256 worked abroad. SBC's assets amounted to 438 billion Swiss Francs, with a total staff of 27,565 of which 10,169 abroad. Both banks established a considerable restructuring cost, posting losses in 1997. They also decided to maintain the UBS name. The new UBS was structured along the business divisions -

<sup>22</sup> *History of UBS* (n.d.). Retrieved April 27, 2003, from www.hoovers.com

<sup>23</sup> *History of UBS Part 5: 1990 - 2000*. (2001), p. 15.

private and corporate clients, asset management, private banking, investment banking and private equity. All central functions were grouped in a corporate center. In the first year, the bank sold its private banking subsidiary Banca della Svizzera Italiana, as one of the conditions under which Swiss regulators approved the merger. The merger did not start off well - the chairman was forced to resign after unexpected large losses outside Switzerland had to be reported, partly due to a large (old) UBS exposure in LTCM. The bank undertook some restructuring over the next period, selling its international trade finance to Standard Chartered in 1999, and taking over Bank of America's private banking activities in Europe and Asia in the same year. The stake in Swiss Life/Rentenanstalt was sold, as well as 2 billion US dollar worth of property loans.

Figure 17.4. *TNI UBS, 1980-2000*



The acquisition pace of its predecessors continued, though. In September 1999 the firm Global Asset Management, domiciled in Bermuda, was acquired for its private banking division. Its asset management activities are enhanced by the purchase of US-based Allegis Realty Investors, specialized in real estate asset management. In 2000, UBS listed its shares on the New York Stock exchange, providing the bank with a "funding currency" for expansion in the United States.<sup>24</sup> This expansion took the form of buying PaineWebber, the fourth largest private client firm in the United States with 8,554 brokers in 385 offices.

### 17.3.3. Credit Suisse

Credit Suisse in the 1980s was a diversified financial company, owning two industrial companies (Fides and Electrowatt) besides Credit Suisse. After the Second World War,

<sup>24</sup> *History of UBS Part 5: 1990 - 2000*. (2001). UBS, p. 24

foreign exchange and gold trading became important activities for Credit Suisse. Mortgage and consumer credit acquisitions drove economic growth in the 1970s.<sup>25</sup>

In 1978 the partnership with American White Weld was superseded with the financial participation of First Boston, a New York investment bank. The new organization, Credit Suisse First Boston (CSFB) established itself as the world’s largest Euromarket player. In the 1980s, Credit Suisse expanded its presence on all five continents, founding new subsidiaries and taking over asset management companies. In the early 1990s, Credit Suisse opened representative offices in Milan, Madrid, Vienna and Moscow, and acquired a majority stake in American securities firm BEA associates Inc.

Table 17.4. *Activities Credit Suisse*

Period	Phase	Objective	Arena	Client				Product			Organizational form							
				Government	Institutional	Corporate	Private	Asset management	Securities	Insurance	Services	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture	
80-89	Broad expansion	1. Maintain domestic market position	Domestic															
		2. Expand worldwide network	Major financial and economic centers															
		3. Increase capital market activities	United States, Europe, Japan															
90-00	Focused expansion	1. Increase domestic market position	Domestic															
		2. Divestment non-financial activities	Domestic															
		3. Expand capital market activities	Europe, United States, Brazil															
		4. Expand asset management activities	Europe, United States															

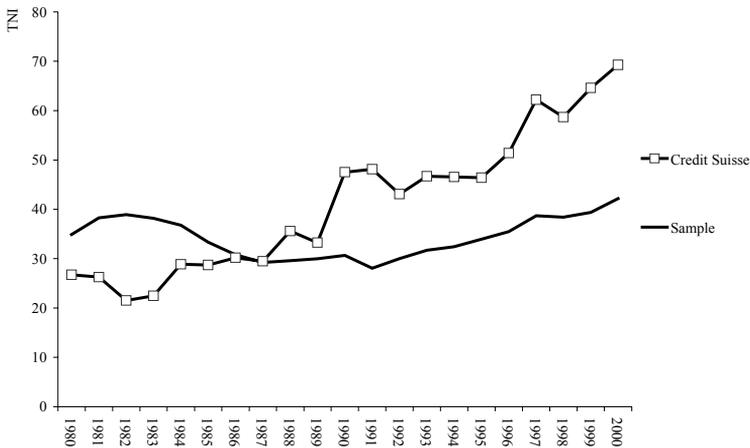
The 1987 stock market crash hurt First Boston badly, and in 1988 Credit Suisse fully acquired First Boston, becoming the first foreign owner of major Wall Street investment bank. First Boston was renamed CSFB; Credit Suisse recapitalized it by injecting new capital and transferring bad loans to the holding company. In the same year, reacting to the increasing deregulation of the financial markets, CSFB was restructured into an investment bank operating internationally through three group companies operating in New York, London and Tokyo (Pohl and Freitag, 1994, p. 1093).

In the next years, Credit Suisse built and restructured its domestic operations. Bank Leu was acquired in 1990, providing domestic private banking services. In 1993 Credit Suisse acquired Volksbank, the fourth largest Swiss bank at the time. Two years later, the bank entered a strategic alliance with insurer Winterthur. The bank demonstrated its concentration on financial activities by selling Elektrowatt, the energy and engineering business of Credit Suisse, in December 1996. The group was now concentrated around four business units - one domestic (retail customers in Switzerland), and three international units (private clients, corporate customers and investment banking, and asset management

<sup>25</sup> *History of Credit Suisse* (n.d.). Retrieved April 27, 2003, from www.hoovers.com.

for institutional investors).<sup>26</sup> In 1997, the bank completed the transformation to bank assurance by acquiring insurance company Winterthur, remaining an autonomous company within the group. Before the successful acquisition of Winterthur though, Credit Suisse had first approached UBS for a merger, which was rebuffed by UBS.<sup>27</sup> In the same year, it bought Barclays' European investment banking business from BZW.

Figure 17.5. *TNI Credit Suisse, 1980 - 2000*



From 1998, Credit Suisse further increased its foreign presence by acquisitions. In 1998 it bought Brazilian bank Banco de Investimentos Garantia, specializing in corporate finance and investment banking. A large asset management purchase took place with Warburg Pincus Asset management in July 1999. The biggest acquisition was to be the US-based investment bank Donaldson, Lufkin & Jenrette in 2000. The investment banking business of the bank was integrated into CSFB, and its asset management were folded into asset Credit Suisse's management business unit.<sup>28</sup> Credit Suisse's foreign expansion did not go smoothly though: in 1999 Japanese regulators revoked CSFB's licence for obstructing an investigation, the harshest penalty ever given to a foreign firm. It also accused the company of helping 60 others hide losses and cover up evidence.<sup>29</sup>

<sup>26</sup> *Credit Suisse Group: Our history, acquisitions/divestitures*. (n.d.). Credit Suisse website. Retrieved April 16, 2003 from [http://www.creditsuisse.com/en/who\\_we\\_are/acquisitions.html](http://www.creditsuisse.com/en/who_we_are/acquisitions.html)

<sup>27</sup> Graham, G. & Martinson, J. (1997, December 8). Comment & Analysis: The Dollars 600bn question: Are SBC and UBS set to take one of the few places at the global banking top table. *Financial Times*.

<sup>28</sup> *Credit Suisse Group: Our history, acquisitions/divestitures*. (n.d.). Credit Suisse website. Retrieved April 16, 2003, from [http://www.creditsuisse.com/en/who\\_we\\_are/acquisitions.html](http://www.creditsuisse.com/en/who_we_are/acquisitions.html)

<sup>29</sup> *History of Credit Suisse* (n.d.). Retrieved April 27, 2003, from [www.hoovers.com](http://www.hoovers.com)

#### **17.4. Commonalities and differences**

The Swiss banking market has some similarities with the Dutch banking market: a high degree of banking concentration, especially in the 1990s. Also, Switzerland is a relatively small economy compared to other European countries, limiting domestic growth opportunities, and creating an outward orientation of activities. On the other hand, the importance of financial centers differed: the country itself was an exporter of capital and a main activity has been deposit taking from foreign residents in Switzerland. Internationalization took off from the 1970s onwards, and the Swiss banks focused on capital market activities, opening branches in all the major international financial centers.

When financial deregulation of financial centers commenced in the 1980s, Swiss banks increased scale and market position in private banking, investment banking and asset management in the largest financial centers, particularly London and New York. Foreign growth became even more important when in the early 1990s the consolidation in the domestic banking market was finished, leading the banks five years later to merge among themselves to keep up with scale enlargement.

The case studies show that the three largest Swiss banks have pursued similar internationalization strategies between 1980 and 2000. When the internationalization of UBS, Credit Suisse and SBC took off in the 1970s, the banks focused on capital market activities, and opened branches in all the major international financial centers. The three banks acquired asset managers, securities firms, investment banks and private banks at a rapid pace from the mid 1980s, and have not stopped doing so in the 1990s. The banks chose all areas that were prone to a continuous process of high investments and increasing scale.

Foreign growth became even more important when in the early 1990s the consolidation in the domestic market was finished. Foreign growth centered around investment banking, private banking, and asset management. Swiss banks have not ventured into foreign retail banking, as for example British banks have. SBC continued its foreign growth, acquiring for example Warburg while Credit Suisse continued its transformation into a bank assurance firm, shedding its remaining industrial holdings and entering an alliance (and eventually buying) Swiss insurer Winterthur. Meanwhile, UBS had to focus on coaching its activities back to financial health. The three Swiss banks were, in 1997, confronted with the mergers among American investment banks. While this was the signal for British bank management to scale down or close their investment banking units, it led to the merger of UBS and SBC, at the time the largest asset management combination in the world.

## 18 Internationalization of Japanese banks

After the Second World War, Japanese banks first established overseas offices in 1952. In the 1950s, international bank activities increased as Japanese immigrants in North and South America sent their remittances back home; trade finance grew as the Japanese economy was rebuilt (Haga, 2002). Internationalization of Japanese banks, with the exception of Bank of Tokyo, grew substantial when the capital markets were liberalized in the early 1980s. In the United States, the Japanese banks initially also moved into California to serve trade links and the local Japanese community. They grew through acquisitions and became in many cases large state-wide retail banks serving mostly non-Japanese clients. By the end of 1988, 4 of the 10 largest banks in California were Japanese owned, representing 11% of total banking assets in the state. The growing presence also attracted criticism: US banks had very limited access to Tokyo's markets, holding about 2% of deposits there (The Banker, 1990).

A decade later however, Japanese banks started to retreat from international banking, faced with several structural problems (Canals, 1997, pp. 258-265). When the Japanese stock market moved downward from 1991 onwards, due to tightening monetary policy triggering an economic recession, Japanese banks had to confront capital losses shrinking the net worth of the banks. This forced the banks to contract their lending activity and to concentrate on the domestic market, withdrawing from international markets.

Between 1990 and 1995, Japanese authorities did little to counter the decline in the conditions of the banking system. Also, Japanese banks were reluctant to raise provisions, due to stringent rules for tax relief, opting for the general provisioning level of 0.3% of total loans instead. The high dependency on bank credit compared to other countries meant that economic growth prospects were closely aligned to the growth prospects of banks, and these were declining. The reluctance of Japanese authorities was partly based on the false hope that the economy would recover, which in turn would strengthen the banks. Even after 1995, when it became clear that the banks' problems had considerably worsened and that a systematic public intervention would become inevitable, regulators hesitated to take action because of their fear of triggering a public panic in the absence of an adequate deposit insurance scheme.

At the end of the 1990s, Japanese banks had scaled down their international activities, with some banks confining themselves to leading or taking part in bond placements.

Table 18.1. *Incentives for Japanese banks to internationalize*

Incentives	Description
Extrinsic	<ul style="list-style-type: none"> <li>• Spreads: Net interest margin low compared to other countries</li> <li>• Economic structure: appreciation Yen against major currencies</li> <li>• Structural surplus capital account. In the 1990s the Japanese stock market declined, forcing deterioration of capital and restructuring</li> <li>• Regulation: liberalization capital markets (1980s), deregulation banking sector (1990s)</li> <li>• Client: initial internationalization by following industrial clients to foreign countries</li> </ul>
Sector extrinsic	<ul style="list-style-type: none"> <li>• Herding: banks eventually emulate Bank of Tokyo: capital markets activities in major centers, and retail bank in the United States</li> <li>• Market power and concentration: domestic low concentration, but highly segmented market.</li> </ul>
Bank intrinsic	<ul style="list-style-type: none"> <li>• Economies of scale and scope: strategies Japanese banks generally considered asset seeking, with profitability as secondary motive</li> <li>• Cost of capital: funding advantage in the 1980s and early 1990s, turned into disadvantage (Japan premium)</li> </ul>

## 18.1. Incentives

### *Clients, markets*

Between 1951 and 1994, investments made by Japanese banks outside Japan were heavily influenced by the investment behavior of the Japanese manufacturing sector (Yamori, 1998). Fujita and Ishigaki (1986, p. 200) conducted a survey among the largest Japanese banks in 1978-9 and found that 7 out of 13 banks followed the customer in their internationalization, 3 banks indicated that their internationalization paralleled that of their client, while the remaining three banks were ahead of their clients. Strong client ties are usually mentioned as a determining characteristic of Japanese banks (Arora, 1995). Arora (1995, p. 184) argued that it is without question that Japanese industry maintained close and long term ties with financial institutions at home. He also observed that there is a tendency in literature to suggest that the internationalization of Japanese banks is tied to these clients, and found this to be an inadequate hypothesis since it still needed to be checked whether this is true. However, the internationalization of Japanese bank does correlate with the rise in trade and foreign investment.

Among European countries, the United Kingdom attracted the largest number of Japanese banks, 28 by 1995 (Arora, 1995, p. 99). Their desire was mainly to participate in

the international financial markets with London as a major financial center. The arrival of Japanese banks in Germany fits the client following hypothesis: the banks opened branches in and around the industrial area of Düsseldorf, between the mid-1960s and the mid-1970s, where the Japanese manufacturing companies in Germany had their units. A second "arrival" took place in the late 1980s in Frankfurt, when Japanese banks opened subsidiaries to participate in the growing capital market activities. On the other hand, with the exception of Bank of Tokyo who was present through the Banque Européenne de Tokyo consortium, Japanese banking presence expanded after 1985 when Japanese FDI started to increase. They were also stimulated by the capital markets deregulation between 1986 and 1988 (Arora, 1995, p. 100).

The 1970s saw the arrival of Japanese banks in the Netherlands also. As with Germany, this coincided with Japanese manufacturing, trading and service firms establishing themselves there. Another reason was the large number of Japanese companies that were listed on the Amsterdam stock exchange (Arora, 1995, p. 102).

Where Germany, and France were client oriented, entry in the United Kingdom, Switzerland and Luxembourg were more driven by access to markets. In Switzerland, Swiss Franc denominated bonds attracted Japanese corporate borrowers because of the low interest rates, relatively easy issuing procedures and a large private placement market. The surge in corporate bond issuing attracted Japanese banks in the 1980s, although they also became active (on a lesser scale) in fund management and private banking. Similarly, Luxembourg was important as a base for Euro-German transactions, offering liberal taxation, absence of minimum reserve requirements and free capital movement. Over time Japanese banks shifted their attention in Luxembourg to trust business and investment activities (Arora, 1995, p. 101).

### *Regulation*

Until 1970, most international banking activities for Japanese banks were highly regulated, with the exception of Bank of Tokyo, specializing in foreign exchanges and maintaining a large overseas branch network (Hasegawa, 1993; Haga, 2002).

Deregulation and liberalization of the Japanese financial system took off in 1984, under pressure of United States government. The deregulation had a strong impact of corporate financing, leading to a shift from Japanese companies bank financing to capital market financing. Banks were not allowed to move to new lines of business and search for new clients, and lost their best borrowers between 1983 and 1989 (Hoshi and Kashyap, 1999, p. 11). Hoshi and Kashyap (1999) argue that the imbalance played a major role in the Japanese banking problems, and that the Big Bang corrected most of these regulatory imbalances.

Late 1996, Japan announced its own Big Bang. Between 1997-98, the ban on financial holding companies was lifted, the foreign exchange market was liberalized, trading commissions were deregulated and individuals were allowed to directly hold accounts abroad (without having to invest in a mutual fund) (OECD, 1998, p. 131). Significant changes also took place when the Bank of Japan Law took effect in April 1998,

designed to enhance independence and transparency by changing appoint procedures of new members on the board, requiring the Bank to meet regularly and publish its minutes quickly (OECD, 1998, p. 102).

Several large and publicly well known financial institutions went into bankruptcy<sup>1</sup> by 1997, leading to a sell off of bank shares in the Tokyo stock market and increasing the cost of funding in the overseas bank markets, the so called “Japan premium”. As a response, the Japanese authorities drafted the “Law to Ensure the Soundness of Financial Institutions” creating the Prompt Corrective Action (PCA) framework. The PCA, modeled after the American framework, was to take effect in April 1998. It introduced a self-assessment process making banks responsible for valuing assets realistically, and specified capital ratio thresholds under which regulators could order banks to take remedial actions. The PCA also added reciprocity for regulators, putting pressure on them to act when a bank would weaken.

Table 18.2. *Major regulatory events in Japan*

Year	Regulatory event	Effect on internationalization	Effect on entry foreign banks
1984	"Real demand" rule for foreign exchange lifted, new financial instruments allowed	Foreign investments allowed	
1984	Securities licences granted to subsidiaries of foreign banks; permission for foreign banks to issues Euro Yen CD's		Range of activities in Japan broadened
1992	Financial System reform bill, allowing banks to enter security business		
1994	Japanese commercial banks are allowed to move into the securities markets		
1988	Financial Revitalization law		

Source: adapted from Hoshi and Kashyap, 1999, Table 3

The year 1997 also saw bank runs from distressed depositors, recognizing the limitations of the deposit insurance scheme. By the end of the year the Minister of Finance announced that the government would guarantee the full amount of deposits in Yen and foreign currencies, regardless of the existing limitations of the deposit insurance.

In the following year two laws were passed by the Diet, amending the Deposit insurance scheme and authorizing the provision of 30 trillion Yen for measures to stabilize

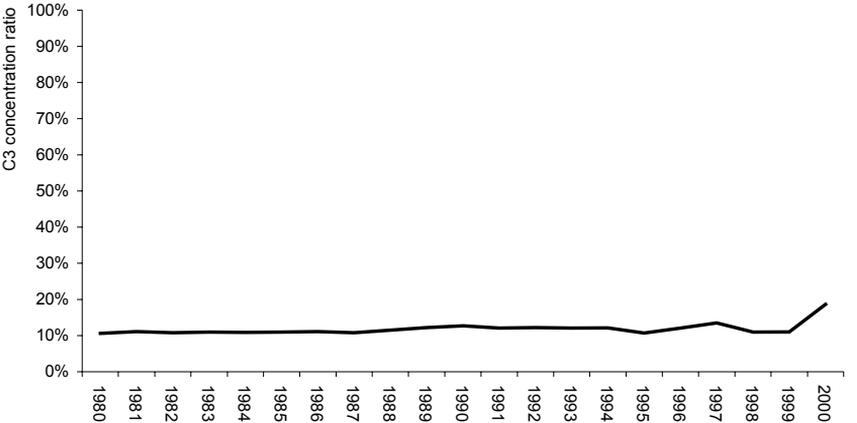
<sup>1</sup> Nissan Life Insurance (April 1997), Sanyo Securities (November 1997), Hokkaido Takushoku Bank (November 1997) and Yamaichi Securities (November 1997).

the financial system. In March 1998, all major banks experienced difficulties in meeting the capital requirement and applied for public capital injections. Besides that, authorities relaxed the accounting rules for tier 2 capital, allowing banks to count 45% of their re-valued real estate holdings as tier 2 capital, and change the accounting basis for equity securities held for investment purposes. Also in 1998, the Financial Supervisory Agency (FSA) was established in June 1998 to take over the supervision of banks from the Ministry of Finance and other regulatory bodies. In October 1998, the Diet passed the Financial Revitalization Law and the Financial Early Strengthening Law, and amended the Deposit Insurance Law to provide a broad framework for the resolution of the banking problems, to be overseen by a Financial Revitalization Committee. The amount of government funds set aside for the strengthening of the banking sector was doubled to 60 trillion Yen, 12% of GDP.

*Market power and concentration*

Compared to other countries, the Japanese banking market has not been highly concentrated. In the deposit market, 20 major Japanese banks accounted for 42% of total deposits. On the other hand, the Japanese capital markets had a oligopolistic character dominated by four securities companies. Entry in the financial markets has been relatively restricted in the past and foreign competition did not have a significant effect in changing the market structure. So Japanese banks had a stable and segmented home market (Arora, 1995, p. 182).

Figure 18.1. *Share of largest three banks in Japan, percentage total assets*



Note: assets three largest banks as % total banking assets. Source largest three banks: The Banker Top 1000, 500, issues 1981-2001. Source total banking assets: broadest measure banking assets in OECD Bank profitability database ("All banks").

Consolidation in the Japanese banking sector was triggered by the fall in stock prices and real estate values. Bank of Tokyo and Mitsubishi bank were the first major

banks to merge in 1996, generally viewed as a far sighted move.<sup>2</sup> The pace of consolidation increased a few years later when on August 20 1999, DKB, Fuji and IBJ announced that they would integrate their businesses into a bank holding company. While the setting up of the holding company was planned for 2000, the actual merger would take place in 2002.<sup>3</sup> The merger was received with skepticism, pointing out the low goals in cost cutting and the lack of a clear leader in the merger organization, creating a slow decision process. In October 14, 1999, Sakura and Sumitomo announced an agreement to a merger of equals by 2002. This announcement was significant in the sense that the keiretsu structure no longer seemed to be a barrier to merge.<sup>4</sup>

### *Cost of capital*

Since the 1970s, Japanese banks have maintained lower equity ratios than their competitors in other countries. The cost of capital advantage is mentioned as one of the main considerations for the Japanese financial institutions' success and aggressive behavior in the 1980s (Arora, 1995, p. 189). The relatively high price earnings ratio of Japanese banks, the low dividend rate and the high credit ratings allowed them to attract international interbank market funds at cheaper rates in the 1980s. As a consequence, Japanese banks could more aggressively enter Eurobond markets, and gained market share quickly. The capital and reserves of Japanese banks remained, compared to other banks, low throughout the period. At the end of the 1980s, the cost of capital advantage became less important (Arora, 1995, pp. 191-193):

- The capital adequacy guidelines required all internationally active banks to raise their capital ratio to 8% of their risk weighted assets. Among others, these guidelines were intended to level the playing field with Japanese banks, by denting the cost of capital advantage.
- The fall of the Japanese stock market hit the Japanese banks in two ways: the value of its investments declined, lowering the value of its Tier 2 capital, while the declining stock market made it more difficult to raise fresh funds to shore up the capital.
- Due to deregulation, funding costs and market rates became closer aligned, having adverse effects on the funding costs of the banks in 1989-1991 when the Bank of Japan raised interest rates to counter the stock market and property speculation bubble.

From 1997, the so called Japan premium existed: additional cost which Japanese banks had to pay to raise funds in foreign markets compared to US and European competitors. This hastened the retreat of Japanese banks from the foreign markets. By

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<sup>2</sup> Wadle, J. & Yabutani, K. (2000, March 10). *The Japanese Banking Industry*. J.P. Morgan (Tokyo), p. 51.

<sup>3</sup> Wadle, J. & Yabutani, K. (2000, March 10). *The Japanese Banking Industry*. J.P. Morgan (Tokyo), p. 29.

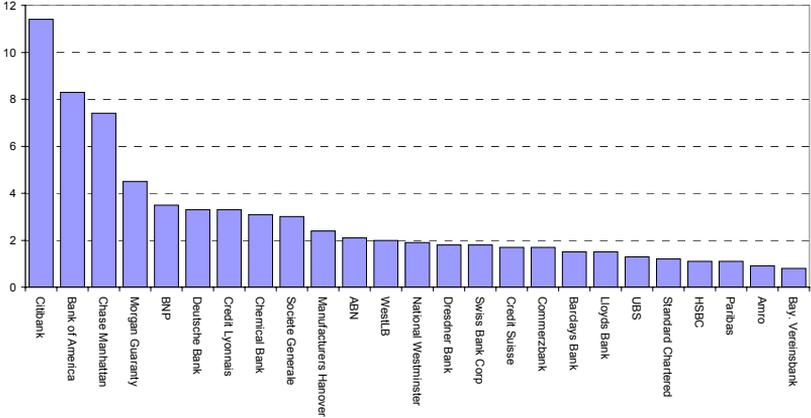
<sup>4</sup> Wadle, J. & Yabutani, K. (2000, March 10). *The Japanese Banking Industry*. J.P. Morgan (Tokyo), p. 29.

2000 this premium disappeared, and Japanese banks hoped to re-establish a presence in Asia.<sup>5</sup>

**18.2. Foreign banks**

In the 1980s, Japanese authorities subjected applications for foreign bank entry on a case-by-case authorization, usually granted on the basis of authority. Also, participations in domestic banks was permitted up to 5% under the Anti-Monopoly Act (Pecchioli, 1983, p. 185). The deposit insurance scheme, introduced in 1971, did not apply for branches of foreign banks (Pecchioli, 1987, p. 272). The foreign banks were mainly engaged in medium term foreign currency loans to major Japanese corporations, short term yen loans and foreign exchange.<sup>6</sup> By 1980, the European and American banks had established a presence in Japan, except for the Spanish banks. The number of foreign banks had increased to 64 in 1980 from 18 in 1970, in anticipation of a liberalization and internationalization of the Japanese banking market. The use of the yen as an international currency was expected to increase, boosted among others by years of current account surpluses.<sup>7</sup> The liberalization did not materialize, and their share in the yen loan market remained relatively low at 3.5%. An increased number of competitors, and a higher cost of funds (being unable to collect public deposits) led to intensified competition, where the traditional dominance of American banks was challenged by European banks in the 1970s<sup>8</sup>.

Figure 18.2. Foreign banks in Japan, asset share of total foreign banking assets, 31/3/1980



Source: The Banker, August 1981, p. 109

<sup>5</sup> Tett, G. & Silverman, G. (2000, August 4). Japanese banks tiptoe back overseas. *Financial Times*, p. 17.

<sup>6</sup> Johnston, R. (1977, September). Foreign banks in Japan. *The Banker*, pp. 119-125.

<sup>7</sup> Haymai, M. (1979, March). Japan's role in the international financial community. *The Banker*, pp. 55-57.

<sup>8</sup> Komaki, R. (1981, August). Foreign banks: patience please. *The Banker*, pp. 105-109.

Permission was not easily granted, and could lead to highly political discussions as Barclays found out in 1990 when its investment banking subsidiary BZW applied for a seat at the Tokyo Stock Exchange, which was only granted after the British government interfered.<sup>9</sup> As the Japanese banking crisis progressed confidence in Japanese banks, which not so many years ago occupied most of the top spots in world rankings, fell so severely that in the fourth quarter of 1997 depositors shifted nearly 15 billion US dollar in deposits from them to foreign banks (OECD, 1998, p. 130).

At the end of the 1990s, foreign banks were allowed to acquire Japanese banks. The Japanese government announced in 1999 that it planned to turn over control of bankrupt Long Term Credit Bank of Japan (LTCB) to a group of American investors led by Ripplewood Holdings. The takeover of LTCB<sup>10</sup> was generally considered to be a test case for whether “American-style, bottom-line-focused capitalists can transform an unprofitable Japanese bank long stuck in low-margin lending”.<sup>11</sup> United States broker securities house Merrill Lynch purchased the assets of failed Japanese broker Yamaichi Securities, Japan’s fourth largest broker, and Salomon Smith Barney, the investment bank of Citigroup, took a 25 percent stake in Nikko Securities, also merging their wholesale operations in a joint venture with Nikko.<sup>12</sup>

The long awaited financial liberalization brought mixed blessings for the foreign banks. The Securities and Exchange Surveillance Commissions (SESC) and the Financial Supervisory Agency (FSA) began to scrutinize the securities units of the foreign banks. Credit Suisse’s derivatives unit was closed in 1999 after the FSA found that the bank had been helping Japanese clients to change their balance sheets via accounting loopholes. Deutsche Bank was fined in May 2000 for helping clients to hide losses; UBS Warburg and WestLB did not escape inspection either.<sup>13</sup> In defense, it was argued by commentators that this had been common practice in the 1990s when assets fell, and Japanese firms preferred a foreign bank to their house bank, because they were considered to be more anonymous than Japanese banks.<sup>14</sup> Aside from interpreting this as a backlash against the growing presence of foreign banks in Japan, a lot of foreign banks operated a universal banking model, whereas Japanese banks did not, introducing additional complexity which the FSA had to adjust to.<sup>15</sup>

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<sup>9</sup> *Financial Times* (1990, March 6), p. 33.

<sup>10</sup> The Japanese government planned to retain a 33% stake at the time.

<sup>11</sup> Landers, P. (1999, September 29). Foreigners to Take Over Japan’s LTCB. *Wall Street Journal*

<sup>12</sup> Tett, G. (1999, September 19). Survey foreign investment in Japan: New invasion turns the tables. *Financial Times*, p. 11

<sup>13</sup> Ibison, D. & Tett, G. (2000, December 5). Japan boosts scrutiny of foreign bank. *Financial Times*, p. 25.

<sup>14</sup> Tett, G. & Nakamae, N. (1999, May 21). Tokyo turns against its ‘friendly’ foreign banks. *Financial Times*, p. 4.

<sup>15</sup> Rafferty, K. (2000, August). Playing a whole new ball game. *Euromoney*, pp. 32-35.

### 18.3. Case studies

The internationalization activities of the following Japanese banks are investigated: IBJ (1980-2000), Sumitomo (1980-2000), Bank of Tokyo (1980-1995), Mitsubishi bank (1980-1995), Bank of Tokyo Mitsubishi, the merger combination of Bank of Tokyo and Mitsubishi (1995-2000) and Dai-Ichi Kangyo Bank (1980-2000). In 1999, a merger was announced between Dai-Ichi Kangyo Bank and IBJ into Mizuho, together with Fuji. Throughout 2000, the banks continued to operate independently so Mizuho has not been considered separately.

#### 18.3.1. IBJ

The Industrial Bank of Japan (IBJ), "almost exclusively a banker to industry"<sup>16</sup>, received permission in 1971 to establish overseas branches to serve the foreign operations of its clients. In 1972, the Industriebank von Japan was founded in Germany, and a year later Luxembourg operations were started, mainly focusing on investment fund management services. In the 1980s, IBJ was confronted with reduced loan demand. Receding economic activity after the oil price hike in 1979 contributed to reduced loan demand, but also disintermediation when corporate bonds became increasingly popular to raise funds instead of bank credit. IBJ began to diversify, starting to issue Eurobonds and buying New York based merchant bank J. Henry Schroder Bank & Trust in 1985. A year later, it bought through a subsidiary Aubrey G. Lanston Company, a primary dealer in US Treasuries. In 1990, it formed the Bridgeford Group to focus on mergers and acquisitions.<sup>17</sup>

IBJ expanded activities in the United States in 1974 with the establishment of New York based IBJ Trust company, offering trust services to multinational companies.<sup>18</sup> By 1993, the bank employed 1,300 staff in the United States in 9 major cities, owning 38 billion US dollar of American assets.<sup>19</sup>

In the early 1990s, IBJ expanded in Europe by setting up branches in Paris, London, Madrid and Milan, also offering a broad range of universal banking services in Germany, Luxembourg and Switzerland. Specialized activities such as project finance or aircraft finance were handled from London. Its international network remained modestly sized, with 25 branches in Japan and 25 foreign branches and offices. Compared to its European and American activities, its presence in the home region seemed relatively modest.

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<sup>16</sup> The Industrial Bank of Japan, Ltd. In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 300

<sup>17</sup> History of IBJ. (n.d.). Retrieved April 27 2003, from [www.hoovers.com](http://www.hoovers.com)

<sup>18</sup> IBJ (1993). *Annual report*, p. 8

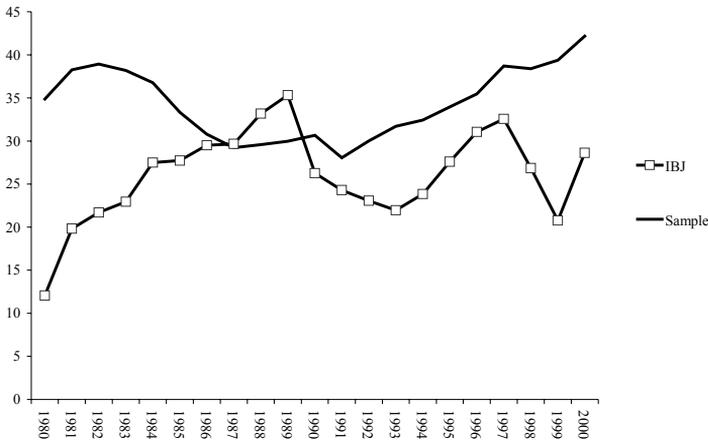
<sup>19</sup> IBJ (1993). *Annual report*, p. 8

Table 18.3. *Activities Industrial Bank of Japan*

Period	Phase	Objective	Arena	Client	Product	Organizational form															
						Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset managment	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
80-91	Broad expansion	1. Maintain domestic market position	Domestic																		
		2. Expand worldwide network	Major financial and economic centers																		
		3. Expand presence in United States	United States																		
92-98	Restructuring, refocus (1)	1. Restructure domestic activities, diversification banking services	Domestic																		
		2. Increase branch network in Europe	Major financial and economic centers, Europe																		
99-00	Restructuring, refocus (2)	1. Increase domestic market position, merging into Mizuho	Domestic																		

In 1990, IBJ stumbled among a domestic banking scandal, lending over 1.8 billion US dollar to a fraudulent restaurant owner; personal relationships between bank management and client may have been to blame. Having lent its share to the Japanese mortgage companies (*Jusen*), IBJ found itself in an earnings squeeze from 1991 onwards, when its earnings were at an all-time high. In 1996 it reported a loss, writing down 37% of its bad loans. The following years provided little relief, when Asian markets protracted with the financial crisis and one of IBJ’s managing directors was involved in a bribery scandal. To counter the negative effects of declining banking and brokerage markets, IBJ and broker Nomura Securities agreed in 1998 to form two joint ventures.

Figure 18.3. *TNI Industrial Bank of Japan, 1980-2000*



In 1999 IBJ was one of 15 major banks to benefit from the governments bank reform fund, to coach the banks back to financial health. In that year IBJ agreed to a three-way merger with Fuji Bank and Dai-Ichi Kangyo Bank. In 2000 the banks combined under Mizuho Holdings, the world’s largest banking company, to cut costs.

18.3.2. Sumitomo

Sumitomo Bank became internationally active again in the 1950s, re-establishing presence in New York and London.<sup>20</sup> In 1971, a Düsseldorf branch was opened, close to Japanese manufacturing investment in that region. In the 1970s it set up activities in Switzerland. For the next decade, the bank would set up branches in the major financial centres, specializing on capital market activities. To this end an international banking division was formed in 1979.<sup>21</sup> In 1984 it acquired a controlling stake in Swiss Banca del Gottardo. Being the first Japanese bank to buy a European bank, Sumitomo used its Swiss bank to lead-manage international bond issues in Switzerland for Japanese borrowers, and developed a private banking business for Italian-speaking customers.<sup>22</sup> In 1986 the bank acquired Heiwa Sogo Bank. Between 1988 and 1990, it further built up its activities in Europe, opening a Frankfurt and Paris branch (1988), an Italian subsidiary (1988) and an Irish finance company (1989). Its shares were listed on the London Stock Exchange from October 1986.<sup>23</sup> From the 1980s, Sumitomo increased financing for non-Japanese corporations while gradually reducing lending to foreign national governments. Large scale projects in, real estate, aircraft, and public work projects were spearheaded.<sup>24</sup>

Table 18.4. *Activities Sumitomo Bank*

Period	Phase	Objective	Arena	Client				Product				Organizational form					
				Government	Institutional	Corporate	Private	Credit	Securities	Asset management	Insurance	Services	Joint venture	Fin. Part	Acquisition	Greenfield	Merger
'80-'91	Broad expansion	1. Build worldwide branch network to service clients	Europe, United States, South East Asia, Brazil	■	■	■		■	■	■				■	■	■	
		2. Shift lending from government to firms	Foreign banking organization	■	■	■		■		■							
		3. Expand capital market activities	United Kingdom, United States	■	■	■		■	■	■				■	■	■	
'92-'97	Restructuring, refocus	1. Restructure domestic banking activities	Domestic		■	■	■		■	■	■						
		2. Maintain foreign branch network	Major financial and economic centers		■	■			■	■	■						
'98-'00	Restructuring, exit	1. Restructure domestic bank activities, plan merger with Sakura	Domestic													■	
		2. Divest foreign activities and financial participations	Europe, United States, major financial centers		■	■			■	■	■						■

The United States market had been targeted in 1972, when it reopened its San Francisco branch.<sup>25</sup> Branches were added in Chicago (1974), Houston (1986), Atlanta

<sup>20</sup> The founding years for the branches and subsidiaries have been taken from Sumitomo Bank (1995), *Annual report, section "A century of experience"*.

<sup>21</sup> Sumitomo Bank. (1990). *Annual report*, p. 6.

<sup>22</sup> Hall, W. (1999, January 11). Sumitomo might sell Banca del Gottarda stake. *Financial Times*.

<sup>23</sup> *History of Sumitomo Mitsui Banking Corporation* (n.d.) Retrieved April 23, 2003, from [http://www.smbc.co.jp/aboutus/English/profile/history\\_p.html](http://www.smbc.co.jp/aboutus/English/profile/history_p.html).

<sup>24</sup> Sumitomo Bank. (1990). *Annual report*, p. 6.

<sup>25</sup> In 1916 the bank opened its first foreign branch in San Francisco.

(1987) and Los Angeles (1988). Retail banking was conducted through the Sumitomo Bank of California, with 46 branches in 1980 and its affiliate Central Bank in Hawaii, with 15 branches in 1980.<sup>26</sup> Capital market activities expanded in earnest in 1986 when Sumitomo took an equity stake in American investment bank Goldman Sachs & Co. and set up trust and securities companies in New York. In the same year, a joint venture with Bankers Trust Company was set up.<sup>27</sup> In 1990 the bank set up additional companies for securities and investment banking in New York.

The Asian market was serviced with opening a Singapore branch in 1973 and a Seoul branch in 1982; a Hong Kong branch was already established in 1962. Then for almost a decade, attention reverted to Europe and the United States. In 1992 it opened a branch in Chinese Guangzhou, setting up a Singapore merchant bank in the same year. In 1993, it established an Bangkok International Banking Facility, and opened a branch in Indonesian Labuan on the Java island. The next year a branch in Shanghai was opened. In the other emerging markets, Sumitomo had set up Brazilian Banco Sumitomo Brasileiro in 1958<sup>28</sup>, having grown to 4 branches in 1980.<sup>29</sup>

Figure 18.4. *TNI Sumitomo Bank, 1980-2000*



The financial problems Japanese banks faced also hit Sumitomo. To save costs, Sumitomo and Daiwa Securities had formed a joint venture with Sumitomo taking a 40% stake, where Daiwa brought in its nine securities subsidiaries, mainly located in Europe

<sup>26</sup> Sumitomo Bank. (1981). *Annual report*, p. 15.

<sup>27</sup> Sumigin Bankers Investment Management Co., Ltd. Source: Sumitomo Bank (1990). *Annual report*, p. 7, section "What activity? Where?".

<sup>28</sup> Sumitomo Bank (1995). *Annual report 1995*, section "A century of experience".

<sup>29</sup> Sumitomo Bank (1981). *Annual report*, p. 15.

and South East Asia.<sup>30</sup> To raise capital, Sumitomo announced the sale of some of its shareholdings in related companies as part of the country's financial reforms.<sup>31</sup> Also, Sumitomo considered the sale of its 54% stake in Banca del Gottarda, partly prompted by the trend that Japanese groups had been borrowing less in Switzerland and other Japanese banks cut back their international business to cope with their domestic problems, reducing the importance of the Swiss bank for Sumitomo.<sup>32</sup>

The announcement of the three way merger between Dai-Ichi Kangyo, IBJ and Fuji prompted the announcement in October 1999 that Sumitomo and Sakura, two of Japan's largest banks would merge in 2002. Although Sakura had a strong domestic retail bank, it became financially weakened due to its bad loans. Sumitomo on the other hand was considered to be one of Japan's strongest banks, and assumed to be the dominant partner in the merger.<sup>33</sup> One trigger for the merger had been the denied request to recapitalize Sakura bank by its keiretsu partners, suggesting weakening ties between the industrial groups.<sup>34</sup> Both banks argued that the merger would prepare them to face foreign competition introduced under the financial deregulation since 1996, and help them cut costs.<sup>35</sup> Additional capital amounting to 1.26 billion US dollar was raised in 2000 with the partial sale of Sumitomo's stake in Goldman Sachs & Co, reducing it from 6.3% to 3.6%, but still remaining the investment bank's largest institutional shareholder.<sup>36</sup>

### 18.3.3. Bank of Tokyo

The Bank of Tokyo was established in 1946 as a specialized bank to finance foreign trade, created by transferring domestic assets of the Yokohama Specie Bank in 1945 (Born, 1983, p. 311). The Bank of Tokyo alone kept more than 50% of the total number of foreign offices established by Japanese banks up to 1969 (Haga, 2002, p. 2). Limited in its domestic operations by regulators, Bank of Tokyo changed into an investment bank in the 1970s. Its reputation as Japan's leading foreign exchange bank attracted international clients; derivatives trading and foreign banking branches were set up. Throughout the next decades, it would have a limited branch network in Japan (mainly offices in Japanese ports) but an extensive foreign network. In 1993, the numbers of domestic branches were 38 compared to 400 overseas.<sup>37</sup>

Bank of Tokyo established in 1968 Banque Européenne de Tokyo, founded as a wholly owned subsidiary where between 1970 and 1974 other Japanese banks became

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<sup>30</sup> The Sumitomo Bank (1999, July). *The Integration of the Overseas Subsidiaries of the Daiwa Securities Group into Daiwa SB Capital Markets Co. Ltd., an affiliate of The Sumitomo Bank, Limited*. Retrieved April 23, 2003, from [http://smbc.co.jp/news\\_e/news\\_back/enews\\_sumi/e19990719\\_01.html](http://smbc.co.jp/news_e/news_back/enews_sumi/e19990719_01.html).

<sup>31</sup> Tett, G. & Nakamae, N. (1999, March 16). Fuji and Sumitomo banks to cut cross-shareholdings. *Financial Times*.

<sup>32</sup> Hall, W. (1999, January 11). Sumitomo might sell Banca del Gottarda stake. *Financial Times*.

<sup>33</sup> Nakamae, N. & Tett, G. (1999, October 15). Japanese banks join merger rush. *Financial Times*, p. 17.

<sup>34</sup> Van der Lugt, H. (1999, October 15). Bankfusie Japan breuk met traditie. *NRC Handelsblad*, p. 15.

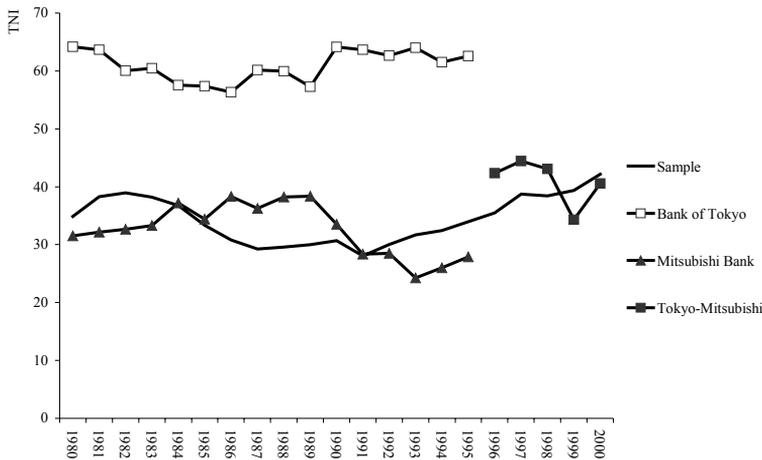
<sup>35</sup> Landers, P. (1999, October 15). Sumitomo, Sakura to Join Forces. *Wall Street Journal Europe*, p. 13.

<sup>36</sup> Bream, R. (2000, August 3). Sumitomo sells more than \$1bn of stock in Goldman. *Financial Times*, p. 15.

<sup>37</sup> Hulme, D. (1994, June). International Banking King Rules Again. *Asian Business*, p. 60.

shareholder. Similar to the consortium banks in London, it engaged in medium term lending similar to the consortium banks in London where it was a 22.5% shareholder in the Western American Bank since 1972. By 1980, Bank of Tokyo became sole owner, and integrated it with its Paris operation where the other Japanese banks had withdrawn (Roberts and Armander, 2001, p. 283, 287).

Figure 18.5. *TNI Bank of Tokyo, Mitsubishi Bank, and Bank of Tokyo-Mitsubishi*



The international flagship of Japanese banks established agencies in California and New York from 1952; the Bank of Tokyo acquired in 1975 Southern Californian First National Bank of San Diego, renaming it California First Bank. The bank was in receivership when the Bank of Tokyo took control over it. In 1988, California First acquired Union Bank from Standard Chartered, which bought the bank in 1979. California first was retail oriented, while Union bank was more corporate based. In 1983, Union Bank bought eighteen branches from Bank of California (Tschoegl, 2000).

Table 18.5. *Activities Bank of Tokyo*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Asset management	Securities	Services	Insurance	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
80-89	Broad expansion	1. Maintain domestic market position	Domestic																	
		2. Expand capital market activities	Major financial and economic centers																	
		3. Increase retail bank network in United States	United States																	
90-95	Consolidation	1. Expand banking activities in the United States	Domestic																	
		2. Expand banking activities in South East Asia	Domestic																	

From the late 1980s the bank targeted the United States and South East Asia for its future loan growth. For the United States, Bank of Tokyo had built a sizeable presence in California. In the wake of the deregulation of interstate banking, Bank of Tokyo believed its position to be better than other Japanese banks, lacking the traditional ties banks such as Mitsubishi and Sumitomo had to major Japanese companies.<sup>38</sup> Expansion in South East Asia was considered to be attractive because of the strong economic growth figures in that region. An important leverage here was the fact the Bank of Tokyo acted as agent for Japanese official development assistance loans made by the Overseas Economic Cooperation Fund and grants made by the Ministry of Foreign Affairs, helping it to penetrate markets beyond its network.<sup>39</sup> In 1993, Bank of Tokyo established a Taiwan branch to start banking and foreign exchange operations, becoming the first bank to start activities in Taiwan after Japan severed ties with Taiwan in 1972.<sup>40</sup> The Bank of Tokyo had lent substantial amounts to Brazil in the 1970s; when the LDC crises started in the early 1980s, the bank actively participated in the renegotiation of the problem loans rather than writing them off.<sup>41</sup>

Table 18.6. *LDC Exposure selected Japanese Banks, 30/9/1990*

Bank	LDC debt exposure, Billion Japanese Yen	As percentage of capital
Bank of Tokyo	502.2	62.8
Sumitomo Bank	299.4	15.0
Mitsubishi Bank	224.8	14.6
Dai-Ichi Kangyo Bank	247.4	13.8

Source: taken from table compiled by James Capel, quoted in Anthony Rowley, *International dowry*, *Far Eastern Economic Review*, 11 April 1991, pp. 46-47

In the early 1990s merger speculation around Bank of Tokyo intensified, as a result of its large LDC debt. Where other Japanese banks had accumulated loans amounting to no more than one-fifth of capital and reserves, Bank of Tokyo had an exposure three times as high (Table 18.6) forcing the bank to take large provisions. This was a progression from 1987 however, when the bank's exposure was nearly one and a half times its capital base. The arrival of the Brady plan, swapping LDC debt for US government backed loans, and the strong appreciation of the Japanese Yen, reducing the relative value of the exposure, alleviated some the problems.<sup>42</sup>

<sup>38</sup> Rowley, A. (1991, April 11). *International dowry*. *Far Eastern Economic Review*, pp. 46-47

<sup>39</sup> Rowley, A. (1991, April 11). *International dowry*, *Far Eastern Economic Review*, p. 47

<sup>40</sup> Terazono, E. (1993, March 3). Bank of Tokyo to set up Taiwan branch. *Financial Times*, p. 26

<sup>41</sup> Bank of Tokyo (1988). In Grant, E.T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 225

<sup>42</sup> Hulme, D. (1994, June). *International Banking King Rules Again*. *Asian Business*, p. 60.

#### 18.3.4. Mitsubishi Bank

The Mitsubishi Bank is one of many companies that originated as a division of the Mitsubishi trading conglomerate, split into independent companies after the Second World War.<sup>43</sup> During the 1950s and 1960s, the bank was an important factor in the rapid growth of the Japanese economy. Its financing activities were primarily directed to the Mitsubishi industrial and trading companies, for which it acted as a house bank. It also did extensive business outside the Mitsubishi group.<sup>44</sup> In the 1960s Mitsubishi followed its Mitsubishi partners overseas, to help finance growing international trade. The bank opened offices in Los Angeles, Paris and Seoul. The bank followed its corporate clients to both export and resource markets, financing and participating in the production and distribution of their products.<sup>45</sup>

Mitsubishi bank found more growth opportunities in corporate banking; retail banking was a low priority for the bank. Mitsubishi was prohibited from certain foreign exchange activities, as well as specific long-term and securities underwriting services (Roberts and Arnander, 2001, p. 320). To circumvent this, Mitsubishi formed the Japan International Bank in London in 1970 together with Sumitomo Bank and four other Japanese banks and securities houses (Roberts and Arnander, 2001, p. 264). The bank's emphasis was on medium-to longer-term Eurocurrency lending, deposits and underwriting Euro-securities. Mitsubishi bank also acquired a stake in Orion bank and Libra Bank (the Latin American consortium as a spin off from Orion Bank) in 1972. By the 1980s the bank was present in all major financial centers.<sup>46</sup>

Mitsubishi established the Mitsubishi Bank of California in 1972; in 1976 it acquired Hacienda bank and in 1984 Bank of California was bought (Tschoegl, 2000). By 1990, the Bank of California had 60 branches in the United States and more than 22% of Mitsubishi banks employees were located in the United States. Acknowledging its importance, management established North American headquarters in January 1989.<sup>47</sup> During the 1980s, the bank was minimally exposed to the LDC crisis and subsequent rescheduling problems that followed, with the bank run as a very conservative operation. New management in 1986 made an effort to transform Mitsubishi into a universal and international bank, creating five groups in the banks: international, merchant, corporate, national banking and capital markets. The banks reorganized New York-based trust and banking subsidiary, previously part of their Californian bank.<sup>48</sup>

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<sup>43</sup> The Mitsubishi Bank, Ltd., (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 321.

<sup>44</sup> The bank has been part of the Mitsubishi group, in 1990 a group with 25 companies also known as keiretsu. There are many small shareholdings in each other companies, and frequent organized meetings of their chairman, but no legal form of affiliation (Mitsubishi Bank, 1990, *20 F filing*, p. 52).

<sup>45</sup> The Mitsubishi Bank, Ltd., (1988) In Grant, E. T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 321

<sup>46</sup> Mitsubishi Bank (1980). *Annual report 1980*, p. 32, "Expansion in Mitsubishi Bank Overseas Facilities"

<sup>47</sup> Mitsubishi bank (1990). *20 F filing 1990*, pp. 58-59.

<sup>48</sup> The Mitsubishi Bank, Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories*, vol. 2, p. 321

Table 18.7. *Activities Mitsubishi bank*

Period	Phase	Objective	Arena	Client					Product					Organizational form				
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset management	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield
'80-'87	Broad expansion	1. Maintain domestic market position	Domestic															
		2. Expand worldwide network	Major financial and economic centers															
		3. Expand commercial banking activities in United States	United States															
'88-'95	Restructuring, refocus	1. Increase domestic market position, acquisition of Nippon Trust Bank (1994)	Domestic															
		2. Diversification of domestic banking activities	Domestic															
		3. Maintain foreign banking network	Whole organization															

When the strong rise of domestic equity and real estate prices collapsed from 1989 onwards, Mitsubishi had a lower than average of non-performing loans to total assets into the mid 1990s, staying away from speculative property loans. In 1994, the bank acquired a majority control in Nippon Trust Bank when the Ministry of Finance urged Mitsubishi to bail Nippon out. Mitsubishi raised its stake in Nippon to 69%, assuming a sizeable amount of unrecoverable loans (Mitsubishi would eventually merge with Nippon in 2000). In return, the Ministry of Finance allowed Mitsubishi to begin issuing debt before other Japanese banks.<sup>49</sup>

### 18.3.5. Bank of Tokyo Mitsubishi

In March 1995, Bank of Tokyo and Mitsubishi Bank announced their merger. Before that, there was a trend towards consolidation in the Japanese banking market from a defensive perspective, usually involving the financial rescue of a weaker financial institution by a stronger one at the behest of the Ministry of Finance. This merger differed in that respect: the two banks were among the best capitalized banks with high profitability, and had the least bad loans of the large Japanese banks.<sup>50</sup> Mitsubishi bank's strength was in retail and corporate banking activities in the domestic market, while the Bank of Tokyo was focused on foreign banking activities. The merger was effectuated the next year with Mitsubishi as the surviving entity, the renamed Bank of Tokyo-Mitsubishi became at the time the largest bank in the world with total assets of 701 billion US dollar, 40% larger than its nearest

<sup>49</sup> *History of Tokyo Mitsubishi*. Consulted April 27, 2003, from www.hoovers.com

<sup>50</sup> Baker, G. (1995, March 29). Size isn't everything: The significance of the Japanese bank merger lies in its implications for the financial system. *Financial Times*, p. 19

rival.<sup>51</sup> Because of its relative small overlap, merger savings were relatively small. By the time the two banks merged, Bank of Tokyo had 363 foreign offices, and only 37 in Japan.<sup>52</sup> In the United States, their Californian banks merged into Union Bank of California (UnionBalCal).

Table 18.8. *Activities Bank of Tokyo-Mitsubishi*

Period	Phase	Objective	Arena	Client					Product			Organizational form								
				Government	Institutional	Corporate	Retail	Private	Credit	Securities	Asset managment	Insurance	Services	Alliance	Joint venture	Part	Acquisition	Greenfield	Merger	Divestiture
96-'00	Restructuring, refocus & exit	1. Restructure bank organization after falling profitability	Whole organization																	
		2. Restructure foreign branch network	Major financial and economic centers																	
		3. Divest part of commercial bank activities	United States																	

In 1998 Bank of Tokyo Mitsubishi was fined for bribing officials of the Japanese Ministry of Finance, and posted a record loss after taking a 8.4 billion US dollar provision for bad loans.<sup>53</sup> Losses continued, and management responded by restructuring, shedding staff and branches and selling part of UnionBanCal. To stand to gain by the deregulation of financial services, Bank of Tokyo Mitsubishi announced among others a partnership with US Lehman Brothers for investment banking. In 2000 it announced plans to form a financial group with Mitsubishi Trust Bank and Nippon Trust Bank.

### 18.3.6. Dai-Ichi Kangyo Bank

Dai-Ichi Kangyo Bank (DKB) became for a while the world's largest bank in terms of assets in the mid-1980s. The bank was the result of a government sponsored merger in 1971, combining Dai-Ichi and Nippon Kangyo Bank. This created the country's largest bank, partly as a reaction to American banks who in the 1960s moved into Japan and gradually gained market share in the Japanese lending market.<sup>54</sup> The merger created a strict balance of power between the former bank executives, slowing growth of the bank, especially outside Japan.<sup>55</sup> In the 1960s DKB further developed banking activities in Taiwan.<sup>56</sup> DKB's competitors avoided setting up activities in Taiwan, in an effort to win

<sup>51</sup> Bank of Tokyo-Mitsubishi Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories*, vol. 35, p. 43.

<sup>52</sup> *History of Tokyo Mitsubishi*. Consulted April 27, 2003, from www.hoovers.com

<sup>53</sup> *History of Tokyo Mitsubishi*. Consulted April 27, 2003, from www.hoovers.com

<sup>54</sup> The Dai-Ichi Kangyo Bank Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories* (1988), vol 2, p. 273

<sup>55</sup> *History of Dai Ichi Kangyo Bank*. Retrieved April 27, 2003, from www.hoovers.com

<sup>56</sup> DKB first started its banking activities in Taipei in 1959. Source: Terazono, E.(1993, March 3). Bank of Tokyo to set up Taiwan branch. *Financial Times*, p. 26

favor with the mainland Chinese. DKB on the other hand set up activities in Taiwan, assuming that dual contacts would be an asset with possible reunification between Taiwan and China. Also controversially, the bank assisted foreign firms entering the Japanese markets<sup>57</sup>.

In general, the foreign expansion of DKB was export led, setting up branches. The bank did not favor acquiring foreign banks, "believing that existing operations often came with unwanted obligations".<sup>58</sup> A major exception took place in 1980, when DKB purchased the Japan-California Bank. The bank entered capital markets in the United States relatively late, when it started its own company in 1986 (the Dai-Ichi Kangyo Trust Company) by purchasing 125 million US dollar in corporate loans from a New York based bank.<sup>59</sup> By 1986, the bank had surpassed Citicorp as the largest bank in assets, owing much to the appreciation of the Yen relative to the US dollar. Its international operations also expanded; the bank opened a representative office in India<sup>60</sup> and by 1987 the bank had established a New York securities subsidiary, an investment consultancy in London and a subsidiary in Hong Kong.

Table 18.9. *Activities Dai-Ichi Kangyo Bank*

Period	Phase	Objective	Arena	Client				Product			Organizational form									
				Government	Institutional	Corporate	Retail	Private	Credit	Asset mangmt	Securities	Insurance	Services	Alliance	Joint venture	Fin. Part	Acquisition	Greenfield	Merger	Divestiture
'80-'92	Broad expansion	1. Build worldwide network for capital market activities and to service client	Major financial centers and economic centers	■	■	■	■	■	■	■			■	■	■					
		2. Maintain commercial bank network	Domestic	■	■	■	■	■	■	■										
		3. Acquire commercial bank and finance activities in United States	Domestic		■	■	■	■	■	■					■	■				
'93-'96	Consolidation	1. Restructure organization to regain profitability	Whole organization																	
		2. Set up commercial banking activities in South East Asia	South East Asia		■	■	■											■		
97-'00	Restructuring, refocus & exit	1. Diversification of banking activities	Domestic		■		■			■	■	■		■						
		2. Merger with IBI and Fuji into Mizuho to restructure bad loans	Domestic																■	
		3. Divest banking/finance activities in the United States to raise capital	United States																	■

<sup>57</sup> The Dai-Ichi Kangyo Bank Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories* (1988), vol 2, p. 274

<sup>58</sup> The Dai-Ichi Kangyo Bank Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories* (1988), vol 2, p. 274

<sup>59</sup> The Dai-Ichi Kangyo Bank Ltd. (1988). In Grant, E. T. (Ed.), *International Directory of Company Histories* (1988), vol 2, p. 274

<sup>60</sup> Murthy, R. (1993 January 12). International Capital Markets: Dai-Ichi shuts Bombay office. *Financial Times*, p. 25

Compared to IBJ or Sumitomo, DKB was relatively well represented in the Japanese retail banking market, where it had 363 branches in all 47 of Japan's prefectures, the biggest network of any Japanese commercial bank and one of the highest concentrations in the heavily populated Tokyo area.<sup>61</sup> DKB participated in the property and lending boom of the 1980s, leaving the bank in the early 1990s with bad loans and devalued assets. DKB tried to offset reduced lending to business by targeting consumer business, but then Japanese families suffered a crisis of confidence.<sup>62</sup>

In response to the difficult domestic situation, DKB restructured its foreign banking activities in 1993, shutting down its Indian operations. DKB further targeted new foreign markets, established offices in Indonesia and China, and strengthened its foreign activities to attract new local business rather than foreign business of Japanese clients. In anticipation of the Japanese program of financial reform, DKB divested a part of its non performing loans and posted its first-ever loss in 1997. In that year, the bank suffered additional problems when top executives resigned in light of a payoff scandal linking DKB to racketeers.<sup>63</sup>

Figure 18.6. *TNI Dai-Ichi Kangyo Bank, 1980-2000*



In 1989, the bank had paid 1.28 billion US dollar to acquire control of CIT, a United States based commercial financing subsidiary, from Manufacturers Hanover who needed to raise capital. Similar to Manufacturers at the time, DKB raised capital in 1997

<sup>61</sup> McDougall, R. & Fringle, M. (1988, January). Dai-Ichi Kangyo: Tough at the Top. *The Banker*, p. 41

<sup>62</sup> *History of Dai Ichi Kangyo Bank*. Retrieved April 27, 2003, from www.hoovers.com.

<sup>63</sup> Eventually, six DKB executives were convicted. Source: *History of Dai Ichi Kangyo Bank*. Retrieved April 27, 2003, from www.hoovers.com.

when it publicly offered 22% of CIT Group. In 1998, it sold another 30%<sup>64</sup>, and in 2001 Tyco International eventually took control of CIT.

Foreign activities were further restructured in 1998, closing down the Milan and Madrid offices and reviewing its Paris office.<sup>65</sup> In the same year DKB bought Kankaku Securities to offer investment services to retail customers, and formed joint ventures with J.P. Morgan to offer mutual funds through DKB's domestic branches. In 1998, Fuji Bank and DKB agreed to form an asset management alliance and jointly buy the pensions and custody business of Yasuda Trust, a bank affiliated with Fuji Bank. A full merger between the banks was not ruled out at the time<sup>66</sup>; as losses continued for both banks DKB agreed to merge with Industrial Bank of Japan and Fuji Bank to form the world's largest bank under the Mizuho name in 2000. In light of this merger, J.P. Morgan and DKB ended their joint venture.

#### **18.4. Commonalities and differences**

Japanese international banking has been the subject of much attention. The introduction of the Basle Accord late 1980s had the ulterior motive to curb the growth of Japanese banks' foreign activities (Wagster, 1996), and the fact that Japanese banks had acquired almost 12% of total United States banking assets (55% of all foreign owned banking assets in the United States) raised competitive issues for American banks. Initially though, up to 1988, most foreign direct investments of Japanese banks were mainly portfolio investments; from 1989 onwards foreign direct investments played a larger role (Hasegawa, 1993). Japanese banks, with the exception of Bank of Tokyo who had a different status, internationalized in the 1980s in much the same way as for example German banks did: establishing activities in the major financial centers and economic centers. The Japanese banks followed their clients, but also expanded in the capital markets. "The oft-quoted Japanese banking strategy is their emphasis on market share or asset growth, with very low profit margins" (Arora, 1995, p. 109).

Due to domestic regulation, foreign profitability on activities could be higher, and because of the low funding - Japanese banks traditionally had one of the lowest capital costs (Hasegawa, 1993) - this gave them a competitive advantage in the financial centers outside. Japanese banks depended heavily on the growing stock market to fuel their expansion in three ways (Arora, 1995, p. 110):

- The substantial investment portfolio to boost net income.

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<sup>64</sup> Abrahams, P. (1998, October 17). Companies & Finance: Dai-Ichi Kangyo to sell off 30% stake in CIT. *Financial Times*, p. 23

<sup>65</sup> Abrahams, P. (1998, August 3). Daiwa cuts overseas operations: Jobs to be lost in London, New York and Hong Kong. *Financial Times*, p. 17

<sup>66</sup> Boland, V. & Harris, C. (1998, December 8). Companies & Finance: Asia-Pacific: Fuji Bank eyes full merger. *Financial Times*, p. 32

- The value of their investment portfolio, which heavily influenced their market valuation.
- The ability of the market to continue to absorb the large stock and bond issues the banks needed to raise capital levels to continue their international expansion.

Krugman and Graham suggest that the internationalization of Japanese banks might well have served to alleviate of Japanese capital surplus; this is supported by the observation that Japanese banks were mostly active in foreign capital market activities, and to a far lesser extent in foreign retail banking (in the United States). Retail banking was a far less important component of Japanese bank internationalization strategies than for example European banks. On the other hand, they have stayed in the United States for a longer time than for example British banks, an indication of their long term commitment.

The growth of internationalization activities for Japanese banks effectively came to a halt in the 1990s, when the stock prices and real estate prices simultaneously declined, deteriorating economic growth and the soundness of Japanese bank loans.<sup>67</sup> Regulation for the bank's capital ratio, determined by the Bank for International Settlements in Basle in 1988 and adopted by among others the Bank of Japan, posed further problems. This too added to the cutback of lending activity. Did Japanese internationalization stir the imagination of worldwide Japanese retail bank network in the latter part of the eighties (Fujita and Ishigaki, 1986), ten years later were international activities scaled back, with some banks confining themselves to leading or taking part in bond issuances.<sup>68</sup> The banks that did meet BIS capital requirements, concentrated their international banking activities at subsidiaries in tax-havens or off shore centers. As an alternative, banks started joint ventures or alliances with domestic or foreign banks for international transactions (Haga, 2002). Japanese government during the 1990s took a number of steps to address the financial problems, culminating in a continuous set of restructuring or rescue attempts between 1993 and 1998 (Hoshi and Kashyap, 1999, p. 1). From 1997, there even existed a *Japan premium*: an additional cost which Japanese banks had to pay to raise funds in foreign markets compared to United States and European competitors. This hastened the retreat of Japanese banks from the foreign markets. However, by 2000 this premium disappeared, and Japanese banks hoped to re-establish a presence in Asia.<sup>69</sup>

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<sup>67</sup> Furthermore, an appreciating Japanese Yen against the US Dollar lowered the relative importance of international activities further.

<sup>68</sup> Which explains the low percentages of foreign employees and branches combined with the high percentages of foreign gross income.

<sup>69</sup> Tett, G. & Silverman, G. (2000, August 4). Japanese banks tiptoe back overseas. *Financial Times*, p. 17.

## 19 Commonalities and differences

This chapter identifies internationalization patterns of banks: what did they have in common, and how did they differ? In the previous chapters, realized internationalization strategies for 44 banks from 8 countries were analyzed. For each bank, a brief case study was presented, supported by the TNI development of the bank, introduced in chapter 10. Also, a framework developed in part I summarized for each bank the phases in internationalization, clients, products and organizational forms. Commonalities and differences for clients and products are first reviewed (19.1), after which organizational form (19.2) and phases in internationalization are discussed. Integration is pursued by applying the previous findings to five stylized types of realized internationalization strategies (19.3).

### 19.1. Clients and products

Banks can offer in principle five product categories: credit, securities, asset management, financial services and insurance. Also, five client types can be distinguished that banks can target: governmental clients (nation states, supra national institutions), corporate clients, institutional clients (other banks, asset managers and insurers), retail clients and private clients. The case studies show that banks which entered new market activities actively serviced and targeted a wide range of clients and products. Two specific patterns have been identified: capital market activities, and foreign retail banking.

#### *Capital market activities*

For capital market activities banks offer credit, securities, asset management, and financial advice to governmental, institutional and corporate clients. The majority of the banks in the sample had set up such operations by 1980: they participated in the Euromarkets, issued bonds to finance their own activities, and took advantage of the financial deregulation in the financial centers. Expanding capital market activities was spurred in the mid-1980s with the financial liberalization in the United Kingdom, and in the mid-1990s with the prospect of restructuring in the European Union.

Table 19.1. *Development capital market activities*

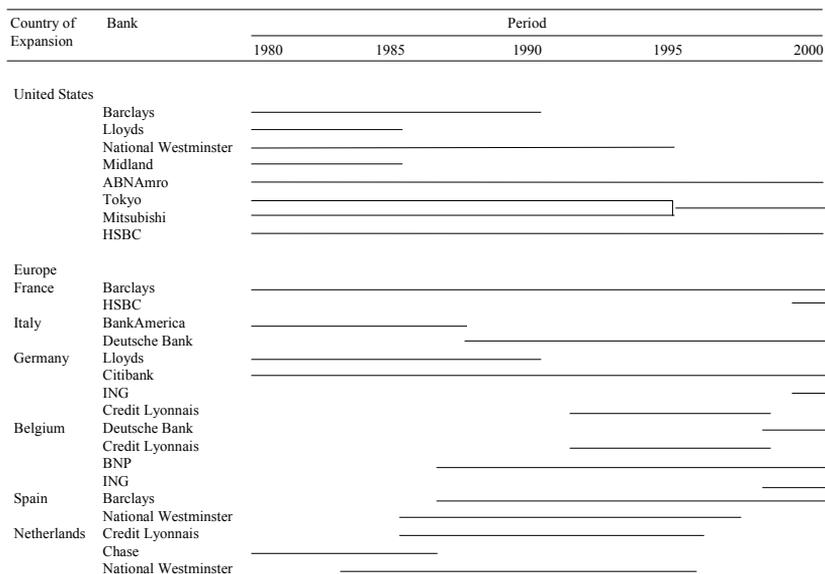
Period	1970s	1980s	1990s
Reason	<ul style="list-style-type: none"> <li>• Growth Eurocurrency markets (London, Paris, Zurich)</li> <li>• Financial liberalization American stock market</li> </ul>	<ul style="list-style-type: none"> <li>• Financial liberalization European capital markets (London, Paris, Amsterdam)</li> <li>• Financial liberalization Japanese capital markets</li> </ul>	<ul style="list-style-type: none"> <li>• Catch up new entrants to profit from current bull market, consolidation existing players</li> </ul>
Example Banks	<ul style="list-style-type: none"> <li>• Chase, Citicorp</li> </ul>	<ul style="list-style-type: none"> <li>• Deutsche Bank, ABN, Société Générale</li> </ul>	<ul style="list-style-type: none"> <li>• Credit Suisse, Deutsche Bank, J.P.Morgan</li> </ul>

For several banks, the decision to participate in the capital markets heavily influenced their strategy. Paribas and J.P. Morgan decreased their commercial banking activities and transformed themselves into investment banks. Both banks however did not have the scale by the end of the 1990s to remain a major market participant in investment banking and sustain the increasing (IT) investments: J.P. Morgan was subsequently acquired by Chase Manhattan in 2000, and Paribas by BNP in 1998. Most of the acquisitions of UBS, SBC, Credit Suisse and Deutsche Bank in the 1990s were capital market related, steadily increasing their reliance on fee income instead of net interest income. The composition of the fee income changed: more lucrative (but volatile) fee income from financial advice and securities (re)distributions on mergers and acquisitions was combined with more stable income from asset management activities.

### *Retail banking*

International retail banking has been the domain of a selected number of banks. Chase and Citicorp set out to expand a retail network in Belgium, The Netherlands, Germany and the United Kingdom in the 1950s and 1960s. European banks in the 1970s and 1980s on the other hand did not expand in retail banking in Europe, but expanded in the United States, especially in California where English and Japanese banks bought retail banks helped by lenient regulation. For most Californian banks, their sale was either instigated by regulation (banks that cannot be bought by domestic competitors due to an increase in market share or banks that need outside capital) or poor performance. By the early 1990s a large number of banks exited from the United States market: they found it difficult to transform these banking operations into profitable ones, and their exit was speeded by the deregulation of interstate banking (cf. Tschoegl, 1987). The general expectation was that this would raise the minimum scale of operations to compete effectively, requiring large amounts of additional investments. Banks that remained were for example HSBC and ABN Amro.

Figure 19.1. *Foreign commercial bank networks in selected countries, 1980-2000*



Note: \_\_\_\_\_ presence of commercial bank subsidiaries

Figure 19.1 suggests a transition in foreign retail banking activities. Eight foreign banks, including all of the British banks, held retail networks in the United States in the early 1980s; by the late 1980s five had opted out. For European banks, the growth of foreign commercial bank networks took place from the mid-1980s. A limited number of banks (HSBC, ABN, Citicorp) have maintained these foreign networks throughout the period. From the 1990s, the following banks pursued retail banking strategies:

- Santander in Argentina, Mexico, Chile
- BBVA in Argentina, Chile, Mexico
- ABN Amro in Brazil and the United States
- ING in Belgium
- HSBC in Mexico, Brazil, the United States/Canada and Hong Kong
- Citibank in Germany

Two groups of banks did not enter foreign retail banking, or only to a limited extent: Swiss banks and Japanese banks. Swiss banks had retail banking activities in their domestic market, but not outside Switzerland. Switzerland was a major financial center and as an economy ran a capital surplus; an explanation might be that setting up foreign capital market activities was a more logical foreign extension of activities than setting up or acquiring foreign retail banks. Japanese banks also entered foreign retail banking to a

limited extent. Their activities were mainly concentrated in California, where the banks initially had some links with Japanese immigrants. More important, lenient regulators allowed takeover of Californian banks by foreign competitors. The existence of an opportunity set - the ability to buy - compared to other more regulated banking markets has probably been the main incentive.

**19.2. Organizational form**

Banks which decided to enter new markets or to strengthen their market position have had a wide range of options available to them as to how they could proceed in implementing their foreign banking activities. Looking back at activities for the case studies, there has been a strong rise in the number of each of the approaches used. Two specific developments in organizational form have been identified: branch network, alliances and joint ventures.

*Branch network*

In general, the objective to build a branch network has been to assist foreign clients, finance activities more cheaply or to evade home country regulation. Activities in financial centers were set up, usually starting with London, New York and Singapore or Hong Kong. This was then expanded to second tier financial centers and economic centers in Europe, the United States, Asia and Latin America.

Table 19.2. *Development of branch networks*

Period	1970s	1980s	1990s
Incentive	<ul style="list-style-type: none"> <li>• Breakdown consortium</li> <li>• Trade related, service existing clients</li> </ul>	<ul style="list-style-type: none"> <li>• Increase trade and exports</li> <li>• Liberalization of capital markets</li> <li>• Opening up markets (Spain)</li> </ul>	<ul style="list-style-type: none"> <li>• Growth Asian (capital) markets</li> <li>• Opening of Eastern European markets</li> <li>• Increase volume securities markers</li> </ul>
Example Banks	<ul style="list-style-type: none"> <li>• Citicorp, BankAmerica, Lloyds, Barclays, ABN,</li> </ul>	<ul style="list-style-type: none"> <li>• Amro, NMB, WestLB, Crédit Agricole</li> </ul>	<ul style="list-style-type: none"> <li>• Deutsche Bank, Dresdner Bank</li> </ul>

*Alliances and consortium banks*

Consortium banks were mainly a feature of the late 1960s and 1970s. With these joint ventures, banks tried to create a platform to service foreign clients and undertake corporate finance activities, while sharing the costs of building such an activity independently. In the beginning of the 1980s, there were a number of banks who relied on the consortium banks to provide an alternative for a foreign branch network. These were Amro and

Midland. Subsequently, a number of banks built their foreign networks by buying out the other shareholders in the consortium banks.

During these alliances, banks probably also acquired detailed information of the partner banks. This could be concluded from the observation that ING (un)successfully acquired former InterAlpha partners from the mid-1990s for its expansion in Europe. From the 1990s, alliances between banks either had to develop specific skills neither bank could achieve alone, or serve as a defensive move in wake of expected restructuring in the European banking market. This usually was accompanied by share exchanges.

Table 19.3. *Selected Alliances between 1980 and 2000*

Alliance to acquire or share specific skills	Alliance to ensure (future) market position
<ul style="list-style-type: none"> <li>• Royal Bank of Scotland – Santander (1990-)</li> <li>• BNP-Dresdner (1988-2000)</li> <li>• Société Générale – BSCH (2000)</li> </ul>	<ul style="list-style-type: none"> <li>• BBVA – UniCredito (2000)</li> <li>• Amro – Generale (1988)</li> <li>• Commerzbank – Banco Hispano Americano (1973, 1990)</li> </ul>

The re-appearance of alliances and joint ventures in the 1990s was more specific than in the 1970s and was also accompanied by mutual equity stakes. Banks opted for mutual equity stakes to forge a stronger link with the other bank than an alliance; the mutual equity stake effectively represented an option to a first right to negotiate with the other bank when consolidation in the (European) banking market was considered.

**19.3. Realized internationalization strategies**

In total 44 case studies have been discussed in the previous chapters, spanning 21 years. For each bank the internationalization activities were also tabulated, identifying phases in activities, the geographical area or region of activity, and additional information about the clients, products and organization form used. In chapter 5, (international) bank strategies were reviewed. A framework was presented, combining bank strategy phases developed by Fujita and Ishigaki (1986), and De Carmoy (1990). Within this framework, four major phases for internationalization activities were identified. These phases were subsequently applied in part II to summarize realized internationalization strategies for the 44 bank case studies. Table 19.4 shows the phases; based on the case studies additional information has been added in the right columns: the range of TNI during a phase and the change in TNI during the phase.

Table 19.4. *Phases of international organization activity*

Strategy phase	Description	Effect on bank organization	Effect on bank's TNI		
			TNI level	TNI change	
1 Entry	Refers to a) a new activity in a new market, b) a new activity in an existing market or c) an existing activity in a new market.	Change/expansion of organizational structure, new strategic goals	0-20%	0-10%	
2 Expansion	Broad	Above average growth of capital commitment to activities	Targeting of several markets, combined with several acquisitions	20-60%	0-20%
	Focused	Above average growth of capital commitment to activities, combined with selective disinvestments in activities and/or markets	Specific targeting of one or few markets, perhaps combined with one large acquisitions	20-80%	0-20%
3 Consolidation	Balanced growth	Average growth of capital commitment to activities, aiming to maintain current market position and/or financial targets.	Change in internationalisation dependent on difference home-foreign growth rates	All levels	-5 - +5%
4 Restructuring	Refocus	Period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Restructuring of activities does not lead to disinvestments and serves to increase profitability and/or lower the cost base	Staff cuts, change of organisational structure and refocusing of strategic goals	20-80%	-5 - +5%
	Refocus & exit	Period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Average growth of capital commitment to activities, combined with selective disinvestments in activities and/or foreign markets to increase profitability or lower the cost base.	Staff cuts, change of organisational structure and refocusing of strategic goals. Disinvestments in the markets which are no longer targeted. Freed capital is used to invest in remaining activities or to generally shore up solvency	all levels	-10 - 0%
	Exit	Period of reformulating strategy or restructuring the organization as a result of a crisis of some sort. Sale or shut down of activities and markets to raise capital and/or reinvest in other existing activities.	Staff cuts, change of organisational structure and refocusing of strategic goals. Disinvestments in the markets which are no longer targeted. Freed capital is used to increase solvency	40-80%	-20 - 0%

Grouping banks on the basis of these phases and the resulting TNI development led to five distinct types of realized internationalization strategies. In general, a stylization strategy is bound to ignore specific choices that banks have made, but on the other hand offers the advantage of defining commonalities in internationalization activities more clearly. The five types are:

- *Accelerating internationalization*

Banks initially develop internationalization activities by setting up branches in major economic and financial centers. As a next step international activities are expanded by increasingly large foreign bank acquisitions. Finally, the bank has to restructure, to consolidate the large foreign acquisitions and to regain or increase its profitability.

- *Moderate internationalization*

In general, banks with *Moderate* internationalization strategies consider internationalization as a support activity of the total bank organization. They develop a foreign branch network and bank activities in major foreign economic and financial centers; acquisitions and establishment of other international bank activities are a reaction to the internationalization activities of other banks, especially banks with

*Accelerating strategies.* Ultimately, restructuring also sets in to consolidate activities and (re)gain profitability.

- *Imploding internationalization*  
Fast increase of internationalization activities, to uphold or increase the bank's relative position compared to other competitors. Because the bank is unable to control the large increase in international activities, a prolonged financial crises occurs. Finally, internationalization activities are divested to raise capital; bank management (under pressure of regulators) refocuses its activities on the domestic banking market.
- *Retreating internationalization*  
After a foreign financial or economic crisis, bank reassess their foreign activities and shift their focus from international activities to domestic activities. Foreign activities are divested to raise capital and/or domestic banking activities are expanded, lowering the degree of internationalization.
- *Established internationalization*  
These are banks with a high degree of internationalization; the banks have been historically committed to international activities, usually building up international activities over a long period.

Table 19.5. *Banks and their model of internationalization*

Accelerating	Moderate	Imploding	Retreating	Established
• HypoVereins bank	• Argentaria	• Midland	• Manufacturers Hanovers	• Tokyo-Mitsubishi
• BCH	• Amro	• Crédit Lyonnais	• Chemical Banking	• ABN
• ING bank	• Fortis		• Mitsubishi Bank	• HSBC
• ABN/Amro	• Bayerische Hypobank		• Bank of America	• Tokyo
• NMB Bank	• Vereinsbank		• Barclays	• SBC
• BBV	• Agricole		• Chase Manhattan	• J.P. Morgan
• Paribas	• Commerzbank		• Dai Ichi Kangyo	• BNP
• Credit Suisse	• IBJ		• Lloyds TSB	• Citicorp
• Deutsche Bank	• Rabobank		• National Westminster	• Société Générale
• Dresdner Bank			• Sumitomo Bank	• Standard Chartered
• Santander				
• UBS				
• WestLB				

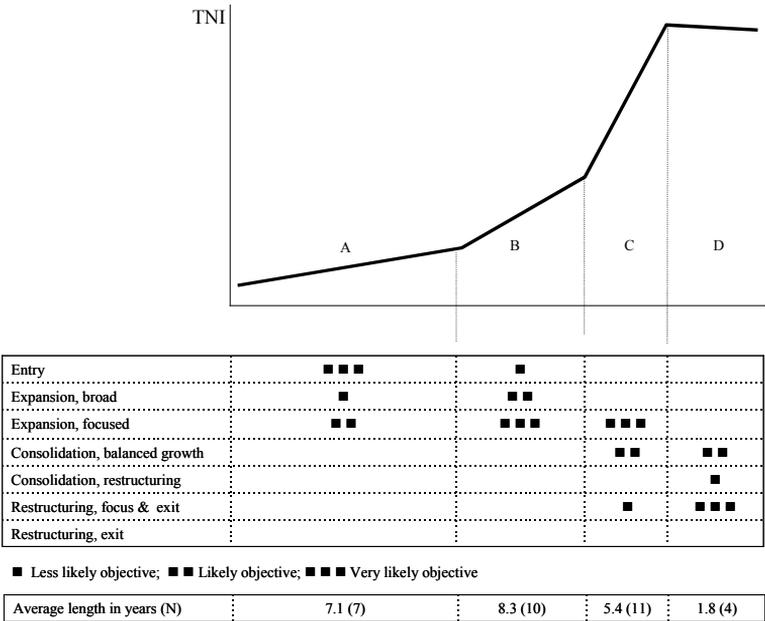
The five types represent the internationalization of all banks in the sample, and is classified in Table 19.5. Besides the two banks representing *Imploding* internationalization, the number banks' models of internationalization is evenly spread between the other four types. Next, the stylized types of realized internationalization strategies are discussed.

*Accelerating internationalization*

The first model fits banks that started internationalization at a moderate pace, increasing the degree of internationalization in one or more subsequent steps, after which a period of consolidation set in (Figure 19.2).

In the first period (stage A in Figure 19.2), the TNI generally moved between 10 and 20%. Foreign activities comprised a branch network in main financial centers and economic centers. For European banks, activities were set up in centers such as Luxembourg, Switzerland, Paris and London to gain access to the Euromarkets and more advantageous sources of finance than in the domestic market. The bank's objective has been to seek resources, acquire skills and funding. Also, market seeking was an important objective, expanding the existing services to be offered to domestic related clients in foreign countries. This stage also includes banks who have actively participated in consortium banks, building their branch networks in the late 1970s partly on the basis of restructured or dissolved consortium bank networks.

Figure 19.2. Stylized model of accelerating internationalization



In the second stage (B), internationalization quickly gathered pace and TNI reached levels between 20 and 40%. Weighing up between domestic and international investments, banks increasingly chose international expansion. Drivers for this change were in Europe the perceived convergence of financial markets, forcing banks to acquire foreign activities to have a European foothold (just in case) and also to re-establish relative domestic positions. The change from stage A to stage B is consistent with "obtaining a foothold strategy". Information about the foreign market is obtained by making small investments, precursor of larger investments in the following years (Molyneux, 2003, p. 13).

A number of banks have a third stage (C), accelerating the already strong growth of internationalization activities. Here, the acquisitions get larger in size, pushing TNI levels between 60 and 80%. The acquisitions in the second stage probably have been integrated relatively smoothly. The increase took place for a number of banks between 1995 and 2000 (ABN Amro, UBS, Credit Suisse ); the funding opportunities in the stock market might have helped as well.

Table 19.6. *Major changes in TNI between 1980 and 2000*

Bank	Year	TNI Change	TNI	Event
ABN-Amro	1997	18.61	69.85	Acquisition Brazilian Banco Real
Barclays	1989	12.31	43.17	
BBV	1996	11.51	40.46	Acquisition South America fund managers
	1997	11.53	51.99	Acquisition South America fund managers
Credit Suisse	1990	14.28	47.53	Acquisition Swiss Bank Leu
	1997	10.83	62.22	Acquisition Swiss Winterthur, BZW branches from Barclays
Deutsche Bank	1993	10.41	31.58	Acquisition Italian, Spanish subsidiaries and branches
	1999	10.40	55.93	
HypoVereinsbank	2000	17.34	36.11	Acquisition Austrian Bankverein
ING bank	1998	15.75	56.24	Acquisition German BHF Bank
Midland	1981	12.38	33.74	Acquisition American Crocker Bank
	1982	11.93	45.68	Acquisition American Crocker Bank
Santander	1997	19.55	53.13	
SBC	1995	10.77	42.67	Acquisition English Warburg
UBS	2000	12.09	65.51	Acquisition American PaineWebber
Westdeutsche Landesbank	1993	10.87	23.87	Acquisition European branch network Standard Chartered
	1995	14.63	34.54	Acquisition English Cook Travel

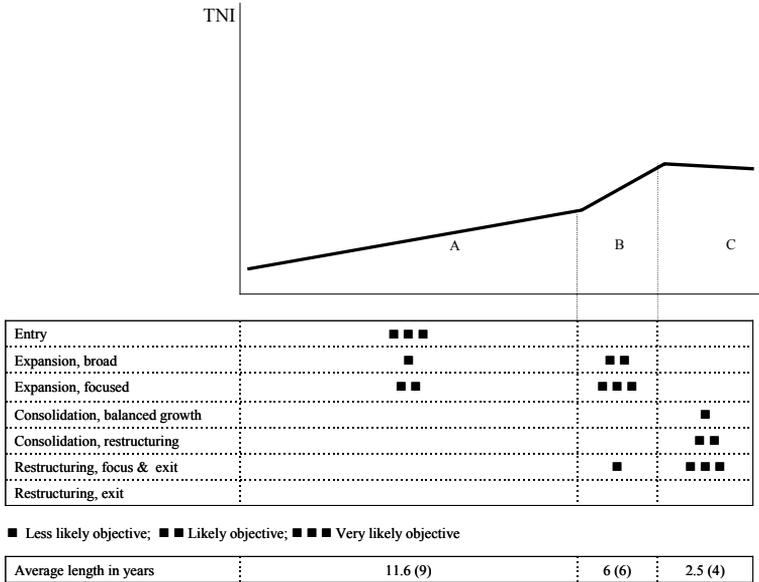
The strong organizational changes in stages B and C have to be absorbed at some point, signaling a consolidation or restructuring period (D). A trigger for this could be threefold. First a financial crisis could force bank management to reconsider its geography-product portfolio. For example, the Asian crises of 1998 made Barclays and ING (further) downscale their investment banking activities, leaving shareholders with the impression the (geographic) span of risk control was not an optimal one. Second, funding opportunities for further expansion might be limited because the stock market is no longer a viable option, forcing the bank to concentrate more on organic growth opportunities than growth by acquisitions. Third, banks might have hit an internationalization ceiling: raising internationalization above a certain level raises questions like representativeness of the management board, and the validity of the location of headquarters. In other words, raising the TNI above a certain level might in some respects be a threat to sitting management.

Bank management at this stage in general refocused: it redefined the Client-Arena-Product areas it would like to excel, finding that it acquired a number of activities in the previous years that would not fit anymore in the bank organization. Key ratio's as solvency, stability of earnings, profitability and loan provisions become more important management drivers, forcing divestments in some activities.

*Moderate internationalization*

Banks with a stable growth of internationalization activities tend to consistently increase their TNI over time. Here too, the first stage is the build up of a branch network, with levels of TNI remaining between 10 and 20 percent. Where other banks accelerate their growth, mostly by acquisitions, these banks prefer to continue a strategy combining greenfields and/or small acquisitions. In some cases they are simply restricted by earlier actions (Commerzbank internationalization activities lagged behind its domestic competitors because it had accumulated less reserves in the 1980s) or focus: Argentaria was created as a domestic oriented bank, and Rabobank had a strong domestic base. At some point, usually when the acceleration in internationalization activities took place for the *Accelerating* banks, these banks also attempted to catch up with their competitors and strongly increase their foreign activities. Rabobank set up an investment banking unit in London in 1995, and Commerzbank, previously focused on Europe, set out to buy a Taiwanese bank. At this stage, TNI generally moved between 20 and 40%.

Figure 19.3. Stylized model of moderate internationalization



Reorientation with these banks generally took place ahead of restructuring with *Accelerating* banks: the low degree of internationalization is probably caused by a more risk averse approach to foreign activities, allowing little room to absorb more volatile results. Also, a relatively late acceleration of internationalization activities might have soon created the awareness that size or infrastructure to effectively compete in markets with other banks could not be achieved without considerable amount of investments. A reorientation takes place (C), focusing on its core activities. Rabobank downscaled its investment banking activities and focused on agricultural finance as an international niche strategy, aligning its international activities with its domestic strengths. Commerzbank set out to keep a confined geographic scope, maintaining a European branch network to support its German clients.

### *Imploding internationalization*

Jean Deflassieux, senior international officer at Crédit Lyonnais in 1980, said that banking internationalization is “a bit like bicycling: if you stop going you fall off”.<sup>1</sup> A strong rise and decline of internationalization between 1980 and 2000 applies to two banks: Crédit Lyonnais and Midland Bank. Within a short period, foreign activities were acquired to achieve status (stage A): Crédit Lyonnais aimed to achieve a similar market position as Deutsche Bank in the European banking market, while Midland felt it lagged in internationalization activities after years of consortium banking and alliances, and wanted a major foreign acquisition to be at par with the other British banks.

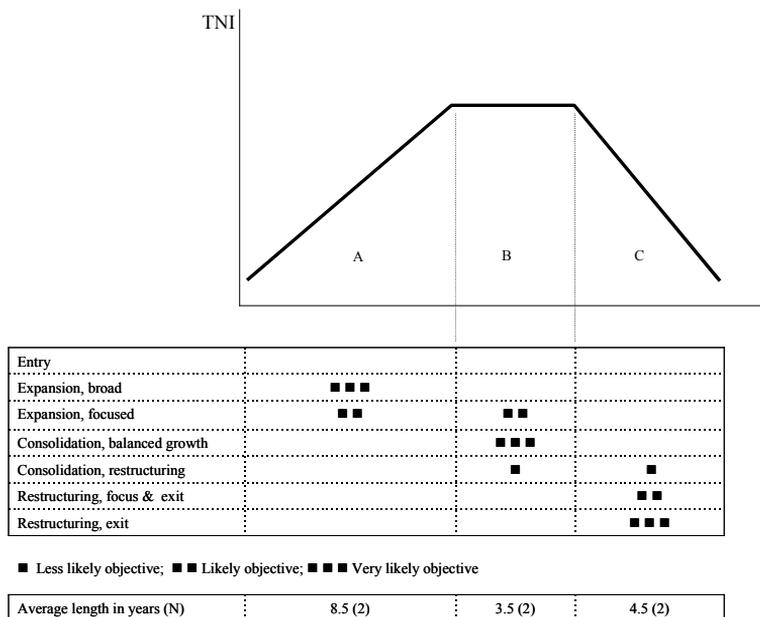
The rise in internationalization and change in market-position came in both cases at a cost: the bank organization became uncontrollable, its problems surfacing in stage B. For example, management of United States Crocker bank did not give its owner, Midland, full insight in its financial statements (Rogers, 1992). Midland was not able, and perhaps did not press hard, to gain disclosure about how its capital injection was spent. The influx of capital in Crocker created unbalanced loan growth, and poor disclosure meant that risks similar to Crocker and Midland were not controlled for the total organization. Crédit Lyonnais had similar problems: it did not have an administrative organization in place to manage the operational risk that were increasing with each additional foreign acquisition.

The decline of internationalization for both banks was a forced exit, as sudden as its entry. Midland had to take large provisions for the losses at Crocker, damaging Midland’s solvency which was only stopped when Crocker was sold at a large loss. Crédit Lyonnais had to sell its European subsidiaries in return for state aid. After this, both banks their independence was ended. The restructuring of Midland was undertaken by HSBC from 1992; the French government restructured Crédit Lyonnais from 1998, and redistributed its shares in a public offering in 2000 making it clear it would not object a (domestic) takeover.

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<sup>1</sup> Lewis, V. (1980, July). France’s nationalised banks - a whiff of re-privatisation. *The Banker*, 43-48

Figure 19.4. Stylized model of imploding internationalization

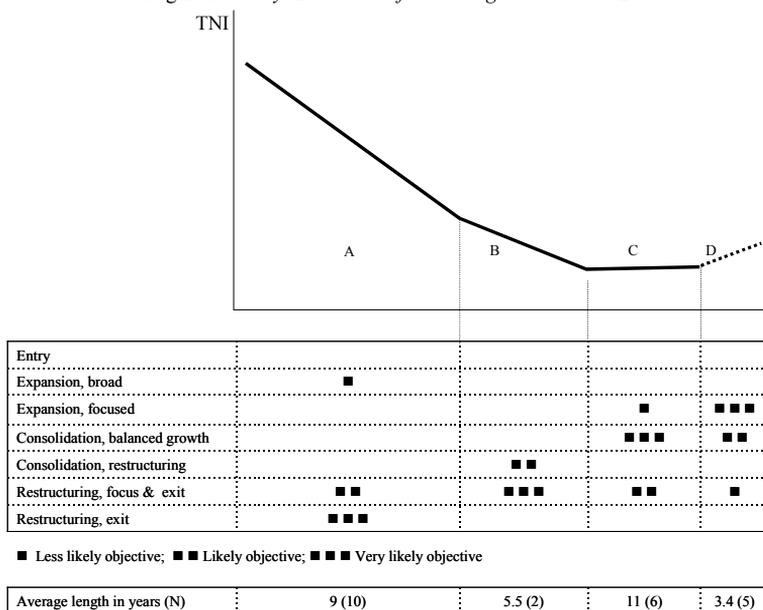


### *Retreating internationalization*

Retreating banks have already acquired high levels of internationalization in an earlier period. They have built a branch network supporting their domestic clients, but also other activities like commercial bank networks. The decline of internationalization is triggered by a crisis; for American and British banks in the early 1980s this was the LDC crises.

Banks then began a period of reorientation: their main concern is to stop the loss making activities, depressing their profitability, solvency as well as their market value. American banks reduced their LDC exposure throughout the 1980s, while playing an active role in the loan restructuring committees until 1985 to salvage some of the loans. Regulatory authorities tended to play an active role, stimulating the decrease in foreign activities because they more domestic mergers and acquisitions to achieve scale and more cost-cutting opportunities. This hastened the decline in TNI in stage B (see Figure 19.5). This also suggests that internationalization was not the preferred growth strategy for these banks in the first place. This is especially the case for American banks, when the regulation on interstate banking was lifted, allowing domestic mergers.

Figure 19.5. Stylized model of retreating internationalization



Note: ..... Re-internationalization, or announced intention to re-internationalize. This does not apply for all Retreating banks

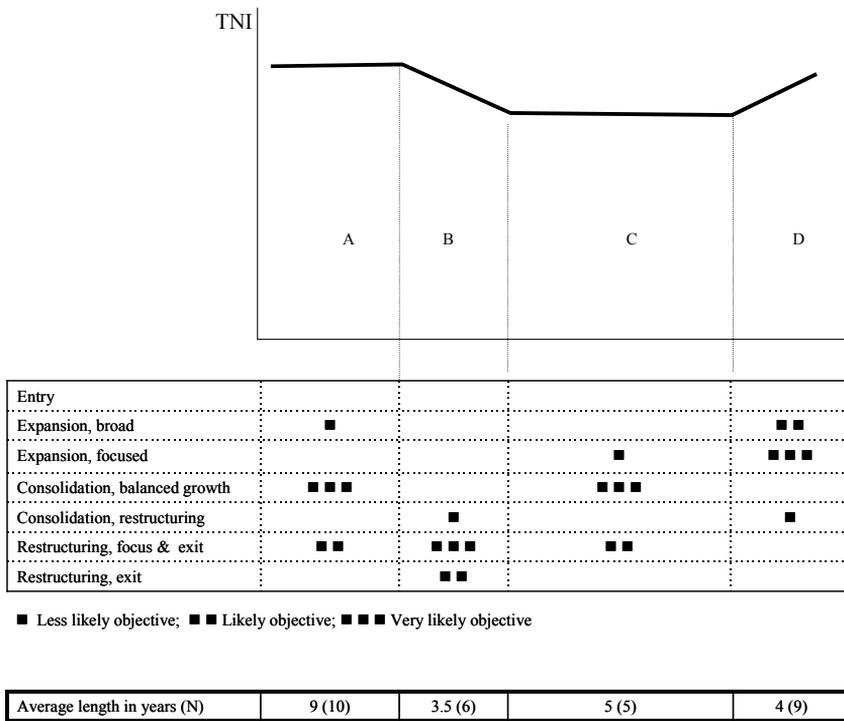
After a period of consolidation, working through the domestic merger, bank management became interested again in internationalization. Chase Manhattan bought J.P. Morgan in 2000 to this end, Bank of America set up investment banking activities in London from 1999 onwards, and domestic oriented banks like Lloyds announced that it might once again reconsider international activities in 2000.

### *Established internationalization*

*Accelerating, Moderate and Imploding* internationalization have in common that initially the level of TNI was low: the bank had to acquire a market position in international banking, and had three routes to choose from. For *Retreating* and *Established* internationalization, the bank's initial position was different. The level of TNI was high, and while *Retreating* banks chose to focus on domestic activities, *Established* banks continued their commitment to international activities, maintaining a TNI level between 30 and 50%. This was the case for J.P. Morgan, Citicorp and HSBC in the 1980s and 1990s, or ABN in the 1980s.

*Established* banks were not immune to change: economic and financial crises, and shifting focus on international banking activities led at time to restructuring activities. However, the banks typically did not decrease their TNI by more than 10 percent, illustrating their commitment to foreign banking activities. This also indicates that the banks have in general balanced international and domestic growth of banking activities.

Figure 19.6. Stylized model of established internationalization



*Characteristics of realized internationalization strategies*

The typologies are based on observations about realized strategies. In other words, the observation of what a bank actually has done has been the basis for identifying the different realized internationalization types. The different strategy types have a long time period in common spanning twenty years, which might be considered a long time for a strategy. Such a long time period is not uncommon<sup>2</sup>, but has some implications: the bank is in the analyses treated as an organization with a sense of historical memory; changes or events in the past bear their mark on strategic thinking today.

<sup>2</sup> One of the path breaking management studies in the 1980s by Peters and Waterman, “In search of Excellence”, examined American (non-financial) companies between 1961 and 1980 (1982, p. 22-23). Another example is Collinas and Porras (1994), who in 1989 studied a sample of American companies founded before 1945 to analyse their long term performance.

Figure 19.7. TNI per strategy type, unweighted average

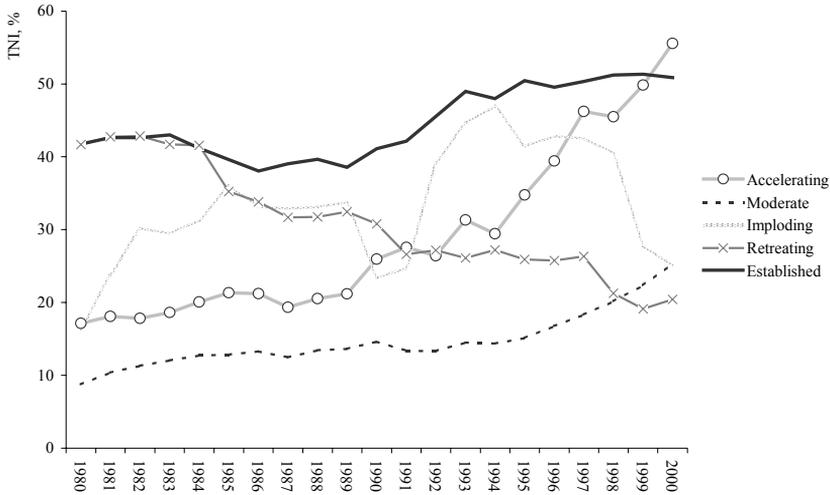


Figure 19.6 shows the unweighted TNI averages per strategic type. *Established* banks show the highest TNI throughout the period, only to be surpassed by *Accelerating* banks in 2000. On the lower end are the *Moderate* banks, showing the lowest average TNI throughout the period to be surpassed by the *Retreated* banks in 1998. *Accelerating* and *Retreated* banks are negatively related: for the *Accelerating* banks TNI increased, especially after 1989. *Retreated* banks show steadily declining levels of TNI, from 1983 onwards.

Table 19.7 presents a number of key figures per strategy and per five year period. Although *Accelerating* and *Retreated* banks are different strategies, they seem to have had similar growth targets: the average asset size in 1995-2000 is similar for *Accelerating*, *Retreated* and *Established* banks.

For the 1990s, *Retreated* and *Established* banks have been better capitalized, but also had higher loan provisions than *Accelerating* banks. *Moderate* banks have had a relatively high degree of provisions in 1981-1985, probably leading to the relatively low capitalization of the banks during that period. This may be partly responsible for the low degree of internationalization: these banks did not have the financial cushions (anymore) in the early 1980s to engage in international activities. If herding has taken place in the 1990s, then it surely was a risk-controlled one: exits were more swiftly decided on than with other bank types.

Table 19.7. Descriptives of realized internationalization strategy types

	1981-85			1986-90			1991-95			1996-00		
	Mean	Standard deviation	N	Mean	Standard deviation	N	Mean	Standard deviation	N	Mean	Standard deviation	N
TNI												
Accelerating	19.25	8.99	36	21.75	10.91	45	29.95	12.07	54	47.08	14.68	54
Moderate	11.85	7.79	35	13.47	9.51	35	14.12	8.60	40	20.01	7.08	33
Imploding	30.16	14.06	10	31.25	7.28	10	36.94	11.59	6	35.75	8.58	5
Retreating	40.82	7.32	50	32.10	6.58	50	26.59	6.71	45	22.58	8.02	35
Established	41.82	16.35	40	39.23	15.84	39	47.01	15.98	40	50.62	16.49	36
Total assets, mln US												
Accelerating	49,626.60	21,414.72	38	107,098.16	55,965.63	46	198,770.75	97,701.00	55	388,009.65	186,632.87	54
Moderate	57,654.46	27,743.10	35	131,998.15	78,085.04	35	197,273.36	105,938.96	40	307,765.64	126,277.77	33
Imploding	86,489.32	11,446.81	10	144,543.19	65,874.29	10	293,437.39	91,321.99	6	230,937.79	57,534.39	5
Retreating	91,592.10	33,367.87	50	188,231.34	129,155.23	50	287,048.66	168,137.01	45	399,202.76	129,719.98	35
Established	77,368.74	34,486.43	40	140,130.92	69,238.69	39	207,602.32	86,186.10	40	395,310.90	190,411.72	36
Profitability, % capital												
Accelerating	12.90	7.19	40	16.42	9.33	46	12.87	6.18	55	13.28	6.70	54
Moderate	15.09	5.61	33	15.16	4.05	35	12.35	4.96	40	12.11	7.96	33
Imploding	15.80	6.70	10	8.20	13.21	10	-2.44	12.69	6	7.76	1.96	5
Retreating	18.83	6.22	50	12.52	19.45	50	13.64	10.69	45	15.93	20.40	35
Established	19.40	5.69	40	13.09	12.30	39	15.37	8.83	40	14.09	15.71	36
Capital ratio												
Accelerating	4.21	1.29	38	4.69	1.26	46	5.03	1.20	55	4.46	1.61	54
Moderate	3.23	1.19	35	4.02	2.38	35	4.42	1.73	40	4.21	1.08	33
Imploding	2.71	1.44	10	3.84	1.24	10	2.98	0.70	6	3.64	0.91	5
Retreating	3.86	1.14	50	4.26	1.26	50	5.11	1.63	45	5.43	1.84	35
Established	3.53	1.66	40	4.24	1.57	39	5.23	1.42	40	5.17	1.61	36
Total provisions, % capital												
Accelerating	14.22	7.62	40	13.87	6.41	44	10.50	5.98	54	8.67	7.23	54
Moderate	21.07	14.02	32	9.83	6.48	34	12.48	10.23	40	9.24	8.16	33
Imploding	33.98	21.59	10	24.01	12.76	10	24.98	9.39	6	16.27	4.10	5
Retreating	9.14	7.83	43	19.69	20.57	50	12.75	10.04	45	13.40	15.48	35
Established	17.67	16.55	38	16.93	16.55	39	10.69	8.47	39	10.55	11.19	36
Asset growth, yearly, US, %												
Accelerating	5.83	15.26	37	24.52	35.91	46	11.53	18.96	55	11.87	18.70	54
Moderate	4.93	17.16	35	17.66	24.38	35	13.94	22.34	40	7.58	25.87	33
Imploding	5.14	12.71	10	14.55	14.46	10	2.24	8.89	6	-11.47	12.23	5
Retreating	9.00	15.38	50	11.62	15.55	50	9.11	20.02	45	14.15	39.05	35
Established	5.76	10.57	40	13.16	14.14	39	9.12	16.55	40	11.28	16.48	36

Finally examined is whether herding applies to the five different realized internationalization strategy types. An incentive identified in chapter 3 to internationalize was herding. Herding takes place when a bank imitates the actions of other banks; the bank must be aware of and be influenced by other banks' actions (Bickshandani and Sharma, 2000). A herding incentive might exist if other banks may know something about the return of foreign bank activities that the bank does not know; the bank may also have an intrinsic preference for conformity and follow (domestic) competitors.

To see whether the realized internationalization strategies are concentrated, Table 19.8 shows banks in the sample, grouped per country and per realized internationalization strategy. *Established* and *Retreating* internationalization strategies tend to be concentrated with American, British and Japanese banks, while *Moderate* and *Accelerating* realized strategies tend to be clustered around German, Dutch, Spanish and Swiss banks. This supports the notion that herding on a country level might exist.

Table 19.8. *Realized internationalization strategies, per country*

	United States	United Kingdom	Japan	France	Germany	Netherlands	Spain	Switzerland
Accelerating				Paribas	Deutsche Bank Dresdner Bank Hypo- Vereinsbank Westdeutsche Landesbank	ING Bank ABN/Amro NMB Bank	BCH BBV Santander	Credit Suisse UBS
Moderate			IBJ	Agricole	Vereinsbank Commerzbank Bayerische Hypobank	Rabobank Fortis Amro	Argentaria	
Imploding		Midland		Credit Lyonnais				
Retreating	Chemical Banking Manufacturers Hanovers Bank of America Chase Manhattan	Barclays LloydsTSB National Westminster	Mitsubishi Bank Dai Ichi Kangyo Sumitomo Bank					
Established	J.P.Morgan Citicorp	Standard Chartered HSBC	Tokyo- Mitsubishi Tokyo	BNP Societe Generale		ABN		SBC



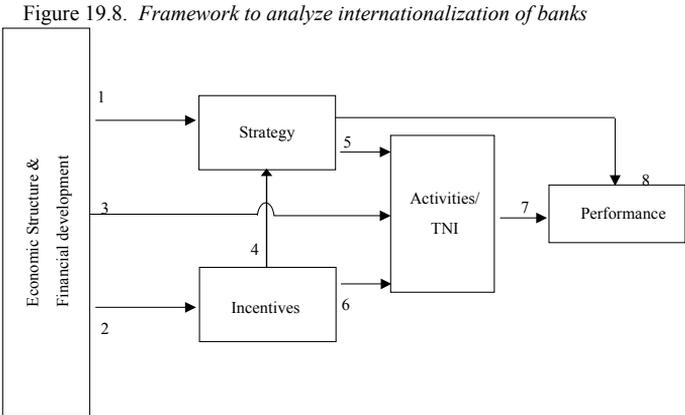
## **Part 3**

# **Effectiveness**



# Introduction to Part 3

In part I, *Concepts*, theoretical foundations for banks to internationalize were investigated and a framework was introduced to combine incentives, strategic motives, activities and resulting performance (Figure 19.8). The framework was then used to formulate hypotheses.



Internationalization patterns of banks were addressed in part II, *Patterns*. Developments affecting banks and their internationalization activities were reviewed, and the bank sample was introduced together with the TNI as a measure for the degree of internationalization. The next step was to examine the internationalization activities of the banks in the sample in the form of case studies. The question was what these internationalization strategies have been, and how did they evolve. From the case studies, common traits in the internationalization activities were identified, and five different types of internationalization strategies were found, consisting of a number of phases.

In Part III, *Effectiveness*, the relationship will be examined between the banks' internationalization and incentives, performance, shareholder return and strategies. Basis for the analyses are the hypotheses formulated in chapter 7, summarizing part I, and the

internationalization strategy types formulated in chapter 19, resulting from the case studies in part II. The following questions are asked:

- What relationships exist between the level of TNI (Trans Nationality Index) and incentives to internationalize (Chapter 20)?
- Have foreign activities delivered a better performance for banks than domestic activities (Chapter 21)? If performance is interpreted broader, such as the relationship between profits and the variability of profits, does a relationship exist between these performance measures and TNI?
- Did the shareholder gain by internationalization, in other words is TNI related to shareholder return?
- Do the previous findings change if the analyses are repeated, taking into account the different types of internationalization strategy? Are certain types of internationalization strategy more or less successful in terms of performance and shareholder return (Chapter 23)?

## 20 Incentives

In this chapter, the incentives to internationalize are integrated into one model and tested. The literature review in part I produced a number of incentives relating to internationalization that have been tested in earlier studies. The incentives are retested here; the added value introduced lies in the dependent variable. This study focuses on the TNI, compared to foreign direct investment. First, a review of the hypotheses is presented (20.1), and the test approach (20.2). After discussing the data variable measurements (20.3), the results are presented (20.4) and discussed.

### 20.1. Hypotheses

The incentives to internationalize were clustered in chapter as 1) sector extrinsic, 2) sector intrinsic and 3) bank intrinsic. The following hypotheses are grouped likewise.

#### *Extrinsic incentives*

**1. Client hypothesis (HYP20.1).** An increase in outward foreign direct investment (FDI) and/or exports leads to an increase in internationalization activities of banks.

**2. Spreads (HYP20.2).** An increase in internationalization activities is negatively related to interest margins and profitability in the home country

**3. Economic structure (HYP20.3).** An increase in internationalization activities is positively related to GDP growth and to GDP per capita.

**4. Small home market (HYP20.4).** Banks in smaller countries and/or higher market concentration show a higher degree of internationalization than banks in larger countries.

**5. Financial development (HYP20.5).** An increase in internationalization activities is positively related to the size of the stock market, or the non interest income earned by banks as a share of total income.

**6. Regulation (HYP20.6).** A relatively high degree of regulation in the home country is positively related to the degree of internationalization

*Sector intrinsic incentives*

**7. Herding (HYP20.7).** An increase in internationalization activities is positively related to an increase of internationalization activities of bank sample.

**8. Market power and concentration (HYP20.8).** An increase in internationalization activities is positively related to home countries with low ratio's of banking assets to GDP and high concentration ratio's of banks.

*Bank intrinsic incentives*

**9. X-efficiency/economies (HYP20.9):** Banks with lower cost-to-income ratio's show a higher degree of internationalization.

**10. Profitability (HYP20.10):** Banks with higher levels of profitability show a higher degree of internationalization.

**11. Capitalization (HYP20.11):** The degree of internationalization is positively related to higher capital ratio's for banks.

**20.2. Test approach**

The relationship between incentives and the degree of internationalization is tested with three groups of analyses (20.4.1). First, the incentives specified from HYP20.1 to HYP20.11 are tested simultaneously, using a pooled linear regression model (see for a discussion of panel data Verbeek [2000, chapter 10]). The results are re-estimated for different time periods, and per country. The dependent variable is TNI, and the independent variables form a combination of bank specific and country specific variables. This allows the following specification<sup>1</sup>:

$$Y_{ijt} = \alpha_j X_{ijt} + \delta_i B_i + \varepsilon_{ijt} \quad (1)$$

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<sup>1</sup>This follows the approach of Demirgüç-Kunt and Huizinga (1999), Mathieu (1996), Demirgüç-Kunt and Levine (2001) and Williams (2002). Mathieu (1996, p. 837) uses a panel of 24 French firms observed between 1976-85 to estimate a model with the ratio of foreign affiliate sales tot total sales as the dependent variable. Similarly, Demirgüç-Kunt and Huizinga (1999) combine bank and country variables to estimate the net interest margin between 1988-95, and Demirgüç-Kunt and Levine (2001) estimate the relationship between bank profitability and bank/country variables.

where  $Y_{ijt}$  is the dependent variable, TNI, for bank  $i$  in country  $j$  in year  $t$ .  $X_{ijt}$  are the independent variables for bank  $i$  in country  $j$  in year  $t$ ; bank specific dummies are also introduced ( $B_i$ ), replacing the constant in the model, and  $\varepsilon_{ijt}$  is an error term.

This model is estimated, varying the time period and grouping the data per country. Also, changes in TNI are estimated. The time period of the data set spans 21 years, from 1980 to 2000. The discussions of banking developments (chapter 8) and the degree of internationalization (chapter 9) suggest that an estimation of the model for the whole time period could neglect structural changes in the banking sector and bank activities. Therefore, the model is estimated for three time periods: 1980-2000, 1980-1989, and 1990-2000. The use of different time periods also allows including Spanish banks in the sample, because for these banks data is available after 1989.

To determine if there is a country of origin effect, regressions are also set up per country in the sample. The regressions per country are done with a smaller set of variables, because the number of observations per country becomes smaller. The number of independent variables compared to the number of observations would lead to over-specification of the model; this is prevented by leaving out a number of variables that were found to have the least explanatory power in the earlier estimation for the whole sample.<sup>2</sup>

After examining the relationship between the level of internationalization and incentives, the relationship is considered between the change in level of internationalization and change in incentives. First differences are calculated for the dependent variable and independent variables. The change in TNI is then regressed for the whole sample, with separate estimations for 1981-1989 and 1990-2000.

A separate analysis considers regulation as an incentive for banks to internationalize (20.4.2). Major regulatory events have been identified per country in the case study discussions (chapters 12-18). For these regulatory events, it is investigated if and how the degree of internationalization has changed prior to the regulatory change, and after the regulatory change.

Finally, the relationship between financial development and the economic structure and degree of internationalization of banks (HYP20.3, HYP20.4, HYP20.5) is analyzed in 20.4.3. Such a relationship might not be visible on a bank level, which is the investigation unit in of the analysis in 20.4.1, but surface on a country level. Therefore the degree of internationalization as dependent variable is calculated as country averages, and the relationship between this measure of TNI and the variables specified in HYP20.3, HYP20.4, and HYP20.5 are examined, using scatter plots and correlation matrices.

### **20.3. Data and variable measurement**

The data set covers 44 banks in 8 countries for 21 years, between 1980 and 2000. In total, 737 observations have been used. Chapter 9 included a detailed discussion of the composition of the sample. The main observations were that the changing composition of

the sample has reduced the number of banks during the period. For the 1980s, the size of the sample remained at 35 observations, decreasing to 27 in 2000. From 1990, four Spanish banks have been included.<sup>3</sup> For a number of firm specific variables in the sample, estimates have been used for missing values. These estimates are mostly for variables with years between 1980 and 1985.<sup>4</sup> Table 20.1 details the independent variables used; the characteristics of the dependent variable, TNI, were discussed in chapter 9.<sup>5</sup>

#### *Extrinsic incentives variables*

Extrinsic incentives have been captured by proxies like FDI, Exports, GDP, and the income structure of the bank: net interest margin and non interest income as a share of total assets. Outward foreign direct investment (*FDI*) has been calculated here as a ratio of GDP (cf. Mutinelli, 2001), *Exports*<sup>6</sup> have also been calculated as a percentage of GDP<sup>7</sup> (cf. Tschoegl, 2002, p. 141), the variable is expected to be positively related to the level of TNI. The data has been calculated on the balance of payments basis from OECD Outlook.

Financial incentives to internationalize have been captured by a number of variables. Achieving higher net interest margin in foreign countries than domestically is an incentive mentioned in a number of studies, (Aliber, 1984; Goldberg and Saunders, 1981). The incentive is represented by *Net interest margin*: net interest income as a percentage of total assets. Lower net interest margin in the home country is expected to stimulate internationalization, showing a negative relationship with TNI.

The discussion of banking developments in chapter 8 showed that in general the decrease of net interest margin has been offset by growth in *Fee income*, calculated as non interest income as a share of gross income. Thus, *Fee income* is expected to have a positive relationship with TNI. Both variables have been calculated from annual reports in local currency. The annual reports data was standardized by fitting the income and balance sheet information in the OECD model.<sup>8</sup>

The size of the economy has two dimensions as an incentive to internationalize: a large economy suggests a large home market and a lower need for internationalization. GDP growth on the other hand is a proxy for domestic growth opportunities, and is

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<sup>2</sup> As a check, the skipped variables have been entered one by one in the country regression, and were left out if no explanatory power was added on a country level also.

<sup>3</sup> Data before 1990 was not available at the sources used; a reasonable estimate based on the case study discussions in chapter 17 would be that the TNI for Banco Central and Banco Bilbao Vizcaya was under 10% for the 1980s. It was probably higher for Santander during that period. These estimates have not been included in the sample and have not been used in the regressions.

<sup>4</sup> These are presented in the appendix.

<sup>5</sup> Most variables are constructed as ratio's, creating similar dimensions as the dependent variable. Beforehand, the use of ratio's reduces the heteroskedasticity effect in the sample.

<sup>6</sup> Variables are in italics.

<sup>7</sup> Use of a ratio limits potential heteroskedasticity. Goldberg and Saunders (1981) use Imports divided by U.S. personal income, here exports as a ratio of GDP is used. A combined variable for imports and exports has also been considered but it was dropped in the end, providing no additional information above exports alone.

<sup>8</sup> This still leaves room for differences on a country basis in accounting standards, adding to the argument of also estimating the model per country.

expected to be negatively related to internationalization of banks. *GDP per capita* has also been considered, but given the relatively low yearly changes in population, this variable did not provide more information than GDP. GDP per capita however, in light of the relationship between financial development and internationalization, is used as a variable in 20.4.3. Population and GDP data has been obtained from OECD Outlook.

Table 20.1. *Independent variable definitions*

Variable	Definition	Hypothesis	Expected direction
<i>Extrinsic incentives</i>			
FDI	FDI/GDP, %	HYP20.1	+
Export	Exports/GDP, %	HYP20.1	+
Net interest margin	Net interest income/total assets bank, %	HYP20.2	-
GDP growth	GDP / GDP[t-1] - 1, %, US dollar	HYP20.3	-
GDP growth per capita	GDP per capita / GDP per capita [t-1]-1, %, US dollar	HYP20.3	-
Market concentration	Total assets largest three banks in country / total banking assets country, %	HYP20.4	+
Fee income	Non interest income/gross income bank, %	HYP20.5	+
Stock market	Total market value bonds and equities / GDP, %	HYP20.5	+
Foreign stock market	Total market value bonds and equities for country / world market value bonds and equities, %	HYP20.5	+
<i>Sector intrinsic incentives</i>			
TNI sample	TNI sample, weighted	HYP20.7	+
Banking assets	Total banking assets / GDP, %	HYP20.8	+
<i>Firm intrinsic incentives</i>			
Efficiency	Operating expenses / gross income, %	HYP20.9	+
Profitability	Profit before tax / capital and reserves, %	HYP20.10	+
Capital ratio	Capital and reserves / assets, %	HYP20.11	+

*Market concentration* is calculated as the sum of total assets of the largest three banks in the country divided by total banking assets in the country.<sup>9</sup> *Market concentration* is also relevant for the small home market incentive (HYP20.4): a higher concentration ratio indicates limited growth opportunities at home and thus an incentive to expand abroad. This is especially relevant since the sample consists of the largest banks in the country.

The largest three banks per country have been obtained from the Top 500 and Top 1000 issues of *The Banker* between 1980 and 2000, and total banking assets have been calculated from OECD Bank profitability statements, calculating the broadest measure of banking types available for each country. Total banking assets was not available for all years. For the United States, Federal Reserve data, flow of funds, were used to calculate total banking assets between 1980 and 1985. For the United Kingdom in 1980-83, France in 1980-87 and Japan in 1980-89, the asset weighted growth rates of the *Banker's* Top 500 in the countries have been calculated as a proxy for total asset growth in the country. These growth rates have then recursively been applied from the first available measure of total banking assets in OECD Bank profitability statements, estimating total banking assets in the missing periods.

Studies addressing financial development generally use financial variables, in relation to GDP. Three variables are constructed to examine the relationship between financial development and internationalization of banks for HYP20.5. *Banking assets* is calculated as total banking assets as a share of GDP. For *Stock market value*, the total value of the domestic stock market securities is calculated as a share of GDP (cf. Demirgüç-Kunt and Levine, 2001). Finally, to assess the pull incentive of the stock markets outside the home country, *Foreign stock market* is calculated as

$$Foreign\ stock\ market = 1 - \frac{Marketvalue\ domestic\ stockmarket,\ US\ dollar}{Marketvalue\ world\ stockmarket,\ US\ dollar} \quad (2)$$

The value of *Foreign stock market* lies between 0 and 1. A higher value serves as a proxy for relatively more fee income opportunities outside the home country, a lower value serves as a proxy for relatively more domestic fee income opportunities. The domestic and the world stock market values have been retrieved from Datastream.<sup>10</sup>

### *Sector intrinsic variables*

The proxies for sector intrinsic variables - herding and market concentration - focus on the relative position of banks in the sample. Herding is represented by *TNI Sample*, the weighted TNI of the total sample. A positive relationship between *TNI Sample* and internationalization of banks is expected, especially when the relationship between

<sup>9</sup> Another choice could have been the C5 ratio.

<sup>10</sup> Turnover of the stock market would have been a better indicator of the potential foreign income to be earned. However, this information was not available for the whole period between 1980 and 2000 in the datasources searched.

changes in TNI of the bank and changes in TNI of the sample are examined (HYP20.7). Banking assets are calculated as total banking assets as a share of GDP to test HYP20.8.

#### *Firm intrinsic variables*

Firm intrinsic incentives address the relationship between the bank's financial ratio's and internationalization. The choice to expand in foreign activities might be motivated by either achieving more efficiency or exploiting the existing efficiency (HYP20.9). Thus *Efficiency*, i.e. the cost to income ratio defined as operating expenses as a share of gross income, is expected to show a negative relationship with the degree of internationalization. Similarly, economies of scale and scope might be better exploited by internationalization and lead to a higher *Profitability*, calculated as profit before taxes as a share of capital and reserves. A positive relationship is hypothesized between TNI and *Profitability* (HYP20.10).

Well capitalized banks can have funding advantages as well as signaling advantages: capital strength as a Unique Selling Point abroad. Stronger capitalized banks can be considered safer and also more profitable since the bank has lower funding costs due to its higher creditworthiness. Bank with a higher capital ratio will enjoy signaling-related advantages for competing outside the home country because they strongly commit their own funds (Bandon, 1998; Heinkel and Levi, 1992). Thus *capitalization*, defined as capital and reserves as a share of total assets, should be positively related to TNI (HYP20.11). Data for profitability, efficiency and capitalization have been calculated from the annual reports. Here too, it should be noted that differences in accounting standards a priori create differences between countries.

#### *Other variables*

Bank specific dummies are used to control for bank specific effects not specified in the model. The *Exchange rate* to the US dollar was also entered as a control variable, to control for variation in TNI due to exchange rate movements: a translation effect occurs when converting foreign income and assets to domestic currency. Its sign cannot beforehand be predicted: for example, if the US dollar depreciates, a bank might speed up an acquisition<sup>11</sup>, increasing the TNI, which then is offset by the translation effect. Finally, *Total assets* are also added as a control variable. This is calculated as the logarithm of total bank assets in US dollar, and controls for a possible weight effect in the sample.

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<sup>11</sup> Jones (1993) has argued for British banks that a depreciated US dollar in the 1980s changed the timing of the acquisitions in the United States, but probably did not influence the decision itself: no "bargain hunting" because of the exchange rate. Goldberg and Saunders (1981) found that the persistent depreciation of the US dollar against major currencies between 1972 and 1979 has explanatory value in explaining the increase of share of foreign banks to total US bank assets.

## 20.4. Results

### 20.4.1. Incentives and level of internationalization

Investigating the relationship between the variables before estimation, an observation is that the correlations between the independent variables and TNI (Table 20.2) are below .4. Most correlations have p values < .05, with the exception of *GDP per capita* and *Profitability*. With regard to correlations between independent variables, relatively high correlations (> .65) are present between the independent variables *Exports*, *Market concentration* and *Foreign stock market*.<sup>12</sup>

*Net interest margin* is negatively related to *Banking assets* ( $\rho = -.64$ ,  $p < .01$ ), but shows a low correlation with *Market concentration* ( $\rho = .12$ ,  $p < .01$ ). An explanation for these correlations could be that countries with a higher degree of banking assets to GDP tend to have funding advantages that translate into lower net interest margins and are therefore unrelated with concentration of the banking market.

Table 20.2. Correlation matrix of independent variables and TNI

	TNI	FDI	Exports	Net interest margin	GDP Growth	GDP per capita	Market concentration	Stock-market value	Foreign stock-market
TNI	1.0000								
FDI	0.2639 **	1.0000							
Exports	-0.1052 **	0.4388 **	1.0000						
Net interest margin	0.1004 **	-0.0717	-0.1478 **	1.0000					
GDP Growth	-0.0838 *	-0.1497 **	-0.1611 **	0.0242	1.0000				
GDP per capita	0.1053 **	0.2161 **	-0.1219 **	-0.3728 **	0.0559	1.0000			
Market concentration	0.2132 **	0.5189 **	0.7573 **	0.1273 **	-0.1210 **	-0.1247 **	1.0000		
Stockmarket value	0.3740 **	0.7470 **	0.1089 **	-0.0773 *	-0.1060 **	0.4695 **	0.3098 **	1.0000	
Foreign stockmarket	-0.2187 **	0.2607 **	0.6594 **	-0.1330 **	-0.1015 **	-0.1617 **	0.5939 **	-0.1578 **	1.0000
Fee income	0.2518 **	0.2561 **	0.0114	-0.4289 **	-0.0713	0.4236 **	0.1131 **	0.3359 **	0.0488
TNI Sample	-0.0173	-0.0298	-0.0789 *	-0.0038	0.0709	-0.1385 **	-0.0595	0.0344	-0.1247 **
Banking assets	0.0795 *	0.3762 **	0.2406 **	-0.6456 **	-0.0616	0.5381 **	0.1075 **	0.4083 **	0.2080 **
Efficiency	0.1053 **	0.0737	0.1767 **	0.0763 *	-0.0534	0.0463	0.1754 **	-0.0416	0.1515 **
Profitability	0.0632	0.0509	-0.0677	0.2434 **	0.0406	-0.2454 **	-0.0127	0.0681	-0.1273 **
Capitalization	0.1922 **	0.2661 **	0.1181 **	0.3816 **	-0.0186	0.1930 **	0.3394 **	0.2571 **	-0.0019
Log total assets	0.1341 **	0.3457 **	-0.1768 **	-0.2951 **	-0.0256	0.7313 **	-0.1287 **	0.5471 **	-0.1174 **
Exchange rate	0.1186 **	0.1752 **	0.0046	0.0509	-0.0661	-0.0584	0.0732 *	0.0384	0.0547

	Fee income	TNI Sample	Banking assets	Efficiency	Profitability	Capitalization	Log total assets	Exchange rate
Fee income	1.0000							
TNI Sample	-0.0293	1.0000						
Banking assets	0.3543 **	0.0228	1.0000					
Efficiency	0.1134 **	-0.2956 **	-0.0606	1.0000				
Profitability	-0.0845 *	0.4211 **	-0.2313 **	-0.3127 **	1.0000			
Capitalization	0.2343 **	-0.0125	-0.1091 **	-0.0470	0.0374	1.0000		
Log total assets	0.2856 **	-0.0360	0.4907 **	0.0901 *	-0.1216 **	-0.0109	1.0000	
Exchange rate	0.0316	-0.0156	-0.0221	-0.0350	0.0475	0.0974 **	0.0654	1.0000

Note. Bivariate correlations, N = 737. \*\*: p value < .01, \*: p value < .05.

<sup>12</sup> In general, high correlation points to multicollinearity, and can be addressed by eliminating one of the variables, making a composite variable, or analyzing each separately.

First, the model is estimated for the whole period, 1980-2000, and the two sub periods, 1980-1989 and 1990-2000.

Table 20.3. *Dependent variable: TNI*

Model	1980-2000		1980-1989		1990-2000	
	coefficient	p-value	coefficient	p-value	coefficient	p-value
FDI	0.6183	0.0008 **	-0.2234	0.5474	0.2457	0.2022
Exports	0.4482	0.0016 **	0.1641	0.2765	0.6887	0.0003 **
Net interest margin	2.0744	0.0377 *	-5.5080	0.0000 **	5.1253	0.0004 **
GDP Growth	-0.0060	0.7916	-0.0086	0.6474	-0.0224	0.5182
GDP per capita	0.0000	0.0815	0.0000	0.0187 *	0.0000	0.3520
Market concentration	0.3594	0.0000 **	0.2031	0.0573	0.2261	0.0019 **
Stockmarket value	-0.1566	0.0000 **	-0.1452	0.0006 **	-0.1041	0.0001 **
Foreign stockmarket	-0.4104	0.0000 **	-0.3412	0.0000 **	-0.2358	0.0395 *
Fee income	0.0875	0.0080 **	-0.1072	0.0479 *	0.0994	0.0147 *
TNI Sample	0.0000	0.3889	0.0000	0.5387	0.0000	0.8047
Banking assets	0.1312	0.0000 **	0.0858	0.0000 **	0.1079	0.0000 **
Efficiency	0.1949	0.0000 **	0.0180	0.7259	0.1413	0.0096 **
Profitability	0.0045	0.8930	0.0241	0.3558	0.0132	0.8350
Capitalization	-0.4436	0.2029	0.3355	0.5284	0.2544	0.5549
Log total assets	6.4770	0.0430 *	-7.9706	0.1249	14.5603	0.0016 **
Exchange rate	0.0337	0.1895	-5.2692	0.0649	0.0338	0.1784
Adjusted R Square		0.8410		0.9470		0.8851
F statistic		60.4349 **		105.9251 **		51.5620 **
df		(59,604)		(49,239)		(57,317)

Note: pooled regression. A constant has not been included in the regression, bank dummies have. The results for the dummies are not displayed in the table. N = 664, 289 and 375 for 1980-2000, 1980-1989 and 1990-2000.

\*\* p value < .01, \* p value < .05

The estimated model has similar explanatory power for both the 1980-1989 and 1990-2000 period. In total, the model includes 14 independent variables, 2 control variables (*Log total assets* and *Exchange rate*), and 44 bank dummies. Of the 14 independent variables, 9 show the expected sign for the whole period, 9 for 1980-89 and 10 for 1990-2000. For all three periods, 7 independent variables have consistently the predicted signs: *Exports*, *GDP Growth*, *Market concentration*, *TNI Sample*, *Banking Assets*, *Efficiency* and *Profitability*. With the exception of *GDP Growth*, the estimates show a positive relationship with TNI.

On the other hand, the estimated values of three variables consistently show the opposite signs: *GDP per capita*, *Stock Market*, and *Foreign stock market*. One variable, *Capitalization*, does not have the predicted sign for the total period, but shows the expected signs for 1980-1989 and 1990-2000. The variable then controls for the difference in levels of capitalization.

Between the different time periods, shifts in significance and signs of estimated variables are observable for *FDI*, *Net interest margin* and *Fee income*. The sign for *Net interest margin* is negative for 1980-1989 (as expected), being positive for 1990-2000. The increasing role of non interest income is positively related to the degree of internationalization of banks in the 1990s, while the decline of net interest margin in the 1980s has positively influenced internationalization.

In short, the results from the model validate the use of different time periods. Of the hypotheses, all three hypotheses relating to bank intrinsic incentives have the predicted signs: Efficiency hypothesis (HYP20.9), Profitability hypothesis (HYP20.10) and Capitalization hypothesis (HYP20.11). The same applies for both sector intrinsic hypotheses: TNI sample (HYP20.7) and Market power (HYP20.8). None of the period estimates for HYP20.7 has p values < .05, while the other variables have at least one estimate with p < .05.

The extrinsic incentive hypotheses are either partially or full rejected. The client hypothesis (HYP20.1) is supported by the results for *Exports* for both periods, but not by *FDI* for 1980-1989. The spreads hypothesis (HYP20.2) is not supported by the results in 1990-2000. The economic structure hypothesis (HYP20.3) is rejected by *GDP Growth* for all periods, and supported by GDP per capita. While the level in *GDP capita* is positively related to TNI, the growth in GDP is negatively related. The financial development (HYP20.5) hypothesis was not rejected by the fee income variable, but rejected for both stock market variables. Moreover, *Stock market* and *Foreign Stock market* have p values < .05.

To check the robustness of these results, the observations are split per country and re-estimated, yielding estimates for the banks in the eight countries in the sample. The split estimations also allow checking for a "country of origin effect": do banks from different countries react differently to the same incentive, because of different cultural, historical, or regulatory reasons.

Re-estimation of the model split per country with the same number of independent variables would create un-interpretable results; the number of variables including bank dummies lead to over-specification because the dataset is limited. To prevent over-specification, 4 variables that did have limited explanatory power<sup>13</sup> have been dropped, reducing the number of independent variables from 14 to 11, and reducing control variables to *Exchange rate*. Also, the bank dummies are dropped in the analysis, assuming equal levels of TNI per bank in the same country. Table 20.4 presents the model summaries; the coefficients are displayed in Table 20.5.

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<sup>13</sup> These were: *GDP*, *GDP per capita*, *TNI sample* and *Stock market value*. These variables had limited explanatory power. Variables that were skipped because of low explanatory power and high correlation with other variables were funding power, relative profitability, stockmarket value, and log total assets.

Table 20.4. Model summary, dependent variable TNI

Country	1980-2000			1980-1989			1990-2000		
	Adjusted R Square	F statistic	df	Adjusted R Square	F statistic	df	Adjusted R Square	F statistic	df
France	0.2300	3.5530	(11,83) **	0.0455	1.1775	(11,30)	0.6742	10.7837	(11,41) **
Germany	0.6855	25.1791	(11,111) **	0.4933	6.2213	(11,48) **	0.6308	10.6298	(11,51) **
Spain	0.6435	7.0721	(11,26) **	a.			0.6435	7.0721	(11,26) **
Switzerland	0.7207	14.8387	(11,48) **	0.6828	6.6746	(11,18) **	0.7333	8.2471	(11,18) **
United Kingdom	0.2487	4.0397	(11,90) **	0.2778	2.6084	(11,35) *	0.5250	6.4249	(11,43) **
Netherlands	0.4742	7.7225	(11,71) **	0.5831	5.8310	(11,27) **	0.3946	3.5479	(11,32) *
United States	0.4148	8.5829	(10,97) **	0.6465	11.4243	(10,47) **	0.6986	12.3577	(10,39) **
Japan	0.1098	1.9865	(11,77) *	0.3771	3.1463	(11,28) **	0.0361	1.1632	(11,37)

Note a: not included in sample

\*\* : p value < .01, \* : p value < .05

Table 20.5. Dependent variable: TNI

Period	Model	France		Germany		Spain		Switzerland	
		Coefficient	p value	Coefficient	p value	Coefficient	p value	Coefficient	p value
1980-2000									
	FDI	0.4097	0.7223	-0.0728	0.9518	-2.4063	0.6332	0.9285	0.1417
	Exports	0.2862	0.7961	-0.0351	0.9214	3.3443	0.1360	0.5885	0.2801
	Net interest margin	-12.6431	0.0016 **	12.6788	0.0003 **	14.0760	0.0251 *	3.7149	0.5939
	Fee income	-0.2595	0.0796	0.2227	0.0015 **	0.8899	0.0105 *	0.0865	0.6865
	Profitability	-0.4334	0.0738	-0.2375	0.1413	1.0073	0.0583	0.1940	0.2900
	Capitalization	-1.7700	0.1366	-2.3832	0.2731	4.0372	0.3478	-2.6965	0.0112 *
	Efficiency	-0.0475	0.8670	0.4118	0.0001 **	0.1920	0.5817	-0.0108	0.9601
	Market concentration	0.5727	0.5206	0.2281	0.7682	0.4490	0.6979	0.1459	0.2836
	Banking assets	0.0204	0.8410	0.2365	0.0026 **	0.1925	0.6386	0.0083	0.8249
	Foreign stockmarket	2.5854	0.3954	0.3100	0.8273	17.9063	0.4113	1.3719	0.7784
	Exchange rate	-1.6542	0.3331	-2.3849	0.5380	0.0454	0.7912	20.5340	0.0592
1980-1989									
	FDI	-3.2527	0.5800	-7.2977	0.3806	a.		1.9343	0.0038 **
	Exports	-0.6297	0.6709	0.3691	0.5902	a.		0.2144	0.7012
	Net interest margin	-11.5195	0.1950	1.4151	0.6563	a.		-29.3208	0.1117
	Fee income	-0.6266	0.0532	0.0597	0.3932	a.		-1.0207	0.0243 *
	Profitability	0.8603	0.1084	-0.0309	0.8025	a.		-3.3681	0.0337 **
	Capitalization	4.9987	0.0970	4.1881	0.0437 *	a.		-11.9584	0.0031 **
	Efficiency	0.0554	0.9227	0.2102	0.0313 *	a.		-1.0221	0.0481 *
	Market concentration	1.0555	0.5679	0.6084	0.6341	a.		0.9107	0.5604
	Banking assets	0.2040	0.4764	0.2783	0.2953	a.		0.0685	0.6180
	Foreign stockmarket	6.3618	0.4901	-0.6076	0.7487	a.		-31.4220	0.0204 *
	Exchange rate	-13.4295	0.9349	-8.6927	0.4658	a.		12.4645	0.5777
1990-2000									
	FDI	-0.5649	0.7564	-0.4816	0.8251	-2.4063	0.6332	0.3145	0.7918
	Exports	-1.4149	0.5212	0.1516	0.9123	3.3443	0.1360	0.2219	0.8709
	Net interest margin	-20.4882	0.0000 **	18.6152	0.0024 **	14.0760	0.0251 *	-5.2337	0.6040
	Fee income	-0.2589	0.1557	0.2651	0.0290 *	0.8899	0.0105 *	0.4601	0.1397
	Profitability	-0.4945	0.0361 *	0.0155	0.9607	1.0073	0.0583	-0.0344	0.8728
	Capitalization	-2.7776	0.0387	-4.5412	0.1983	4.0372	0.3478	-0.0332	0.9825
	Efficiency	-0.0364	0.9038	0.8377	0.0002 **	0.1920	0.5817	-0.2195	0.4114
	Market concentration	1.5975	0.4082	-1.1818	0.4304	0.4490	0.6979	0.0830	0.7223
	Banking assets	-0.1669	0.7633	0.3837	0.0069 **	0.1925	0.6386	0.1185	0.2100
	Foreign stockmarket	-1.1196	0.8339	0.9166	0.9018	17.9063	0.4113	13.6847	0.2027
	Exchange rate	-2.1881	0.1710	3.2503	0.6689	0.0454	0.7912	34.2245	0.3504

Note: a. Not included in sample. b. Exchange rate excluded, due to unity.

\*\* : p value < .01, \* : p value < .05

Table 20.5. (Continued)

Period	Model	United Kingdom		Netherlands		United States		Japan	
		Coefficient	p value	Coefficient	p value	Coefficient	p value	Coefficient	p value
1980-2000									
	FDI	-1.5886	0.0747	-0.0837	0.9318	-12.7302	0.0342 *	-0.3857	0.9318
	Exports	-2.3804	0.1116	0.4010	0.2706	7.6279	0.0081 **	1.4537	0.2592
	Net interest margin	-14.6103	0.0027 **	-2.7851	0.6214	6.0047	0.0072 **	5.3717	0.2416
	Fee income	-2.6400	0.0000 **	0.4420	0.0639	0.8978	0.0000 **	0.1071	0.2486
	Profitability	-0.2401	0.1649	-1.2091	0.0094 **	-0.0381	0.7032	-0.0500	0.5948
	Capitalization	-1.1632	0.5334	0.9640	0.4846	-3.3275	0.0297 *	3.9639	0.0262 *
	Efficiency	-0.5335	0.2145	0.4572	0.1915	-0.3117	0.1665	0.2046	0.0070 **
	Market concentration	0.9716	0.0893	0.1473	0.6248	-2.4558	0.0092 **	0.3455	0.5816
	Banking assets	0.5061	0.0379 *	0.0301	0.5857	0.2505	0.5442	-0.0002	0.9968
	Foreign stockmarket	1.4282	0.6728	-4.9494	0.4758	-1.2343	0.0001 **	-0.3939	0.0134 *
	Exchange rate	-9.7233	0.4563	2.0776	0.7074	b.		-597.6383	0.6601
1980-1989									
	FDI	-9.2840	0.0849	-0.7890	0.6917	0.0583	0.9935	-0.0972	0.9938
	Exports	-1.2252	0.5926	-0.1102	0.8158	-2.2601	0.5659	-1.7404	0.6770
	Net interest margin	-3.6605	0.6291	6.2082	0.4650	-1.2794	0.6450	2.3115	0.7115
	Fee income	0.5033	0.6101	0.8598	0.0316 *	0.6396	0.0012 **	-0.1541	0.4133
	Profitability	0.3297	0.1375	-0.4412	0.3596	0.1505	0.0941	0.5366	0.0389 *
	Capitalization	-13.5700	0.0035 **	-2.2567	0.2793	-1.9888	0.1653	10.9365	0.0064 **
	Efficiency	-1.8870	0.0435 *	1.6766	0.0000 **	-0.0659	0.6982	0.3297	0.0112 *
	Market concentration	1.8960	0.3316	0.7129	0.5754	5.4095	0.0783	-5.0239	0.5786
	Banking assets	1.4380	0.1457	0.2537	0.5662	-0.4363	0.4973	0.0648	0.5190
	Foreign stockmarket	4.7692	0.4822	12.0561	0.3024	-0.0880	0.8218	-0.4361	0.5237
	Exchange rate	54.1531	0.0482	-43.3100	0.2307	b.		-4,717.2335	0.5294
1990-2000									
	FDI	-1.6400	0.1922	1.0772	0.5768	-4.9766	0.5244	2.7271	0.7816
	Exports	-3.8738	0.2100	-0.4160	0.7362	10.0895	0.0146 *	2.6017	0.6244
	Net interest margin	-19.7456	0.0025 **	21.1761	0.0936	22.8358	0.0000 **	14.2190	0.1248
	Fee income	-4.7734	0.0000 **	1.9209	0.0050 **	2.4505	0.0000 **	0.2441	0.0774
	Profitability	0.1728	0.6203	-4.3088	0.0022 **	0.0669	0.8297	-0.1555	0.2826
	Capitalization	5.1615	0.0285 *	-7.4097	0.0604	0.5192	0.8061	3.7488	0.1795
	Efficiency	0.1647	0.7624	-1.5542	0.0894	0.2878	0.5522	0.0851	0.4069
	Market concentration	2.0475	0.0928	0.0531	0.9477	-0.9911	0.3308	0.0857	0.9522
	Banking assets	0.5087	0.2432	-0.1406	0.4941	0.7115	0.4332	-0.1135	0.8261
	Foreign stockmarket	-4.2658	0.3727	-32.4515	0.1074	0.6290	0.2552	-0.5581	0.0632
	Exchange rate	-15.6420	0.6369	11.8866	0.2503	b.		-692.7810	0.6853

Note: a. Not included in sample. b. Exchange rate excluded, due to unity.

\*\* : p value < .01, \* : p value < .05

Based on the adjusted R Square, the model best explains the variance in level of TNI for German banks, Swiss banks and American banks for both time periods. For English banks, the explanatory power almost doubles from  $R^2 = .27$  between 1980 and 1989 to  $.52$  in between 1990 and 2000. French banks also show a strong increase: from  $R^2 = .04$  between 1980 and 1989 to  $.67$  between 1990 and 2000. The opposite is true for Dutch banks, with a decrease in adjusted R-square from  $.58$  to  $.39$  in the following period.

The adjusted R-Square for American banks is comparable for both periods. In 1980-1989 the explanatory power is practically absent for French banks ( $R^2 = .04$ ), for 1990-2000, this applies to Japanese banks ( $R^2 = .03$ ). Table 20.5 lists the coefficients per country. The numbers of signs in Table 20.5, in accordance with the predicted signs of the model estimated per country, are summarized in Table 20.6.

Table 20.6. *Number of signs in accordance with prediction, out of ten variables*

	France	Germany	Spain	Switzer- land	United Kingdom	Nether- lands	United States	Japan
1980-2000	6	5		7	4	7	3	5
1980-1989	7	6		5	6	5	5	4
1990-2000	2	6	8	7	6	3	7	6

Note: the exchange rate as variable has not a predicted sign and is therefore not shown in this table.

Spanish banks in 1990-2000 have the highest number of estimated signs in line with the hypotheses: 7 out of 10. French banks have shown the lowest number of estimated signs in line with the hypotheses for 1990-2000, 2 out of 10.

For the variables, the numbers of signs in accordance with the predicted signs are summarized in Table 20.7. The correct signs are concentrated with sector extrinsic variables – *Market Concentration*, *Banking assets* - and two firm extrinsic variables, *Net interest margin* and *Foreign Stockmarket*. Besides correct signs, these three variables have p values lower than .05 in more than one country. Variables like outward *FDI* and *Exports*, representing the client incentive hypothesis (HYP20.1), have the least correct signs in 1980-89 for the country estimations.

Table 20.7. *Number of signs in accordance with prediction, out of eight country estimations*

	1980-2000	1980-1989	1990-2000
FDI	2	2	3
Exports	6	2	5
Net interest margin	3	4	3
Fee income	6	4	6
Profitability	2	4	4
Capitalization	3	3	4
Efficiency	4	4	5
Market concentration	7	6	6
Banking assets	7	6	5
Foreign stockmarket	5	3	4
Number of countries	8	7	8

Note: the exchange rate as variable has not a predicted sign and is not therefore not shown in this table.

Summarizing, estimation of the model split by country indicates that there is a country of origin effect: the F-statistics and number of correct signs per country show periods where variables other than the incentives must have had more explanatory power for the degree of internationalization of banks. This applies for French banks (1980-1989),

Japanese banks (1990-2000) and to a lesser extent for English banks (1980-1989). Also, estimations per country could not support FDI as incentives to internationalize. On average, the variable *Exports* is supported for 1980-2000 and for 1990-2000. Sector extrinsic variables (*Market concentration*, *Banking assets*) are supported.

Summarizing the results, the model for the relationship between the level of TNI and incentives explains variation to a large degree. With regard to extrinsic motives, the client hypothesis (HYP20.1), expecting a positive relationship between exports, FDI and TNI, is supported by the results for *Exports* both periods. With the results per country, the coefficients for *Exports* show mostly the predicted signs for 1990-2000, but not for 1980-1990. FDI as an incentive to internationalize is supported for 1990-2000, but not for 1980-1990. The results per country show for most countries negative signs for FDI in both periods; this makes FDI - in terms of sign predictions - the worst performing variable.

The spreads hypothesis (HYP20.2) is not supported by the results in 1990-2000. Between the different time periods, shifts in significance and signs of estimates between *Net interest margin* and *Fee income* are observable. The sign for *Net interest margin* is negative for 1980-1989, being positive for 1990-2000. The increasing role of non interest income is positively related to the degree of internationalization of banks in the 1990s, while the decline of net interest margin in the 1980s has positively influenced internationalization.

The other extrinsic incentive hypotheses are either partially or full rejected. The economic structure hypothesis (HYP20.3) is rejected by *GDP Growth* for all periods, and supported by GDP per capita. While the level in *GDP capita* is positively related to TNI, the growth in GDP is negatively related. Relatively richer countries tend to have banks with a higher degree of internationalization, unless there are domestic economic growth opportunities.

A higher degree of *Market concentration* is positively related to a higher level of TNI. This result is consistently repeated in country estimates. On the other hand, Market concentration is negatively related to either GDP Growth or GDP per capita, and supports HYP20.4, but to a low degree. This suggests that *Market concentration* per se is an incentive, and not tied to the size of the economy. Therefore, HYP20.6, the small home market hypothesis, is partly supported by the results.

The financial development (HYP20.5) hypothesis was not rejected by the *Fee income* variable, but rejected for both *Stock market* variables for the whole sample. The country estimation showed in general correct signs for the *Foreign Stock Market*, suggesting that there is overall support for the financial development hypothesis.

All three hypotheses relating to firm intrinsic incentives are not rejected by the results: these are the Efficiency hypothesis (HYP20.9), Profitability hypothesis (HYP20.10) and Capitalization hypothesis (HYP20.11). The same applies for both sector intrinsic hypotheses: TNI sample (HYP20.7) and Market power (HYP20.8).

Firm intrinsic incentives have strong explanatory power and different effects per country, such as capitalization. The unanswered question here is if a higher TNI depletes the capitalization of the bank, or that banks with higher capitalization in general have

lower degrees of internationalization, due to the banks (risk averse) strategy or other bank specific restrictions.

*Efficiency* also influences the level of TNI: efficient banks tend to show higher levels of TNI. Since banks with higher levels of TNI in time have become more dependent on fee income, they are bound to have higher cost levels, suggesting that their efficiency efforts have been significantly better from the other banks in the sample.

#### 20.4.2. Incentives and regulation

Regulation has always played an important part in the activities of the financial intermediary due to its externalities. In order to prevent or mitigate the consequences of externalities, government can decide to regulate financial intermediaries. Regulation for financial intermediaries can be set up through three different channels: regulation as an incentive for banks to internationalize, regulation controlling the entry and conduct of new foreign banks in country and international regulation.

##### *Regulatory changes and domestic banks*

Here it is investigated if a relatively high degree of regulation in the home country is positively related to the degree of internationalization (HYP20.6). A number of important regulatory changes have been identified, and it is investigated how the TNI has changed for the banks before and after the year of regulatory change. The years before are important to see whether there are anticipatory effects prior to the year of regulatory change, while the years after show the actual effect in TNI. These figures are then analyzed: is there a change in trend visible or not?

In chapter 12-18, major regulatory changes have been identified per country, while it was also indicated whether these changes had effect on the internationalization activities of banks. This has led to a number of major regulatory changes, presented in Table 20.8. Next, for each regulatory change the difference in average TNI per country for 1 to 4 years before the year of regulatory change is calculated, and for 1 to 4 years after the year of regulatory change:

$$\text{TNI Change} = \text{TNI}_{t-n} - \text{TNI}_t \quad (1)$$

Where  $t$  is the year of regulatory change, and  $n$  is between  $-1$  and  $-4$  or between  $1$  and  $4$ .<sup>14</sup> The results are shown in Table 20.8, per country and per regulatory event. On the right side of table two arrows are shown, indicating the general direction for the differences in TNI for the period before and after year of regulatory change.

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<sup>14</sup> The value  $n = 0$  is left out since this leads per definition to TNI Change = 0.

Table 20.8. Changes in average TNI per country 1 to 4 years before and after regulatory changes

Year	Regulatory change	t, t-4	t, t-3	t, t-2	t, t-1	t, t+1	t, t+2	t, t+3	t, t+4	change TNI* before after
France										
1984	Deregulation financial markets	4.73	3.34	2.68	0.75	0.47	-1.01	-0.34	0.67	↘ →
United Kingdom										
1986	Deregulation financial markets	-8.19	-8.85	-9.21	-2.85	-3.50	-3.91	-1.44	-6.51	↘ ↘
Netherlands										
1990	Abolishment seperation bank/insurance	1.01	-0.16	-1.19	1.65	2.12	3.12	3.67	2.76	→ ↗
United States										
1981	International Banking Facility				-0.15	-0.19	-3.20	-6.38	-9.14	↘ ↘
1983	International Lending Supervision		-3.34	-3.20	-3.00	-3.18	-5.95	-7.84	-9.69	↘ ↘
1991	Foreign Bank supervision	-5.16	-2.79	0.18	0.98	1.09	1.17	1.06	1.49	↗ →
1994	Interstate	-2.04	-1.06	0.03	0.11	0.44	0.00	0.44	-1.60	↘ →
1999	Gramm Leach Bliley	-2.88	-2.25	-2.69	-0.58	-1.19				↘ ↘
Japan										
1985	Deregulation financial markets	-1.94	-2.06	-2.16	-4.28	0.74	2.08	5.57	5.33	↘ ↗
1997	Deregulation financial markets	7.00	4.83	3.05	1.07	-5.58	-13.46	-8.52		↘ ↘

Note: t, t-n shows the difference between the average TNI in t and the average TNI in t-n. The TNI is calculated as unweighted TNI averages for the banks in the country.

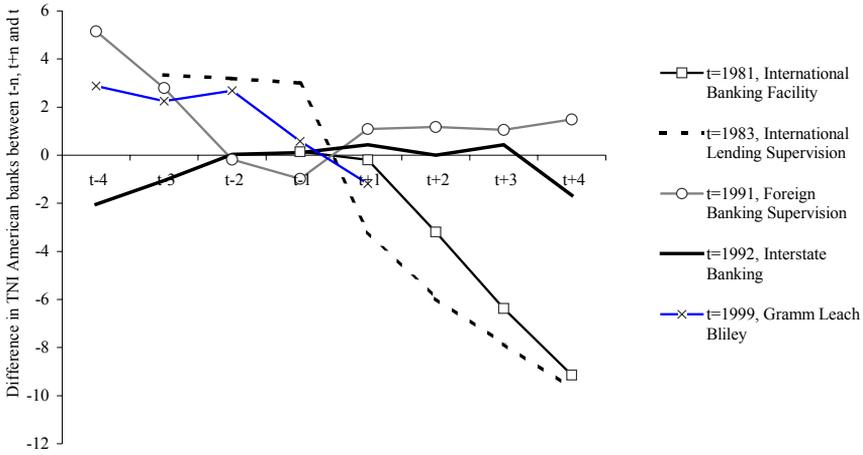
\*: The signs indicate the general direction of the change in TNI before, and after the year of regulatory change. The upward arrow indicates an increasing positive difference in TNI in the years before/after the year of regulatory change, while the horizontal arrow indicates a constant change and the decreasing arrow a negative change.

In 2 out of 9 instances there was an increase in TNI after the years of regulatory change: Japan in 1985, and the Netherlands in 1990. In 4 out of 9 instances there was a decrease in TNI: 2 relating to deregulation of financial markets (United Kingdom, 1986 and Japan, 1997). The other 2 were American changes in regulation, in 1981 and 1983. Finally, 3 out of 9 instances showed no substantial change in TNI: legislation in the United States (1991, 1992), and deregulation of French capital markets in 1984.

The United States has been an important area to internationalize to; Figure 20.1 shows the development of changes in TNI before and after major regulatory changes in the United States. The International Banking Facility was created to attract off shore dollars back to the United States, and the International Lending Supervision was designed to encourage prudent lending practices (see chapter 12). While the latter did contribute in curbing foreign lending, agreeing with the negative change in TNI in the years following the passing of the Act, the International Banking Facility was more used by foreign banks (Dombrowski, 1996). The effects due to the passing of the IBF can probably be ascribed to the effects of the International Lending Supervision.

To show the effects of regulatory changes for foreign banks in the United States, foreign assets as a share of total banking assets instead of TNI in equation (1) are calculated. The results are shown in Figure 20.2.

Figure 20.1. Average change in TNI for American banks before and after regulatory changes

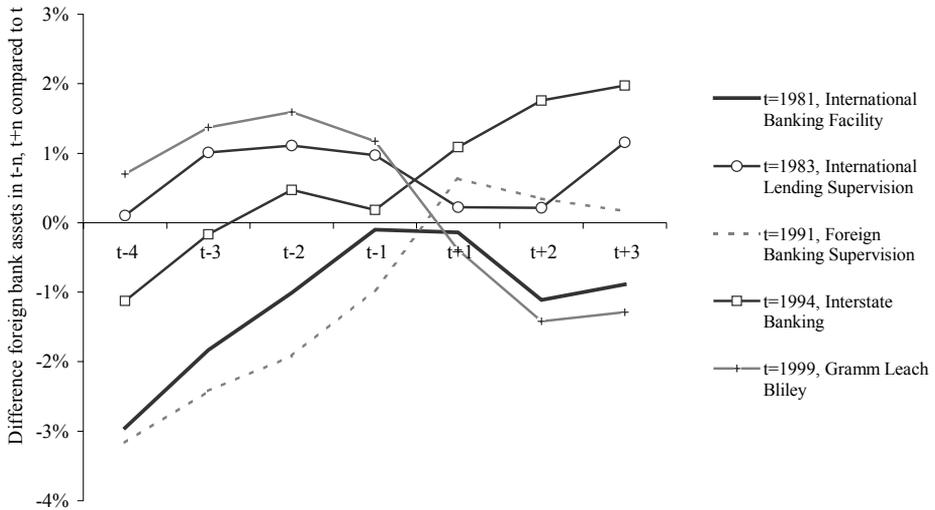


Note: t+n is difference between TNI at t, the year of regulatory change, and n years before or after. TNI is calculated as unweighted country average TNI. The time series legend shows the year of regulatory change.

The years after the implementation of the IBF, foreign asset share in total United States bank assets decreased, while the TNI of American banks in the sample decreased with over 8% in the subsequent four years. This is more likely the effect of the LDC crisis, IBF facilities did not cause the expected repatriation of offshore funds by American, and the facilities were in majority used by foreign banks (Dombrowski, 1996). The legislation for the International Lending Supervision Act had no significant effect for foreign banks before and after 1983. For domestic American banks, average TNI decreased with almost 10% in 4 years. The legislation for the Foreign Banking Supervision might well have had an effect for foreign banks; while foreign asset share increased in the years before 1991, the years after foreign asset share remained relatively stable.

The introduction of interstate banking did not affect the degree of internationalization before and after 1994. It did not affect foreign banks also, since the share of foreign assets systematically increased before and after 1994. The implications of interstate banking - increasing scale of banking operations in the United States and higher required investments to remain competitive - were an incentive for Barclays to exit retail banking in the United States. Apparently there were on average more foreign banks attracted by the opportunities than threats of interstate banking. More substantial effects might result from the Gramm-Leach-Bliley Act, basically abolishing separation between commercial banking and insurance. The domestic TNI has been declining prior to the change, as well as the foreign share of assets.

Figure 20.2. Change foreign assets in the United States before and after regulatory changes

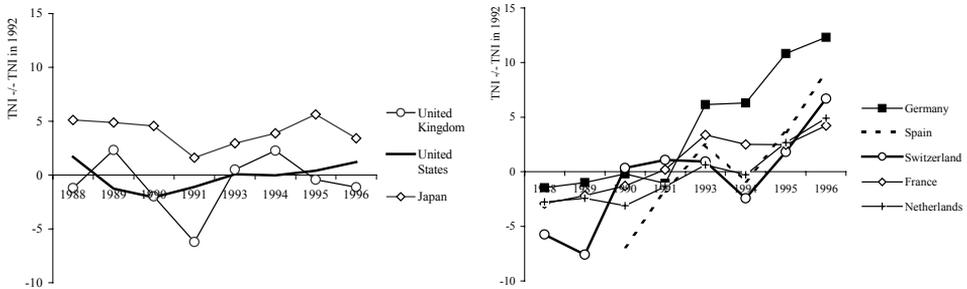


Note:  $t+n$  is difference between % foreign assets at  $t$ , the year of regulatory change, and  $n$  years before or after.  
 Source: foreign assets: Federal Reserve Bank.

**Basle Accord**

One regulatory change affected almost all banks in the sample, the Basle Capital Accord. Introduced in 1988 and to be implemented in 1992, the Accord introduced a framework for banks obliging them to maintain a minimum capital standard Accord. Financial regulators implemented them on a country level.

Figure 20.3. Changes in TNI compared to implementation Basle Accord in 1992



Note: average TNI of banks in country.

The degree of internationalization did not change for Japanese banks the years after 1992, although ensuring a level playing field with less capitalized Japanese banks had been an ulterior motive for British and American regulators to promote the capital adequacy

framework (see also Chapter 8.3). For American banks, no changes are detectable: the average change in TNI before and after 1992 remained close to zero. For European banks, it cannot be said that implementation of the Basle Accord has introduced a watershed in internationalization activities before and after 1992.

Summarizing, the relationship between change in regulation and change in TNI is mixed. Two regulatory changes can be marked as increasing regulation. In the United States, after the implementation of the Foreign Banking Supervision act foreign bank share did not increase anymore. The implementation of IBF had a positive effect for foreign banks and a negative for domestic banks. The other changes in regulation might be classified as deregulation: the liberalization of financial markets, or the liberalization of industry. Finally, there is no direct relationship between average TNI and the implementation of the Basle Accord.

#### 20.4.3. Financial structure and development

The analyses in 20.4.1 included relationships to be investigated between independent variables on a macro level, such as *Stockmarket* or *GDP per capita*, while the dependent variable was on a micro level, TNI per bank. Here, the TNI is aggregated per country, and the relationships between financial development, economic structure and TNI are further examined.

Banks, stock markets and bond markets are larger, more active and more efficient in richer countries, showing that financial systems are on average more developed in richer countries (Demirgüç Kunt and Levine, 2002, p. 6). Relative differences in stock market and banking assets to GDP have an effect on the performance of the banking system, not on financial structure itself. Demirgüç-Kunt and Levine investigated the relationship between economic development and bank, non-bank, and stock market development. They concluded that in higher income countries, banks and other financial intermediaries tend to be larger, more active and more efficient (Demirgüç-Kunt and Levine, 2001, p. 84). Taking into account that the countries in the sample are among the higher income countries, it is next investigated what the relationship is between the degree of internationalization and economic development, bank, non-bank and stock market development. Specifically, how has the relationship developed over time for the different countries?

The relationship is measured per country in a model, with the weighted TNI per country as dependent variable, and four measures as independent variables. First, *GDP/Capita* equals the ratio of GDP in local currency to the total population of the country.<sup>15</sup> GDP and population data were derived from the OECD Economic Outlook database. The second one is *Bank assets/GDP*, equaling the ratio of total assets of deposit money banks to GDP. Total assets were derived from the broadest banking assets measure

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<sup>15</sup> GDP in local currency is more appropriate than GDP in US dollar, since the focus is not on a cross-country comparison. With a cross country comparison, the exchange rate effect would be mitigated by relative comparison. Here, it would introduce variability which is not reflected in the independent variable TNI.

published in the OECD Bank profitability database; the variable is a general indicator of bank activity in the private sector (Demirgüç-Kunt and Levine, 2001, p. 85). Third, *Market capitalization/GDP* is the ratio of the total market value of domestic securities traded on the domestic exchanges to GDP, and measures the relative market size of the stock market (Demirgüç-Kunt and Levine, 2001, p. 93). Finally, the relative importance of other participants for acquiring funds is represented by *nonbank assets/GDP*, focusing on insurance companies, investment companies and finance companies.<sup>16</sup> *Nonbank assets/GDP* is the ratio of total reported assets of institutional investors, reported in the Institutional Investors database from the OECD, as a share of GDP.

Demirgüç and Levine (2001, p. 95) find that the overall size of the financial sector rises sharply with GDP per capita. A relationship between GDP per capita and country weighted TNI is presented in Figure 20.4.

There is a positive relationship between GDP per capita and TNI for Germany, Switzerland, France, Spain, and the Netherlands. A negative relationship can be observed for the United States, while the relationship is weak and negative for Japanese banks and English banks. The banks in Spain, Germany and the Netherlands have in common that there is a marked difference in the relationship prior and after 1990, TNI increases relatively faster than GDP per capita in the earlier period. The same also applies to Swiss banks, with one exception: the relative increase in GDP per capita in the 1990s is substantially lower than the Netherlands, Germany or Spain. Although these differences are partly caused by using nominal GDP instead of real GDP in US dollar, these differences are relevant since banks report in local (nominal) currency. From this perspective, the small home country effect might have been more relevant for Swiss banks than for Dutch banks.

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<sup>16</sup> Similar to the variable *claims of other financial institutions on private sector/GDP* (Demirgüç-Kunt & Levine, 2001, p. 85).

Figure 20.4. Relationship between TNI and GDP per capita, 1980-2000

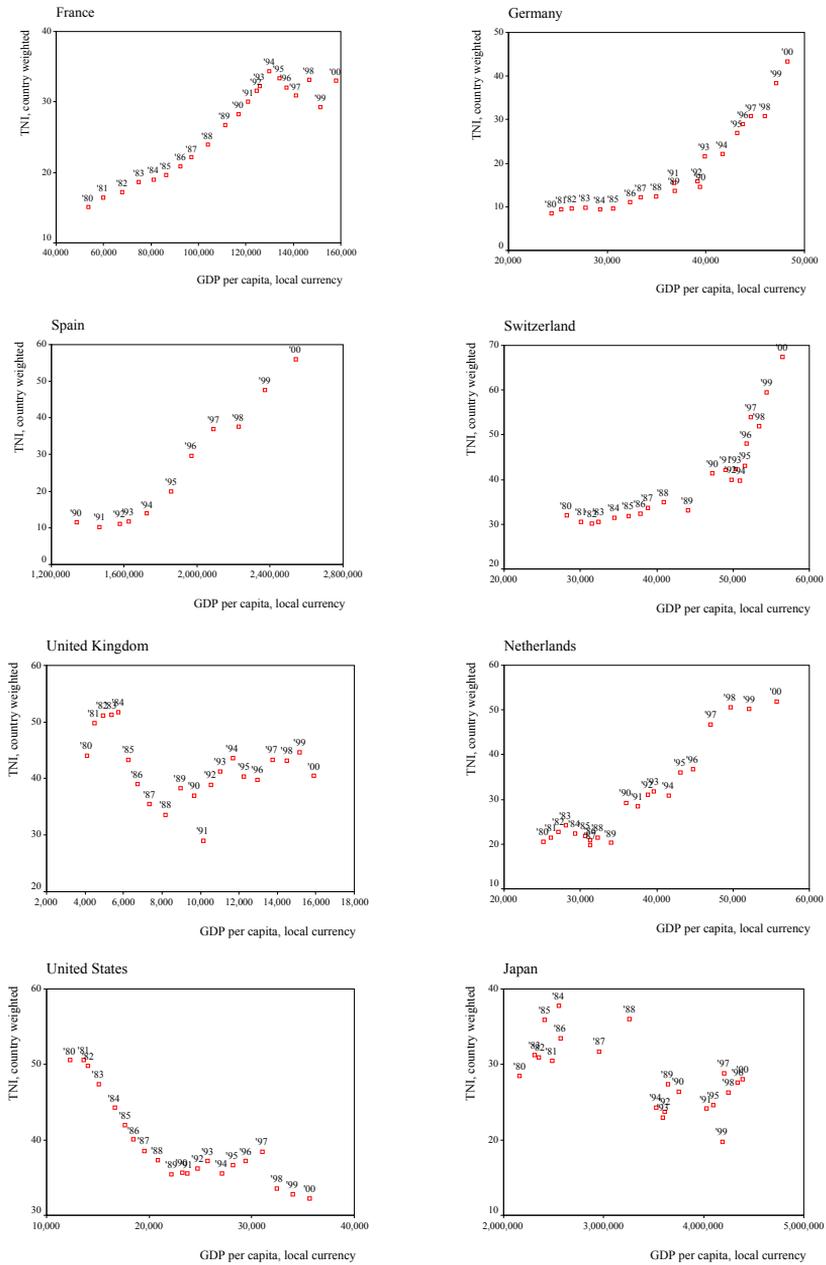


Table 20.9. *Correlations between financial development indicators and TNI per country*

	GDP /capita		Bank assets /GDP		Nonbank assets /GDP		Market capitalization /GDP	
	Correlation	p value	Correlation	p value	Correlation	p value	Correlation	p value
France	0.9465	0.0000 **	0.8420	0.0000 **	0.8568	0.0000 **	0.6726	0.0008 **
Germany	0.9067	0.0000 **	0.9779	0.0000 **	0.9688	0.0000 **	0.9570	0.0000 **
Spain	0.9696	0.0000 **	0.7522	0.0076 **	0.9239	0.0000 **	0.9579	0.0000 **
Switzerland	0.8479	0.0000 **	0.9092	0.0000 **	0.8324	0.0000 **	0.9455	0.0000 **
United Kingdom	-0.3226	0.1538	-0.0729	0.7536	-0.2454	0.2970	-0.1448	0.5311
Netherlands	0.9487	0.0000 **	0.9646	0.0000 **	0.8615	0.0000 **	0.9734	0.0000 **
United States	-0.8636	0.0000 **	-0.0527	0.8205	-0.8022	0.0000 **	-0.6444	0.0016 **
Japan	-0.6516	0.0014 **	-0.3932	0.0779	-0.1189	0.7276	-0.5657	0.0075 **

Note: Pearson correlation, bivariate. N=21 for all countries and variables except variables for Spain (N=11) and nonbank/GDP variable for Japan (N=11).

Source: OECD Bank profitability (bank assets) OECD Institutional investors (non bank assets) OECD Economic outlook (GDP, population), Datastream (market capitalization). TNI own calculations.

\*\* : p value < .01, \* : p value < .05

Table 20.9 presents the correlations between TNI per country and the four measures of financial development: *GDP/capita*, *Bank assets/GDP*, *Nonbank assets/GDP* and *Market capitalization/GDP*. The correlations between the four variables and TNI are both positive and higher than .83 for France, Germany, Spain, Switzerland and the Netherlands. For the other three countries (Japan, the United Kingdom and the United States) negative correlations are calculated; correlations between TNI and *Bank assets/GDP* are negative and weak for the United Kingdom ( $\rho=-.07$ ) and the United States ( $\rho=-.05$ ). The different measures for financial development have a strong positive relationship with the degree of internationalization of banks in France, Germany, Spain, Switzerland and the Netherlands. A negative and weak correlation exists for Japanese banks and British banks. Finally, a strong and negative correlation between financial development indicators and the degree of internationalization exists for American banks. This is similar to the graphical relationship between *GDP/capita* and TNI in Figure 20.4.

Summarizing the findings for HYP20.5, hypothesizing a positive relationship between financial development variables and TNI, there is a stronger relationship between financial development variables and TNI on a country level than between financial development variables and TNI for individual banks. The relationship between TNI and bank assets, GDP per capita, and stock market is confirmed for France, Germany, Spain, Switzerland and the Netherlands. The relationship is rejected for the United States, the United Kingdom and Japan.

## 20.5. Summary

This chapter investigated the relationship between the degree of internationalization of banks, presented in the case studies in Part II, and the incentives to internationalize, formulated in Part I. A pooled regression model tested the relationship between the incentive variables and TNI for different periods. The estimations were further split up by country. Also, changes in TNI were estimated. The model for the relationship between the level of TNI and incentives explained variation to a large degree. For the whole sample, a number of incentives were not rejected as hypotheses:

A number of hypotheses were not confirmed, an important being the client hypothesis (HYP20.1). Expecting a positive relationship between exports, FDI and TNI has been supported by the results for *Exports* both periods but not by *FDI* for 1980-1989. When country estimations are considered, the estimated coefficients show mostly negative values. An explanation for the partial rejection of the client incentive could be that these "traditional" explanations had some weight prior to 1980, but lost their explanatory power as banks began to develop different strategies in the 1980s.

The spreads hypothesis (HYP20.2) is not supported by the results in 1990-2000 either. Between the different time periods, a shift in significance and signs of estimates between *Net interest margin* and *Fee income* are observable. The sign for *Net interest margin* is negative for 1980-1989, being positive for 1990-2000. The increasing role of non interest income is positively related to the degree of internationalization of banks in the 1990s, while the decline of net interest margin in the 1980s has positively influenced internationalization.

The firm intrinsic incentive hypotheses are either partially or full rejected. The economic structure hypothesis (HYP20.3) is rejected by *GDP Growth* for all periods, and supported by GDP per capita. While the level in *GDP capita* is positively related to TNI, the growth in GDP is negatively related. Relatively richer countries tend to have banks with a higher degree of internationalization, unless there are domestic economic growth opportunities.

A higher degree of *Market concentration* is positively related to a higher level of TNI. This result was consistently repeated in country estimates. On the other hand, Market concentration is negatively related to either GDP Growth or GDP per capita, and supports HYP20.4, but to a low degree. This suggests that market concentration is in itself an incentive, and not directly related to the size of the economy. Therefore, HYP20.6, the small home market hypothesis, is partly supported by the results.

The financial development (HYP20.5) hypothesis was not rejected by the fee income variable, but rejected for both stock market variables for the whole sample. The country estimation showed in general correct signs for the Foreign Stock Market, suggesting that there is overall support for the financial development hypothesis.

The influence financial development has on incentives to internationalize (HYP20.5) was further investigated. A relationship was established between GDP per capita and the TNI per county. There is a stronger relationship between financial development indicators and aggregate measures for TNI than for individual banks. The relationship between TNI and bank assets, GDP per capita, and stock market is confirmed

for France, Germany, Spain, Switzerland and the Netherlands. The relationship is rejected for the United States, the United Kingdom and Japan. Also, the negative (and weak) relationship has more similarities for Japan and the United Kingdom than for the United Kingdom and the United States.

The relationship between change in regulation and change in TNI (HYP20.6) is mixed. Two regulatory changes can be marked as increasing regulation. In the United States, after the implementation of the Foreign Banking Supervision act foreign bank share did not increase anymore. The implementation of IBF had a positive effect for foreign banks and a negative for domestic banks. The other changes in regulation might be classified as deregulation: the liberalization of financial markets, or the liberalization of industry. Finally, there is no direct relationship between average TNI and the implementation of the Basle Accord.

Both hypotheses relating to sector intrinsic hypotheses are not rejected: TNI sample (HYP20.7) and Market power (HYP20.8). The same applies to the results for the hypotheses of firm intrinsic incentives: Efficiency hypothesis (HYP20.9), Profitability hypothesis (HYP20.10), and Capitalization hypothesis (HYP20.11).

# 21 Bank Performance

Through internationalization, a bank might aim to improve its profitability, or realize more stable profitability through geographical diversification. The goal of this chapter is to determine if international activities have delivered a better performance than home country activities, and what relationships exist between performance measures of banks and TNI. There are several performance measures which can be evaluated, leading to the presentation of a number of analyses. First, the hypotheses are reviewed (21.1) and test approach discussed (21.2), after which the analyses are presented (21.3).

## 21.1. Hypotheses

In chapter 7, hypotheses with regard to internationalization and performance were formulated. The first ones postulate a relationship between the degree of internationalization and profitability: does internationalization lead to a higher profitability, and can this be attributed to higher profitability of foreign activities?

**1. Degree of internationalization (HYP21.1):** A higher degree of internationalization is positively related to a higher performance of the total bank.

**2. Performance differential (HYP21.2).** Profitability of foreign banking activities is higher than profitability of domestic profitability.

The next two hypotheses test if the variability of profitability is more stable for higher levels of internationalization (HYP21.4), or if a higher degree of internationalization improves the return-risk trade off of banks (HYP21.3). Return is here defined as profit before tax as a share of capital and reserves, while risk is calculated as the standard deviation of return.

**3. Variability earnings (HYP21.4):** A higher degree of internationalization lowers the variability of earnings of the total bank.

**4. Risk/return (HYP21.3):** A higher degree of internationalization of banks is positively related to the return-to-risk ratio's; there is an optimal degree of internationalization for the return-risk ratio of banks.<sup>1</sup>

## **21.2. Test approach**

With the exception of American and English banks, there has been a hesitance publishing performance figures for the different regions. When the international activities of the banks were low, they probably did not have material effect on the results, but banks with high degrees of TNI also did not disclose this information in their annual reports. The approach taken with the tests has therefore been to first analyze the hypotheses with the existing data, given their limitations. Where possible, the next step then has been to construct and estimate measures for the whole sample which allow general conclusions.

The first test for HYP21.1, testing if more internationalization leads to higher performance, is tested by evaluating a one variable regression model, with profit before tax as percentage of capital as the dependent variable and TNI as the dependent variable. The constant in the model then represents profitability without internationalization. This is done per bank, per country and per period.

The second group of tests for HYP21.2 aims to determine foreign and domestic profitability, and use these measures to test if foreign performance is higher than domestic performance. This is done in two steps. First, existing data is considered. Second, an alternative is introduced to measure foreign and domestic profitability.

The approach for the next tests is similar to the first test. Profits, variability of profits, and return-risk measures are calculated for five year periods, and then regressed with TNI to test if internationalization increases the return-risk profile (HYP21.3) or lowers the variability of earnings (HYP21.4).

## **21.3. Results**

### **21.3.1. Degree of internationalization and performance**

The first test is to determine if an increase in internationalization leads to a higher performance (HYP21.1). This is tested in two steps: does such a relationship exist for the individual banks in the sample between 1980 and 2000. Next, does such a relationship

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<sup>1</sup> The concept is derived from investment portfolio management (see for example Bodie, Kane & Marcus, 1996, p. 200; Maginn & Tuttle, 1990, p.2-22). With a correlation of less than one between foreign and domestic activities, the weight of foreign activities might be increased to a) create a combination with the lowest variance of earnings (minimum-variance) with higher earnings or b) create a combination where the earnings are higher than a) and the variance of earnings remains the same as in the initial situation. Both combinations then lie on the efficient frontier: a line showing the highest earnings at a given level of risk.

exist for the whole sample. A straightforward approach is to evaluate one variable regression model per bank

$$Y_{it} = \alpha_i + \beta_i \text{TNI}_{it} + \varepsilon_{it} \quad (1)$$

The dependent variable is profit before tax as percentage of capital and reserves; TNI is the independent variable. The constant  $\alpha$  in the model represents the level of profitability if the bank would not have internationalized (TNI=0). This test focuses on the direction of coefficient  $\beta$ . If  $\beta$  is negative (positive), then a higher degree of internationalization is associated with lower (higher) profitability. The number of observations varies per bank, so the significance of  $\beta$  provides less information and is ignored here. At the most, 21 observations per bank can be found, while on the lower side at most 3 observations per bank can be observed. Table 21.1 presents the estimated coefficient  $\beta$  per bank, in combination with the adjusted R-Square and the p value for  $\beta$ .

Table 21.1. *Relation between performance and TNI per bank, 1980-2000*

Bank	Adjusted R square	Coefficient	p value	n	Bank	Adjusted R square	Coefficient	p value	n
HSBC	0.7767	0.7778	0.0002 **	11	Societe Generale	0.1018	-0.8155	0.0866	21
Mitsubishi Bank	0.7555	1.7494	0.0000 **	16	Santander	0.0902	-0.2376	0.1918	11
Credit Lyonnais	0.6632	-0.8553	0.0000 **	21	National Westminster	0.0828	0.4297	0.1103	21
NMB Bank	0.6593	-0.8418	0.0008 **	12	LloydsTSB	0.0811	-0.6292	0.1128	21
ABN/Amro	0.5889	0.0789	0.0035 **	11	Dai Ichi Kangyo	0.0766	0.7911	0.1194	21
Vereinsbank	0.5342	-0.7008	0.0003 **	18	Sumitomo Bank	0.0628	1.1051	0.1425	21
Tokyo	0.5086	-0.4261	0.0012 **	16	J.P. Morgan	0.0608	1.7589	0.1526	20
WestLB	0.5051	0.1473	0.0002 **	21	BNP	0.0296	0.5038	0.2198	21
Fortis	0.3434	-0.3581	0.0341 *	11	Chemical Banking	0.0268	0.4739	0.2543	16
Rabobank	0.3316	-0.2518	0.0047 **	20	Manufacturers Hanovers	0.0091	0.9058	0.3233	11
SBC	0.3228	-0.8996	0.0082 **	18	UBS	-0.0007	0.1328	0.3334	21
Citicorp	0.3142	0.8536	0.0048 **	21	IBJ	-0.0249	-0.3579	0.4824	21
Amro	0.2997	-0.4599	0.0588	10	Commerzbank	-0.0300	-0.2234	0.5258	21
Tokyo-Mitsubishi	0.2821	-3.4218	0.2071	5	Dresdner Bank	-0.0415	-0.0307	0.6574	21
ABN	0.2520	-0.4415	0.0795	10	Credit Suisse	-0.0453	0.0364	0.7195	21
Bay. Hypobank	0.1797	-0.6484	0.0451 *	18	Barclays	-0.0483	0.0598	0.7812	21
Standard Chartered	0.1780	2.0862	0.0324 *	21	Midland	-0.0493	0.2295	0.5028	12
Deutsche Bank	0.1561	-0.1603	0.0431 *	21	Chase Manhattan	-0.0511	-0.0506	0.8682	21
Agricole	0.1317	0.2077	0.0768	18	BBV	-0.0771	-0.0508	0.6069	11
Bank of America	0.1302	-0.4260	0.0602	21	BCH	-0.0891	-0.1586	0.5074	7
Paribas	0.1244	-0.4572	0.0765	19	Argentaria	-0.1118	0.1917	0.6717	9
ING (bank)	0.1229	-0.0630	0.1887	9	HypoVereinsbank	-0.4028	-0.3508	0.9080	3

\*\* : p value < .01, \* : p value < .05

There are 44 banks in the sample, of which 25 show a negative relationship between TNI and profit before tax as a percentage of capital and reserves. In other words, there is no tendency towards a positive or negative relationship for the whole sample. For 12 banks, the adjusted R Square is negative indicating absence of any relationship. This is not due to the number of observations for the regression; 7 of these 12 banks have the longest possible period of data availability (21 years). Also, most of the banks showing no relationship between performance and TNI have pursued strategies increasing their TNI:

*Accelerating* strategies (UBS, Dresdner bank, Credit Suisse, BBV, Argentaria) or *Moderate* (Commerzbank, BCH, Hypovereinsbank).

A stronger relationship is observed for 15 banks in the sample, showing a relationship between TNI and performance is shown with an adjusted R-Square higher than .25. Of these banks, 10 out of 15 show a negative relationship between the level of TNI and profit before tax. In short, the estimated signs of relationship between TNI and performance for the banks are equally distributed for the positive and negative direction. For almost a quarter of the sample, there is no relationship observable.<sup>2</sup>

A limitation of the analysis is that different and overlapping time periods are covered. For example, data for Midland bank is available from 1980 to 1991 while data for Bank of America covers the full 21 years between 1980 and 2000. The regression results for Midland might have less explanatory power than Bank of America's due to the shorter time period. On the other hand the estimation for Bank of America might yield insignificant results because over the long time period, a “V-shaped” recovery is in general poorly estimated by a single linear measure. To counter this problem, different time periods were considered by calculating average TNI and profitability for five year period, further grouping the TNI in steps of 20%.

Table 21.2. *Change of TNI between 20% brackets per five year period*

		Change TNI from				
		0-20	20-40	40-60	60-80	80-100
To	0-20	29	3			
	20-40	3	43	7		
	40-60	1	6	14		
	60-80			3	5	
	80-100					2
Total		33	52	24	5	2

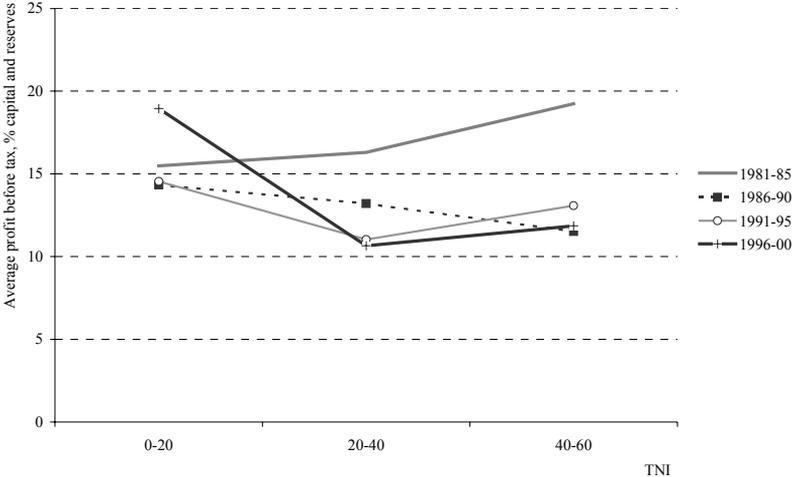
In Table 21.2, the numbers represent the number of occurrences of the TNI values for full five year periods, moving from one TNI-bracket to another. Condensing the total number of 737 yearly observations to full five year periods produces 116 observations; the largest group has a TNI of 20-40%. The table further shows that observations for TNI larger than 60% should be ignored when drawing general conclusions; the 7 observations constitute 6% of the total number of observations.

The next question is then to see what the dynamics are: how many banks shift from one TNI-bracket to another? Changes take place between the 20-40% TNI-bracket, and the 40-60% TNI-bracket. There are relatively few banks that have moved from one bracket to a higher one: Credit Suisse, Deutsche Bank while Bank of America did the opposite. The

<sup>2</sup> Similar results are yielded if profit before tax as a percentage of total assets is taken as a measure for performance, or if performance is corrected for domestic performance or the performance of the sample.

average profitability per TNI bracket, excluding TNI higher than 60%, for the different five year periods is shown in Figure 21.1.

Figure 21.1. Relation between TNI and performance, five year periods



For the sample as a whole this suggests that between 1981 and 1985 there was a linear and positive relationship between TNI and performance, and between 1986 and 1990 the relationship became negative but still was linear. Between 1991 and 2000 the relationship turned out to be V-shaped: profitability for banks with TNI level of 20-40% was lower than for banks with TNI levels of 0-20%. The means of the first three brackets have significantly different levels of means.<sup>3</sup>

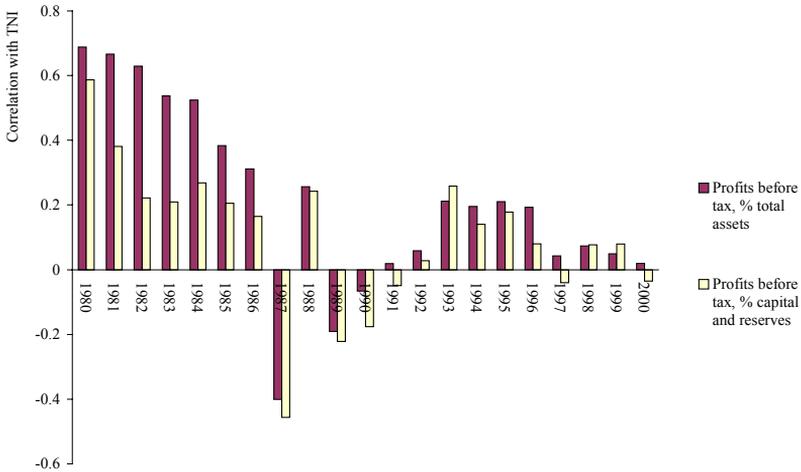
Summarizing, for most banks and most time periods there is a negative relationship between performance and TNI. This suggests that a degree of internationalization lower than 20% would have yielded the best performance. Also, for most banks an increase in internationalization correlates with a decrease in profitability, but this result is valid cross-section, not longitudinal.

A closer look warrants the positive linear relationship between TNI in 1981-1985 in Figure 21.1, changing to a negative one in 1986 to 1990. The relation between total performance and TNI is determined by calculating the bivariate correlations between TNI and profit before tax per year. Figure 21.2 shows that the relationship between the two measures steadily breaks down: the correlation was almost .6 in 1980, steadily declining to under .2 in 1986. Negative correlations can be observed for 1987, 1989 and 1990; from 1991 onwards the relationship between TNI and profitability has broken down

<sup>3</sup> Using T test with p values < .05. There are 7 observations not shown in this graph, because they are not representative compared to the other observations. 4 out of 7 are Standard Chartered (2 observations for TNI 60-80%, 2 for higher than 80%). The other three are ABN Amro, HSBC, and Credit Suisse, all with TNI's between 60-80%.

completely.<sup>4</sup> Correlations between TNI and profitability as a percentage of assets remain more persistent, suggesting an asset driven approach to TNI until 1985. After a restructuring period in 1987-1990, similar values for the correlations indicate that both performance measures have been synchronized.

Figure 21.2. Bivariate correlations between TNI and profit before tax, per year



Summarizing, a positive relationship between profitability and the degree of internationalization cannot be found on a bank level. For almost a quarter of the banks in the sample no such relationship has existed between 1980 and 2000; for the other half no tendency towards a positive or negative relationship can be observed. For the total sample, there is a positive relationship between 1981 and 1985. For the other periods up to 2000, there is a negative relationship between profitability and the degree of internationalization. The negative relationship in 1986-90 is determined by the years 1987 and 1989. After 1990 a weak form of a negative and V-shaped relationship exists. Banks with the lowest levels of TNI in the sample, 0-20%, have shown the highest performance. Banks with TNI levels of 40-60% have shown a higher performance than banks with a TNI of 20-40%, but both reported lower performance levels than banks with TNI of 0-20%. Overall do the results not support the hypothesis that a higher degree of internationalization is positively related to a higher performance of the total bank (HYP21.1).

### 21.3.2. Profitability home versus foreign: analysis for reported figures

It is now investigated if profitability of foreign activities is higher than profitability of domestic activities (HYP21.2). Two analyses will be presented; the first one presents differences in performance based on reported data by banks (actual figures for a smaller

<sup>4</sup> For 1980-1985 and 1987 significance is below a .05 level.

number of banks). Banks have published this information to a limited degree. In 1980, 15 out of 44 banks reported such information, increasing to 20 out of 44 in 2000. A second analysis is then set up to analyze differences in performance for the whole sample with estimated figures for the whole sample. An alternative measures is developed here for foreign and domestic profitability, using benchmark profitability data and asset weightings.

Table 21.3. *Data availability of domestic and foreign profitability*<sup>5</sup>

Country	Bank, period of data availability
France	Crédit Agricole (1992-2000), BNP (1982-2000), Crédit Lyonnais (1983-2000), Société Générale (1983, 1987-2000)
Germany	Commerzbank (1995-2000), Deutsche Bank (na), Bayerische Hypobank (na), Dresdner Bank (1997-2000), Hypovereinsbank (1998-2000), Vereinsbank (1992-1997), Westdeutsche Landesbank (na)
Spain	Argentaria (na), BBV (na), BBVA (na), BCH (na), Santander (na), BSCH (na)
Switzerland	Credit Suisse (1995-2000), UBS (na), SBC (na)
United Kingdom	Barclays (1980-2000), HSBC (1992-2000), Lloyds/TSB (1980-2000), Midland (1980-1991), National Westminster (1980-2000), Standard Chartered (1980-2000)
Netherlands	ABN (1980-1989), ABN Amro (1990-2000), Amro (na), Fortis (1996-2000), ING Bank (1992-2000), NMB (na), Rabobank (na)
United States	Bank of America (1980-1997), Chase Manhattan (1980-2000), Chemical Banking (1984-1995), Citicorp (1980-2000), J.P. Morgan (1980-1999), Manufacturers Hanover (19800-1990)
Japan	Dai Ichi Kangyo (1994-2000), IBJ (1994-2000), Mitsubishi Bank (1987-1995), Sumitomo Bank (1997-2000), Tokyo Mitsubishi (1996-2000), Tokyo Bank (na)

na: not available

The best disclosed performance measure between for the banks in the sample with a geographic dimension is profit before tax as a share of total assets; Table 21.3 presents the banks that have reported longer series of foreign and domestic profitability. Information before 1990 leans strongly on the information provided by British and American banks, and to a lesser extent on French banks. It cannot be stated that when internationalization became more important for banks, they started to report more internationalization-related information in their financial reports. Banks like SBC, UBS or Deutsche Bank did not report this information although they progressed significantly with their

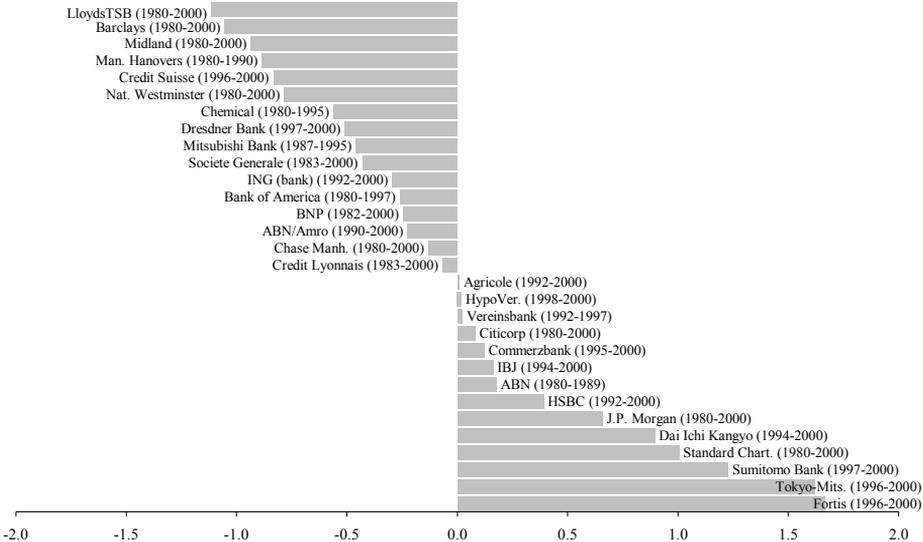
<sup>5</sup> Incidental reporting by for example Deutsche Bank has been left out, as have incidental reporting for Rabobank, NMB Bank and Tokyo Bank.

internationalization activities. A general remark is usually found in the financial report stating something like "due to the integrated nature of our activities worldwide a geographical breakdown does not provide additional information"; the information provided by British and American banks in the 1980s proves otherwise. Difference in profitability between foreign and home activities (PD) is calculated as<sup>6</sup>

$$PD = \frac{PBT_F}{ASS_F} - \frac{PBT_H}{ASS_H} \tag{1}$$

Where  $PBT_{F/H}$  is foreign/domestic profits before tax, and  $ASS_{F/H}$  foreign/domestic assets. The relative size of foreign activities does not influence the value of PD; the difference in profitability does not change if the bank has 1% or 10% foreign assets.

Figure 21.3. Differences in reported foreign and domestic profitability, for variable time periods



Note: Average difference foreign and domestic profit before tax, % total assets. Time period between brackets

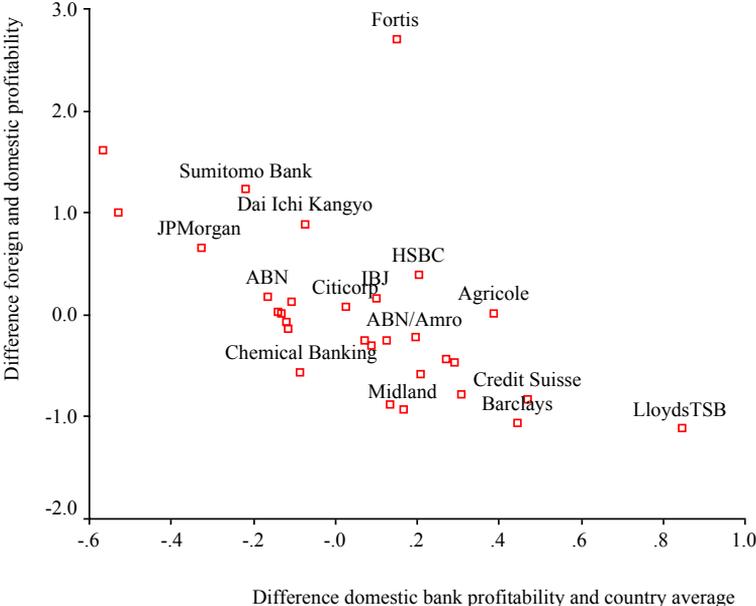
<sup>6</sup> A more common measure is the relative return of foreign assets, RELROFA (Rugman, 2000, p. 126):

$$RELROFA = \frac{\text{profit before tax (foreign)} / \text{assets (foreign)}}{\text{profit before tax (total)} / \text{assets (total)}}$$

where unity represents an equal relative contribution of profits from foreign and host activities, values larger/smaller than unity represent a relative larger/smaller contribution of foreign activities to total profits. This measure has not been used; the values tend to show very large swings for banks when profit before tax becomes negative.

In total 30 out of 44 banks have reported at some time foreign and domestic profitability figures for three or more years between 1980 and 2000; 14 banks have not reported such figures. Of these 30 banks, 16 have shown a negative difference in profitability (Figure 21.3). When banks show a negative difference in profitability, is this caused by a relatively lower profitability of foreign activities or a relatively higher profitability of domestic activities? To answer this, a scatter plot is presented in Figure 21.4. On the vertical axis, the difference between foreign and domestic profitability is shown, and on the horizontal axis the difference is shown between domestic profitability and average domestic profitability in the home country. Correcting domestic profitability for the average profitability in the country gives an indication if the bank performs relatively well domestically or not. For average profitability of the country, asset weighted profit before tax as a percentage of total assets has been taken from the OECD Bank Profitability database.

Figure 21.4: Scatter diagram between difference in foreign and domestic profitability, and difference in domestic and average domestic profitability



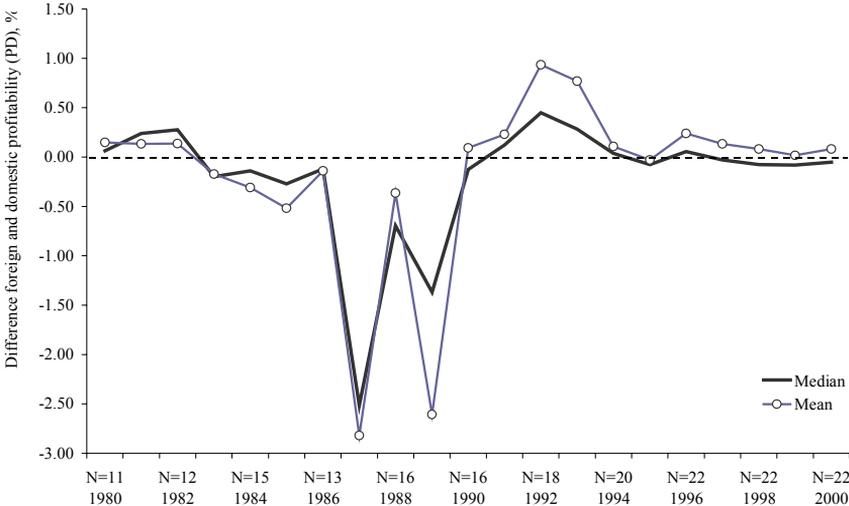
The relationship presented in Figure 21.4 is negatively sloped with a correlation of  $-.59$  ( $p < .01$ ,  $n=30$ ). There is one outlier, Fortis, reporting a relatively higher difference between foreign and domestic profitability than would have been expected given the general negative relationship. An explanation for this might be the relatively favorable period of reporting for Fortis, between 1996 and 2000. The scatter plot indicates PD is negatively related to the relative domestic performance: high levels of PD are associated with a lower than average domestic performance and vice versa. Of the 30 banks, there are

only three banks that have both a positive PD and a positive relative domestic performance: Citicorp, HSBC, IBJ. Crédit Lyonnais, Chemical Banking and Chase Manhattan on the other hand showed both a negative PD and a negative relative domestic performance.

The negative relationship suggests that a relative positive domestic performance is not necessarily related to a relatively successful foreign performance. It suggests that lagging domestic performance might have been an incentive for some banks to internationalize since additional performance is relatively more easy to achieve outside the home country than within.<sup>7</sup> It can also be interpreted another way: some banks with relatively high domestic performance (Credit Suisse, Barclays) perhaps have the buffers and reserves to sustain relatively lower foreign performance.

The observed negative relationship between PD and the relative domestic performance is difficult to generalize, due to differences between time periods of banks. Banks who reported on average a negative PD did this during an average length of 13.6 years compared to 8.6 for banks reporting a positive PD: the difference in years is a combination of not reporting the figures, and the higher number of mergers in the 1990s, limiting the maximum reporting period for some banks. A better approach would be to consider the information per year for the sample. Figure 21.5 shows the mean and median difference in foreign and domestic profitability between 1980 and 2000.

Figure 21.5. *Difference foreign and home profitability*



<sup>7</sup> This explanation is partly included in the small home market incentive: due to a small home market, growth opportunities and opportunities to exploit economies are limited decreasing profitability and increasing the incentive to internationalise.

Of the 21 years, the median value is negative for 11 years. The representativeness of the banks who reported foreign and domestic profitability compared to the sample increased throughout the period: before 1990 not more than 16 banks reported these figures, increasing to 22 in 2000. The highly negative values for PD between 1987 and 1989 are followed by a short period of high PD values between 1990 and 1994. The values from 1980 to 1987 and 1994 to 2000 remain closer to zero. PD does not differ significantly from zero for the whole sample.

Figure 21.5 shows that PD in 1987 or 1989 differs substantially from the other PD values. This can be explained by the large provisions banks had to take in 1987 and 1989, since securities activities were mainly concentrated in financial centers (outside the home country for a number of banks). Another explanation is the large provisioning in 1987 banks booked to write off LDC loans, led by Citibank after six years of unresolved negotiations to reschedule LDC debt. Two years later, LDC write offs were once again large when the Baker plan led to a final agreement to end the LDC crisis for banks.

To determine in which years PD showed values significantly different from zero, a regression model has been estimated with PD as the independent variable, and the year dummies as independent variables. Estimated coefficients with p values < .05 were 1987, 1989, 1992 and 1993.<sup>8</sup> From 1983 to 1989, foreign activities were on average less profitable, especially since 1987. A financial recovery period was visible in the early 1990s, especially in 1992 and 1993. This suggests that timing has been important: banks who have increased their international activities significantly in the early 1990s, should have enjoyed above average returns, while banks who established international activities in the 1980s will have experienced rebounding foreign profitability. On the same note, an exit from international banking in the early 1990s will have meant that "recovery advantages" were not reaped, while exiting or expanding from 1995 will not on average have changed performance for better or for worse. The conclusion is then that for the banks who have reported geographic distribution of profits:

- Performance of foreign activities is lower than domestic, but does not differ significantly from zero.
- The negative performance difference is concentrated around 1987 and 1989.

<sup>8</sup> The estimated model is  $PD_{ijt} = \gamma_i T_i + \epsilon_{ijt}$  where dependent variables are the year dummies ( $T_i$ ). The results are shown in the following table:

Dummy	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Coefficient	0.1478	0.1340	0.1373	-0.1728	-0.3079	-0.5177	-0.1385	-2.8181**	-0.3641	-2.6054**	0.0929
N	11	11	12	14	15	13	13	16	16	16	16

Dummy	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Coefficient	0.2291	0.9349**	0.7675*	0.1085	-0.0296	0.2401	0.1339	0.0811	0.0166	0.0812
N	15	18	18	20	22	22	23	22	23	22

F(21,367) = 7.614, adjusted R Square = .322.  
 \*\*: p value < .01; \*: p value < .05

- Entry and exit moments matter for the total profitability of the international activities.

These conclusions are based on a limited sample of banks who have reported information. Are these results repeated if a performance analysis applicable to the whole sample is set up? The approach to examine the relationship between TNI and performance is now to straightforward estimate domestic and foreign profitability. Per definition, total profitability should equal:

$$\frac{PBT}{ASS} = wa_F \cdot \frac{PBT_F}{ASS_F} + (1 - wa_F) \cdot \frac{PBT_H}{ASS_H} \quad (3)$$

Where  $wa_F$  is the share of foreign assets,  $PBT_{H/F}$  profit before taxes in the home/foreign country, and  $ASS_{H/F}$  total assets in the home/foreign country. Assuming that  $PBT/ASS$  and  $wa_F$  are known, two substitute values for  $PBT_{H/F}/ASS_{H/F}$  can be introduced. For domestic profitability, the ratio is extracted from the OECD Bank profitability database, and for foreign profitability the weighted average of the profitability for the banks in the sample outside the home country is calculated. In chapter eight, where the representativeness of the sample was discussed, one finding was that the sample showed similar characteristics as the Top 1000 banks compiled by The Banker, so using the sample's profitability as a proxy seems plausible. The following model per bank is then estimated per bank:

$$\left(\frac{PBT}{ASS}\right)_{it} = \alpha_i \cdot \left[wa_F \cdot \frac{PBT_F}{ASS_F}\right]_{it} + \beta_i \cdot \left[(1 - wa_F) \cdot \frac{PBT_H}{ASS_H}\right]_{it} + \varepsilon_{it} \quad (4)$$

Coefficients  $\alpha$  and  $\beta$  are estimated for bank  $i$ , and beforehand the sign of the values cannot be predicted. Values larger than one suggest that the bank is able to generate higher profits than the average of the sample, while lower suggest the opposite. Negative values suggest loss making periods. Another way of interpreting the coefficients is to view them as sensitivity coefficients of the bank's total earnings to domestic and foreign profitability.<sup>9</sup>

Having regressed the model in equation (4), the estimated coefficients  $\hat{\alpha}$  and  $\hat{\beta}$  are then used to calculate the difference between host and home profitability (PD).

$$PD = \hat{\alpha} \cdot \frac{PBT_F}{ASS_F} - \hat{\beta} \cdot \frac{PBT_H}{ASS_H} \quad (5)$$

The results are presented in Table 21.4, where the average PD values per year are displayed. Also, the results of t-tests are presented, testing if the average PD values per

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<sup>9</sup> Similar to an Asset Pricing Theory framework.

year differ significantly from zero. The results suggest that for the whole period, there was not one single year where foreign profitability was on average higher than domestic for the whole sample.

Table 21.4. *Difference foreign and domestic profitability (PD), adjusted figures*

Year	Average	p value T-test	N
1980	-0.6020	0.0101 *	32
1981	-0.4917	0.0140 *	33
1982	-0.4523	0.0148 *	33
1983	-0.5220	0.0109 *	34
1984	-0.5004	0.0104 *	34
1985	-0.5801	0.0069 **	34
1986	-0.5845	0.0073 **	34
1987	-0.2325	0.0505	34
1988	-0.6138	0.0263 *	34
1989	-0.3358	0.0234 *	34
1990	-0.4672	0.0022 **	36
1991	-0.2533	0.0291 *	36
1992	-0.2994	0.0353 *	36
1993	-0.3381	0.0804	36
1994	-0.4755	0.0167 *	36
1995	-0.4210	0.0476 *	36
1996	-0.4662	0.0132 *	35
1997	-0.4968	0.0132 *	35
1998	-0.4862	0.0297 *	34
1999	-0.6653	0.0052 **	30
2000	-0.5314	0.0176 *	29

Note: one sample test, test value = 0.

\*\* : p value < 0.01, \* : p value < 0.05

The PD values can also be presented per bank, and tested if they differ from zero. The results are presented in Table 21.5. Of the 44 banks, 15 banks show a positive difference between foreign and domestic profitability. The negative PD values are on average larger than the positive values. If the profitability of banks within a country tends to be similar, then a clustering in PD is also expected and observable to some extent in Table 21.5. A check with the reported figures<sup>10</sup> suggests that most banks are well placed as far as sign and the relative size of the difference in the ranking is concerned. Three banks are misplaced: HSBC, Standard Chartered and Citicorp. While HSBC and Standard Chartered reported a yearly average positive differences in profitability (respectively 0.39% for 1990-2000 and 1% for 1980-2000), Citicorp did report positive differences also (0.08% for 1980-2000). The outcome of the regression leads to large negative values

<sup>10</sup> Taking account of differences in time periods of the two analyses: with the regression of the adjusted figures, the full period of the bank's existence between 1980 and 2000 is taken, while with the reported figures shorter periods due to data availability apply. The differences in reported figures are presented in appendix yy.

however. These three banks have all been classified as banks with 'Established' internationalization strategies in chapter 19.

Table 21.5. *Difference foreign and domestic profitability (PD) per bank, adjusted figures*

Year	Mean	p value T-test	n	Year	Mean	p value T-test	n
Argentina	1.4236	0.0000 **	9	Barclays	-0.2180	0.0144 *	21
Agricole	0.9195	0.0000 **	21	Paribas	-0.2741	0.0003 **	19
Vereinsbank	0.6520	0.0000 **	18	Tokyo-Mitsubishi	-0.3150	0.3869	5
JPMorgan	0.6460	0.0000 **	20	HypoVereinsbank	-0.3219	0.1001	3
ABN	0.5185	0.0000 **	10	ING (bank)	-0.4317	0.0000 **	9
Mitsubishi Bank	0.3564	0.0008 **	16	Deutsche Bank	-0.4473	0.0000 **	21
Tokyo	0.3341	0.0004 **	16	Fortis	-0.5164	0.0008 **	5
Westdeutsche Landesbank	0.2426	0.0000 **	21	Credit Lyonnais	-0.7492	0.0000 **	21
Bay. Hypobank	0.1800	0.0000 **	18	Credit Suisse	-0.8343	0.0000 **	21
IBJ	0.1683	0.0826	21	UBS	-0.9206	0.0000 **	21
Dai Ichi Kangyo	0.1564	0.1767	21	Midland	-1.0010	0.0000 **	12
BNP	0.1173	0.0009 **	21	Chase Manhattan	-1.0478	0.0000 **	21
Societe Generale	0.0765	0.0318 *	21	Santander	-1.1409	0.0000 **	11
Rabobank	0.0600	0.2260	20	BCH	-1.1530	0.0000 **	7
Commerzbank	0.0391	0.2761	21	Chemical Banking	-1.3172	0.0000 **	13
Dresdner Bank	-0.0313	0.3722	21	HSBC	-1.5140	0.0001 **	11
ABN/Amro	-0.0737	0.0984	11	Bank of America	-1.6797	0.0000 **	21
Amro	-0.0881	0.1396	10	Standard Chartered	-1.8411	0.0000 **	21
Sumitomo Bank	-0.1070	0.4770	21	Citicorp	-1.9379	0.0000 **	21
BBV	-0.1889	0.2218	11	LloydsTSB	-2.0319	0.0000 **	21
NMB Bank	-0.1951	0.0016 **	12	SBC	-2.1439	0.0000 **	18
National Westminster	-0.1964	0.0212 *	21	Manufacturers Hanovers	-4.3429	0.0000 **	11

Note: one sample T test, test value = 0.

\*\* : p value < .01, \* : p value < .05

Summarizing, the reported difference between foreign and domestic profitability show that although there are a number of banks who have reported a positive difference throughout the reported period, it cannot be said for all banks in the sample. The entry and exit moment is a determining factor: before or after 1987-89 matters a great deal in performance. When generalizing the reported differences for all banks during the whole period, the outcome was that the differential in performance was negative, per year as well as for the majority of banks (29 out of 44). Moreover, the negative differentials show larger values than the positive differentials. Taking out the "misplaced" banks in the regression, there still remains a strong negative bias. Hypotheses HYP21.2, the profits generated in host countries are higher than the profits at home, is therefore rejected for the whole sample.

### 21.3.3. Risk, return and internationalization

So far, the analyses have failed to support the hypothesis that foreign profitability is higher than domestic profitability. But this may not have been the bank's primary motive to internationalize: a higher degree of internationalization might stabilize profitability, or the return/risk profile of the bank might be improved. The bank can steer its risk/return profile through internationalization: geographical diversification is achieved by adding activities

in countries with different economic cycles - especially relevant for international retail banking - and/or adding activities which can be done more efficiently outside the home country than domestically. Three hypotheses are investigated: a higher degree of internationalization lowers the variability of earnings of the total bank (HYP21.3), and internationalization leads to an improvement of the risk/return profile of the bank (HYP21.4).

Risk and return are defined in terms of profitability: for return, the average of profit before tax as a percentage of capital is calculated over a period of five years, and the standard deviation for return over the same period is taken as a measure for risk (cf. de Nicoló et al., 2003). With these variables, the return-risk ratio is then calculated as average return divided by the standard deviation of the return over the last five years. The period is then divided into four five-year periods: 1981-1985, 1986-1990, 1991-1995 and 1996-2000. Only banks with a full five-year history for any of these periods have been used, to prevent non-comparability. This leaves 107 five-year periods to be investigated. The following table shows the partial correlations, controlling for the time period.

Table 21.6. *Correlations between risk and return measures*

	Average TNI	Change in TNI	Risk	Return	Return- risk	Assets	Capital	Exchange rate
Average TNI, 5 years	1							
Change TNI, 5 years	0.0267 (0.7830)	1						
Risk	0.2415 (0.0110) *	-0.2214 (0.0210) *	1					
Return	0.0626 (0.5180)	-0.078 (0.4200)	-0.2821 (0.0030) **	1				
Return-risk ratio	-0.2341 (0.0140) *	0.0256 (0.7910)	-0.5224 (0.0000) **	0.1376 (0.1540)	1			
Assets, US dollar	0.0271 (0.7790)	0.2334 (0.0150) *	-0.113 (0.2420)	0.0241 (0.8040)	-0.0756 (0.4340)	1		
Capital, US dollar	0.1372 (0.1550)	0.0346 (0.7210)	-0.0793 (0.4130)	0.1766 (0.0660)	-0.032 (0.7410)	0.7144 (0.0000) **	1	
Exchange rate	0.4004 (0.0000) **	-0.2871 (0.0020) **	0.3844 (0.0000) **	0.109 (0.2590)	-0.1845 (0.0550)	-0.1026 (0.2880)	0.0534 (0.5810)	1

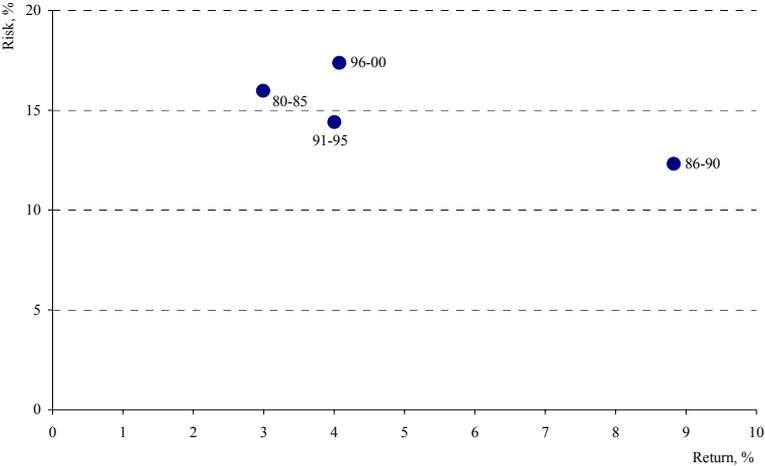
Partial correlation coefficients, controlling for five-year period. N=107.

\*\* : p value < .01, \* : p value < .05

The correlations indicate a moderate positive relationship between risk and TNI, and no relationship between return and TNI. The return-risk measure uses risk as denominator, therefore a negative relationship between this ratio and TNI seems plausible. As a control measure correlations between TNI and total assets, capital and exchange rate are also shown. While exchange rate is positively correlated to risk, it is uncorrelated with return: exchange rate increases the variability of earnings, but does not influence the average return. In Figure 21.6 the average risk and return for the whole sample is presented, confirming the anomaly of the 1986-1990 period found in 21.3.1. The average risk and return for the other three periods are clustered; in 1996-2000 banks in the sample

earned more than in 1991-1995 while having the same risk. Given that the majority of banking crises in the 1990 took place since 1995, the relative risk/return position would suggest that banks have held their positions well.

Figure 21.6. Average risk and return for the whole sample



To determine the relationship between TNI and risk, a model is estimated for the separate time periods.<sup>11</sup> Table 21.7 presents the regression results with risk as the dependent variable, and average TNI as the independent variable. As a control variable, return was also added to take account of the expected relationship between risk and return.

Table 21.7. Relationship between TNI and risk, dependent variable risk

Model	1981-85		1986-90		1991-95		1996-00	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
TNI	0.0054	0.8074	0.2281	0.0174 *	0.0853	0.0237 *	0.0483	0.1318
Return	0.0457	0.5051	-0.6705	0.0042 **	-0.0174	0.8453	0.0578	0.4356
Constant	1.8724	0.1137	10.8875	0.0171 *	1.6286	0.3346	1.1671	0.5523
Adjusted R-Square	-0.0506		0.4404		0.1151		0.0354	
F- statistic	0.3495		11.6232		2.8862		1.4222	
Degrees of freedom	(2,25)		(2,25)		(2,27)		(2,21)	

\*\* : p value <.01, \* : p value < .05

As far as the direction of the coefficient is concerned, for all four periods the level of TNI is positively related to the level for risk. It has explanatory power for 1986-90, and to a lesser extent for 1991-95. In the other periods the adjusted R Square is almost zero,

<sup>11</sup> Examination of the scatter plot suggested that the different time periods should be treated as variable intercept, variable coefficient models. This reduces the attractiveness of estimating the relationship for the different time periods in one model.

indicating an absence of a relationship between TNI and risk. A disadvantage of the estimated model presented in Table 21.7 is that structural differences in levels of return and risk between countries are not corrected for. Therefore, return is adjusted for country averages, and risk is recalculated. The country averages have been taken from the OECD Bank profitability database. The re-estimated results are shown in Table 21.8.

Table 21.8. *Relationship between TNI and risk, adjusted for country averages, dependent variable risk*

Model	1981-85		1986-90		1991-95		1996-00	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
TNI	0.0110	0.4154	0.0328	0.0244 *	0.0040	0.7419	0.0143	0.3307
Return	-0.6968	0.4169	0.0138	0.9753	-0.3768	0.2393	1.4884	0.0471 *
Constant	1.6818	0.0481 *	0.8412	0.1932	1.7389	0.0062 **	-0.3445	0.7525
Adjusted R-Square	-0.0365		0.1241		-0.0115		0.1103	
F- statistic	0.5251	0.5979	2.9134	0.0729	0.8346	0.4449	2.4263	0.1127
Degrees of freedom	(2,25)		(2,25)		(2,27)		(2,21)	

\*\* : p value < .01, \* : p value < .05

If the results in Table 21.8 are compared to the ones in Table 21.9, then adjustment of risk and return for country averages has decreased explanatory value. The F statistic shows that the coefficients in the country-adjusted model do not differ significantly from zero ( $p < .05$ ). This leads to the conclusion that hypothesis HYP21.3 has to be rejected for the 1986-1995 period, where a higher degree of internationalization leads to higher variability of earnings. For the other periods, no relationship exists (which also rejects HYP21.3 to some extent).

With regard to the return-risk hypothesis (HYP21.4) the same analysis as above is performed, with the return-risk ratio as the dependent variable and TNI as the independent variable (Table 21.9). Re-estimating this model for country averages yields insignificant results similar to the ones in Table 21.8 and are not shown here.

Table 21.9. *Relationship between TNI and return-risk, dependent variable return-risk ratio*

Model	1981-85		1986-90		1991-95		1996-00	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
TNI	0.0535	0.3767	-0.2752	0.0095 **	-0.1917	0.0224 *	-0.0293	0.4824
Constant	6.5996	0.0041 **	13.4310	0.0002 **	12.9359	0.0001 **	7.1747	0.0006 **
Adjusted R-Square	-0.0071		0.2024		0.1432		-0.0217	
F- statistic	0.8091	0.3767	7.8503	0.0095 **	5.8475	0.0224 *	0.5105	0.4824
Degrees of freedom	(1,26)		(1,26)		(2,28)		(2,22)	

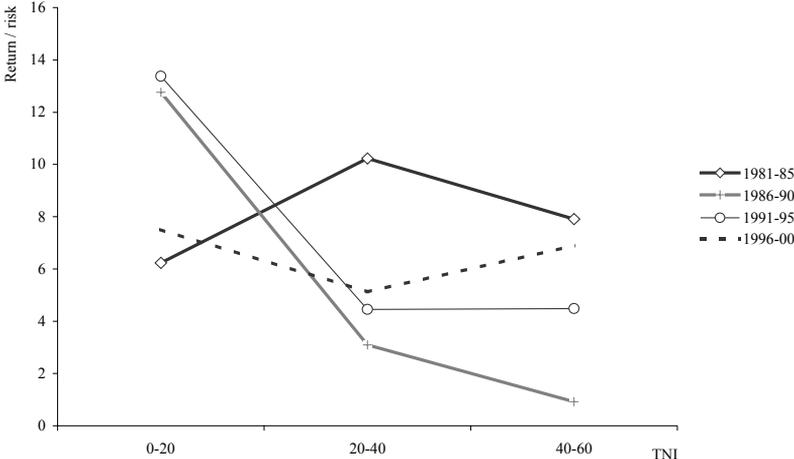
\*\* : p value < .01, \* : p value < .05

The estimated relationship between return-risk and TNI mirrors the one between return and TNI: the signs of all coefficients are negative, and for 1986-95 the model as such is significantly different from zero at a .05 level to have explanatory power. For the other periods, the model has no explanatory power. This suggests that HYP21.4,

internationalization improves the return-risk profile, must be rejected: higher levels of TNI are negatively related to the return-risk ratio, in particular for the 1986-95 period.

Finally, if the relationship between return-risk and TNI is negative, is this then proof that a low degree of internationalization tends to be associated with high return-risk ratios and vice versa? This seems to be true when a graph is plotted between average return-risk and TNI intervals of 20%, for the four five-year periods (Table 21.9).

Figure 21.7. Average return-risk ratio for different time periods and TNI values



Between 1986 and 1995, having a TNI below 20% would have been associated with significant larger return-risk values than banks with higher degrees of TNI. Summarizing, there is a positive relationship between TNI and the variability of profitability, especially between 1986 and 1995. Correcting for average profitability per country, the positive relationship remains intact but explanatory power decreases considerably. Estimation of the relationship between return-risk and TNI yield negative coefficients, the level of TNI is negatively related to the return-risk ratio.

These findings lead to a rejection of hypothesis HYP21.4 (risk-return) and HYP21.3 (variability of profitability). Also, for most banks the return-risk ratio decreases with higher levels of TNI. Therefore it can be concluded that low levels of TNI benefit the return-risk profile of the bank the most.

**21.4. Summary**

In this chapter, the relationships between different measures of performance and TNI have been investigated. To correct for periods with different levels of profitability, five year periods have been constructed to take account of these differences. A relationship between total performance and TNI has been found, differing per five year period. For 1981-85, a

higher level of TNI was linearly associated with higher performance, 1986-1990 showed an opposite linear relationship. Between 1991 and 2000, the relationship became U-shaped; performance decreases with an increase in TNI and then increases again with further increases in TNI. Three out of four periods do not support hypothesis HYP21.1, and in fact suggest the opposite: a higher level of TNI decreases performance.

Hypothesis HYP21.2 stated that profits generated from foreign activities are higher than domestic activities. The analyses based on reported performance shows that profitability of foreign activities on average are lower than domestic activities. This is mainly concentrated between 1983 and 1990, indicating that the years of entry and exit matter to total profitability. If additional analyses are considered to take account of the total sample, foreign profitability compared to domestic profitability becomes negative for all years between 1980 and 2000. Hypothesis HYP21.2 is therefore also rejected.

The expected diversification advantages were further investigated, hypothesizing that geographical diversification advantages should allow the bank to generate more stable results (HYP21.3), and improve its return-to risk ratio (HYP21.4). Having earlier established that foreign activities do not structurally generate more return, the burden lies with the reduction of risk. Risk here is calculated as the five-year standard deviation of profit before tax as a percentage of capital and reserves, with return as the five-year average. Regressing risk as the dependent variable with return and TNI for different five year periods, the estimated coefficient for TNI is positive for all periods: an increase in TNI increases risk. However, the model is only significantly different from zero for the 1986-1990 period. Hypothesis HYP21.3 is therefore rejected: no relationship exists between TNI and risk except for 1986-1990 where the opposite sign is observed.

Next, hypothesis HYP21.4 asserted that internationalization improves the return-risk ratios of banks. The results for HYP21.2 (to a large extent a negative relationship between performance and TNI) and HYP21.4 (no relationship between risk and TNI) imply that if the relationship between TNI and risk is more or less a constant, that the construction of a return-risk ratio will show similar characteristics as the performance variable. This is the case; internationalization in general leads to a worsening of the return-risk ratio for banks, not an improvement. This implies a rejection of HYP21.4.



## 22 Shareholder Performance

Chapter 21 investigated the relationship between profitability as performance measure and the degree of internationalization. This chapter focuses on shareholder return as performance measure. The share price of a bank is forward looking, its price daily determined by a large group of buyers and sellers, and presents a consensus in the financial market about what the bank is worth. On the other hand, it is a dangerous criterion because it is unstable (Nickell, 1995, p. 2). For example, the total market value of banks like UBS, Citicorp and Barclays decreased with more than 40% in a period of 3 months in 1998 in the wake of the Asian crisis, only to increase again to their former market value before the end of the year.

This chapter investigates the relationship between shareholder return as performance measure of banks and the degree of internationalization. First, the hypotheses are reviewed (22.1), and the test approach discussed (22.2). The characteristics of shareholder return of the sample are presented (22.3) and the test results analyzed (22.4).

### 22.1. Hypotheses

The first two hypotheses investigate if stock market participants consider the degree of internationalization as one of the variables to influence the bank's share price.

**1. Degree of internationalization (HYP22.1).** Banks with a higher level of internationalization tend to show above average shareholder returns.

**2. Change in internationalization (HYP22.2).** Banks with an increase in degree of internationalization show above average shareholder returns.

For hypotheses HYP22.1 and HYP22.2, above average returns are calculated by adjusting shareholder return for a benchmark. Two benchmarks will be used, a shareholder return index on a country level, and on a world wide level.

The next two hypotheses are similar to Hypotheses HYP21.3 and 21.4 analyzed in chapter 21, and test if the volatility of shareholder return is more stable for higher levels of

internationalization (HYP22.3) or if a higher degree of internationalization improves the return-risk trade off of banks (HYP22.4). In other words, do shareholders adjust the valuation of the bank for expected advantages of internationalization such as more stable profitability or lower provisioning through geographical diversification of loan risks. Return is here defined as the annualized total shareholder return (i.e. price return including reinvested dividends), while risk is calculated as the annualized standard deviation of the monthly total shareholder return .

**3. Volatility shareholder return (HYP22.3):** A higher degree of internationalization lowers the volatility of total shareholder return of the bank.

**4. Return / risk (HYP22.4):** A higher degree of internationalization of banks is positively related to the return-to-risk ratio's; there is an optimal degree of internationalization for the return-risk ratio of banks.<sup>1</sup>

Diversification advantages of internationalization may not be fully grasped by investors, especially when the bank initiates large foreign acquisitions. For both large increases and large decreases in TNI, positive effects for shareholder return are expected for an *ex ante* and *ex post* reason. A large increase in TNI signals *ex ante* that the bank has acquired foreign activities and now has more opportunities to further exploit its internalization advantages. On the other hand, a decrease in internationalization might signal that either domestic activities are more profitable to exploit, and/or that by divesting foreign activities, that *ex post* the performance of foreign activities has been too low.

**5. Large TNI changes (HYP22.5).** A large change in the degree of internationalization compared to an earlier period is followed by period of higher shareholder return and/or lower volatility of shareholder return.

## 22.2. Test approach

Is there a positive relationship between TNI and shareholder return? To test the first two hypotheses (HYP22.1 and HYP22.2) a model is set up and estimated with shareholder return as dependent variable. In 3.x the relationship between TNI and shareholder return has been discussed; an observation was that TNI is not the only driver to influence shareholder return, so the independent variables in the model include drivers for shareholder return such as profit before taxes or provisions. The model is estimated with

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<sup>1</sup> The concept is derived from investment portfolio management (see for example Bodie, Kane & Marcus, 1996, p. 200; Maginn & Tuttle, 1990, p.2-22). With a correlation of less than one between foreign and domestic activities, the weight of foreign activities might be increased to a) create a combination with the lowest variance of earnings (minimum-variance) with higher earnings or b) create a combination where the earnings are higher than a) and the variance of earnings remains the same as in the initial situation. Both combinations then lie on the efficient frontier: a line showing the highest earnings at a given level of risk.

different dependent variables: local shareholder return, return relative to a country benchmark, and return relative to a worldwide benchmark. Besides calculating these variables in local currency, they are also calculated in US dollar. The comparison of the estimated results for the different dependent variables might provide additional insights for the analysis; for example if a relationship exists for a shareholder return in local currency but not for a shareholder return relative to a world wide benchmark, this might suggest that investors do compare value the performance of the bank relative to country peers, not to a world wide peer group.

The next two hypotheses (HYP22.3 and HYP22.4) examine if advantages of internationalization materialize through a decrease in volatility of shareholder return, or an improvement in the return / risk ratio. This is done by calculating ratio's for different time windows: for example risk is calculated 1..4 years from a certain year and compared to the risk calculated 1..4 years before the certain year. This is then compared to the level in TNI or the changes in TNI that have taken place.

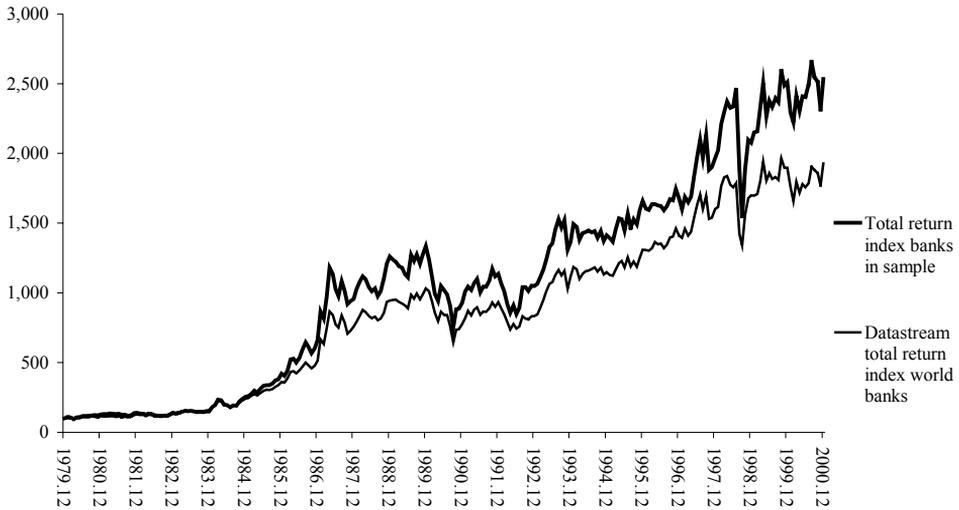
Finally, large changes in TNI (HYP22.5) might indicate the realization strategic shifts in the activities of the bank. A selection of changes in TNI larger than 10% or less than -10% is made, and the changes in return, risk and return / risk are compared, using the same methodology as in the previous hypotheses. Does this effect diminish after a number of years?

### **22.3. Shareholder return**

The data for the total shareholder return (and related to that market value and price-earnings ratios) was collected from the Datastream database, all in US dollar as well as local currency on a monthly basis from December 1979 until December 2000. For the equity return the total return index is used; this includes price changes as well as reinvested dividends. Raw prices also have been collected, to check when trading ceased for acquired or merged banks. The sample of banks listed on a stock market is smaller than the total sample: Crédit Agricole, Crédit Lyonnais, Rabobank did not list shares between 1980 and 2000. ING bank and Fortis are part of financial conglomerates, and their parent company's share has been used. For Fortis, having two parent companies, the figures for the Belgian and the Dutch parent company have been combined. Market to book value has been calculated using the total assets reported in the annual reports

Appropriate benchmarks have been found in the Datastream indices: they are one of the few publicly available indices covering a 20 year period, providing total market value besides total return information. The indices used are the world index, covering all equities, the world bank index, covering all bank stocks, and the country bank indices. Figure 21.3 presents the total return index for the sample, the Datastream world bank index and the Datastream world index. The world's largest banks have shown a higher return during 1980 and 2000 than the broader world bank index.

Figure 22.1. Total shareholder return index for the sample



Note. Total return index, marketvalue weighted, in US dollar. Rebased at December 1979 = 100.  
Source. Datastream, own calculations

The higher return is generated between 1984 and 1986, a period where the US dollar depreciated considerably. The higher return could therefore be explained by an overweight of European and Japanese banks in the sample. For the periods after 1985, additional return is achieved through a considerable increase in risk. Table 22.1 summarizes the annualized standard deviation and return per five year periods.

Table 22.1. Annualized total shareholder return, and standard deviation

Period	Sample		Datastream world banks index		Datastream world index	
	Return	Standard deviation	Return	Standard deviation	Return	Standard deviation
1980-85	27.01%	21.23%	23.85%	16.81%	17.49%	12.86%
1986-90	17.19%	31.24%	16.58%	26.01%	16.02%	18.42%
1991-95	12.30%	19.14%	10.99%	15.10%	11.96%	11.53%
1996-00	8.86%	25.91%	8.04%	21.32%	11.86%	15.33%
1980-00	16.64%	24.29%	15.13%	19.59%	14.46%	14.53%

Note: return and standard deviation are annualized monthly figures.  
Source: Datastream, own calculations

The world's largest banks have shown a higher return during 1980 and 2000 than the broader world bank index (Table 22.1). The higher return is generated between 1984

and 1986, a period where the US dollar depreciated considerably.<sup>2</sup> The higher return could therefore be explained by an overweight in the sample of banks outside the United States. For the periods after 1985, additional return is achieved through a considerable increase in risk. The returns for the sample are higher than the world bank index but the standard deviation is 4 to 5% higher, suggesting that the spread of returns around the mean is 16 to 20% higher than for the world bank index. Finally, the period 1996-2000 is the only period where the yearly return for banks is lower than that of the world bank index.

## 22.4. Tests

### 22.4.1. Shareholder return and TNI

To begin the analyses of the relationship between total shareholder return and TNI, a simple model is estimated. The arbitrage pricing theory (APT) allows us to use many factors to explain security returns of banks. The APT assumes that the rate of return on any security is a linear function of the movement of a set of fundamental factors,  $r_n$ , and common to all securities. The required rate of return by shareholders (TSR) can be determined by a number of factors (Weston and Copeland, 1992, p. 422):

$$R = r_f + r_1\beta_1 + \dots + r_n\beta_n \quad (1)$$

Where  $r_f$  represents the risk free rate of return,  $r_{1...n}$  the different risk premium factors, and  $\beta_{1...n}$  the sensitivity of the rate of return to factor N. The determinants of the required rate of return for banks can be based on factors such as industrial growth, change in yield curve, changes in short term and long term inflation rate, and changes in the credit risk by the bank itself (Behm, 1994, p. 117). Here, the analysis focuses on the relationship between the degree of internationalization and shareholder return. The following model is estimated:

$$TSR_{ijt} = \alpha_i + \beta_1 r_{1it} + \dots + \beta_n r_{nit} + \varepsilon_{it} \quad (2)$$

A constant ( $\alpha_0$ ) is introduced to take account of the variables not specified,  $\beta_{1...n}$  represents the sensitivity of TSR to the different risk premium factors  $r_{it}$ .  $TSR_{ijt}$  is the dependent variable for bank  $i$  in year  $t$ . Six different measures for TSR are created as independent variable, 1..j, to examine generality of the results (cf. Sirower, 1997):

- *TSR1: raw return.* Total return in local currency.
- *TSR2: country adjusted return.* Total return<sub>it</sub> -/- local stock market return in local currency.

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<sup>2</sup> See also figure 8.10 in Chapter 8.

- *TSR3: world adjusted return.* Total return<sub>it</sub> -/- world stock market return in local currency.
- *TSR4: raw return, US.* Total return in US dollar.
- *TSR5: country adjusted return, US.* Total return<sub>it</sub> -/- local stock market return in US dollar.
- *TSR6: world adjusted return, US.* Total return<sub>it</sub> -/- world stock market return in US dollar.

The independent variables are presented in Table 22.2, together with their definitions and expected signs. The variables *TNI change* and *TNI* are the most important ones in the analysis. This follows directly from hypothesis HYP22.1, stating that banks with a higher degree of internationalization generate above average shareholder return. This effect could also be correlated with other effects relating to the soundness of the bank (*Capitalization, Provisions*), income structure (*Fee income*) or profitability (*Net income*).

Table 22.2. *Variable Definitions for Total Shareholder Return*

Variable	Definition	Expected direction
TNI change	Change in TNI, year on year difference	+
TNI	TNI bank	+
Fee income	Non interest income / gross income, percentage	+
Capitalization	Capital and reserves / total assets, percentage	+
Net income	Net income / capital and reserves, percentage	+
Provisions	Total provisions / capital and reserves, percentage	-
PE ratio	Total market value / profit before tax, percentage	+
Change in yield curve differential	Difference long term interest rate and short term interest rate, year on year difference	+
Change in asset position	Difference total assets bank and total assets largest bank in sample, year on year difference	-
Change in exports	Exports / GDP, year on year percentage change	+
Change in GDP per capita	GDP / capita, US dollar, percentage change	+

Goldberg and Saunders (1980) examined the motives for foreign banks to enter the United States. A low price earnings ratio (*PE ratio*) could be a reason to acquire banks in

the foreign country. The PE ratio might be low compared to the PE ratio in the domestic country, making it attractive for the bank to acquire a bank in the foreign country: while domestic funding is relatively cheap, the contribution to earnings is immediate. An acquisition of a high PE ratio indicates that either the bank expects to improve earnings or that the acquisition is herding-inspired. As a common sense measure, relative outperformance over a lagging period might be included. The PE ratio has been calculated by dividing total market value by profit before tax.

The macro economic environment is represented by the change in *Yield curve differential*, *Change in exports* and *GDP per capita*. Increases in the yield curve differential and GDP per capita serve as an indicator of positive economic expectations, influencing banks through and increase in the net interest margin and a lowering of the loan provisions, increasing profitability.

The *Change in exports* serves two purposes: besides serving as an indicator of the domestic economic growth opportunities, it could also serve as a signal for investors for the potential profitability of foreign activities, supporting the TNI and TNI change variables. Finally, herding is represented by change in assets position. If investors are sensitive to herding, there would be a positive relationship between TSR and a closing of the gap between the bank and the world's largest bank.

The independent variables are available on a yearly basis. Therefore, the different measures for TSR are calculated on a yearly basis, and regressed in an unbalanced panel model. Beforehand, no country or bank specific effects are expected for TSR2, TSR3, TSR5 and TSR6. These variables are adjusted for average country or world TSR. In line with earlier analyses, the model is estimated for three different periods, 1980-1989, 1990-2000 and 1980-2000. Table 22.3 presents summary statistics for the estimated models, grouped by different periods and six measures of TSR. The coefficients are displayed in Table 22.4.

Table 22.3. *Model summary*

Independent variable	1980-2000			1980-1989			1990-2000		
	Adjusted R Square	F Statistic	df	Adjusted R Square	F Statistic	df	Adjusted R Square	F Statistic	df
TSR1	0.1090	6.4184	(11,476) **	0.1181	3.3250	(11,180) **	0.2329	9.1439	(11,284) **
TSR2	0.1494	8.7772	(11,476) **	0.1219	3.4102	(11,180) **	0.2313	9.0703	(11,284) **
TSR3	0.0842	5.0728	(11,476) **	0.0906	2.7296	(11,180) **	0.1794	6.8620	(11,284) **
TSR4	0.1511	8.8790	(11,476) **	0.2825	7.8367	(11,180) **	0.1590	6.0686	(11,284) **
TSR5	0.0459	3.1314	(11,476) **	0.0973	2.8721	(11,180) **	0.0652	2.8692	(11,284) **
TSR6	0.1181	6.9297	(11,476) **	0.2023	5.4046	(11,180) **	0.1124	4.3949	(11,284) **

\*\* : p value <0.01

The estimated models for the six measures of TSR have explanatory power; the F statistics all have p values < .01. The US dollar influences the adjusted R Squares for the different periods: for 1980-1989, the adjusted R Square is higher for TSR4,5,6 (TSR in US dollar) compared to TSR 1,2,3 (TSR in local currency) while the opposite applies for

1990-2000. Table 22.4 shows the coefficients of the different models for the three time periods.

Table 22.4. *Coefficients, dependent variable total shareholder return (TSR1-6)*

Period	Model	TSR1		TSR2		TSR3		TSR4		TSR5		TSR6	
		Coefficient	p value										
1980-2000													
	Constant	-15.6946	0.0878	-17.6458	0.0046 **	-23.8151	0.0081 **	-8.8320	0.3380	-10.7115	0.0659	-17.5664	0.0443 *
	TNI change	0.7451	0.0523	0.3734	0.1497	0.9058	0.0158 *	0.5257	0.1720	0.1577	0.5157	0.7174	0.0490 *
	TNI	0.1469	0.1585	0.1362	0.0332	0.1140	0.2622	0.0692	0.5075	0.0781	0.2362	0.0452	0.6472
	Fee income	0.1198	0.3240	0.0906	0.2694	0.1616	0.1732	0.0962	0.4297	0.0347	0.6516	0.1297	0.2606
	Capitalization	0.1496	0.8972	0.1074	0.1940	0.1056	0.3502	-0.3684	0.7513	0.7191	0.3271	0.6363	0.5628
	Net income	1.1582	0.0000 **	0.4694	0.0001 **	0.8544	0.0000 **	1.1642	0.0000 **	0.4372	0.0001 **	0.8599	0.0000 **
	Provisioning	-0.6943	0.0000 **	-0.3036	0.0049 **	-0.6697	0.0000 **	-0.7700	0.0000 **	-0.3502	0.0006 **	-0.7433	0.0000 **
	PE ratio	0.1275	0.0711	0.0896	0.0606	0.1498	0.0300 *	0.1118	0.1148	0.0686	0.1248	0.1351	0.0440 *
	Change in yield curve differential	2.2625	0.0736	0.0235	0.9780	-0.6176	0.6163	3.3748	0.0080 **	0.7177	0.3695	0.1536	0.8980
	Change in asset position	32.2966	0.1684	44.7097	0.0049 **	-26.8550	0.2406	12.4179	0.5974	19.3880	0.1916	-46.8432	0.0356 *
	Change in exports	-1.8497	0.0714	1.2755	0.0658	0.3286	0.7425	-5.7872	0.0000 **	-1.5885	0.0146 *	-2.6585	0.0065 **
	Change in GDP per capita	-0.3001	0.0164 *	-0.3271	0.0001 **	-0.0719	0.5548	-0.0274	0.8266	-0.1113	0.1590	0.1815	0.1255
1980-1989													
	Constant	1.6136	0.9400	-35.4042	0.0163 *	5.9638	0.7947	2.5425	0.9090	-32.4916	0.0223 *	3.9719	0.8625
	TNI change	1.2857	0.1468	-0.1421	0.8137	1.6323	0.0855	1.1434	0.2136	-0.4719	0.4180	1.5463	0.1032
	TNI	-0.1042	0.5966	0.0414	0.7580	-0.1376	0.5135	-0.2622	0.2003	-0.0803	0.5356	-0.2556	0.2256
	Fee income	0.0964	0.6947	0.0934	0.5772	-0.0848	0.7468	0.2611	0.3065	0.1544	0.3405	0.0594	0.8212
	Capitalization	-0.5693	0.8366	4.7861	0.0118 *	-1.2656	0.6684	-1.1615	0.6853	4.4583	0.0150 *	-1.8439	0.5327
	Net income	1.0479	0.0049 **	0.7868	0.0020 **	0.7146	0.0711	1.1466	0.0031 **	0.8168	0.0009 **	0.8635	0.0295 *
	Provisioning	-0.9377	0.0004 **	-0.6059	0.0007 **	-0.8620	0.0020 **	-0.9955	0.0000 **	-0.6063	0.0005 **	-0.9575	0.0006 **
	PE ratio	0.7121	0.0546	0.2065	0.4120	0.3945	0.3179	0.7523	0.0506	0.1956	0.4209	0.4049	0.3054
	Change in yield curve differential	-3.5746	0.1790	-2.1838	0.2285	-8.0870	0.0048 **	-2.2400	0.4165	-1.3383	0.4442	-6.9024	0.0159 *
	Change in asset position	205.4685	0.0022 **	68.5447	0.1304	54.2079	0.4446	173.7311	0.0122 *	33.0719	0.4487	41.1860	0.5612
	Change in exports	-1.4889	0.3756	2.2893	0.0468 *	-0.9442	0.5992	-6.9068	0.0001 **	-1.7535	0.1141	-4.8601	0.0074 **
	Change in GDP per capita	0.2788	0.2182	-0.0219	0.8872	0.1825	0.4506	0.4120	0.0803	-0.0056	0.9701	0.3029	0.2112
1990-2000													
	Constant	-29.9059	0.0028 **	-13.3572	0.0584	-28.0967	0.0018 **	-23.5083	0.0109 *	-5.4892	0.3892	-20.6124	0.0131 *
	TNI change	0.5953	0.1209	0.4537	0.0955	0.4385	0.2031	0.3430	0.3335	0.2614	0.2882	0.2249	0.4806
	TNI	0.2161	0.0617	0.1572	0.0552	0.1722	0.0972	0.1983	0.0639	0.1390	0.0611	0.1501	0.1186
	Fee income	0.0998	0.4589	0.0351	0.7129	0.0838	0.4888	-0.0009	0.9943	-0.0749	0.3865	-0.0164	0.8840
	Capitalization	1.7781	0.1690	-0.2482	0.7861	1.5879	0.1715	1.7270	0.1489	-0.4346	0.5999	1.4365	0.1817
	Net income	1.0047	0.0000 **	0.4723	0.0011 **	0.9150	0.0000 **	0.9508	0.0000 **	0.4117	0.0016 **	0.8466	0.0000 **
	Provisioning	-0.4269	0.0493 *	-0.1455	0.3433	-0.4017	0.0395 *	-0.4793	0.0172 *	-0.2233	0.1087	-0.4540	0.0122 *
	PE ratio	0.1246	0.0563	0.0890	0.0515	0.0981	0.0902	0.1095	0.0665	0.0680	0.1003	0.0814	0.1288
	Change in yield curve differential	3.7335	0.0000 **	1.1438	0.2324	1.0910	0.3685	4.5210	0.0003 **	1.6960	0.0510	1.6185	0.1503
	Change in asset position	-25.2106	0.2827	27.8797	0.0942	-16.1665	0.4429	-47.0321	0.0309 *	6.4441	0.7576	-38.9579	0.0466 *
	Change in exports	0.7019	0.5895	1.8419	0.0464 *	3.3367	0.0046 **	-1.6057	0.1828	-0.2635	0.7522	0.9683	0.3713
	Change in GDP per capita	-0.7262	0.0000 **	-0.5125	0.0000 **	-0.2751	0.0273 *	-0.4037	0.0017 **	-0.1962	0.0276 *	0.0454	0.6930

\*\* p value < 0.01, \* p value < 0.05

First, TNI change has mostly positive coefficients for both periods. For 1980-1989, the level of TNI is negatively related with TSR for 5 out of 6 measures, while all are positive for 1990-2000. The change in TNI, as well as the level of TNI have no coefficients with a p value < .05 for all periods estimated.

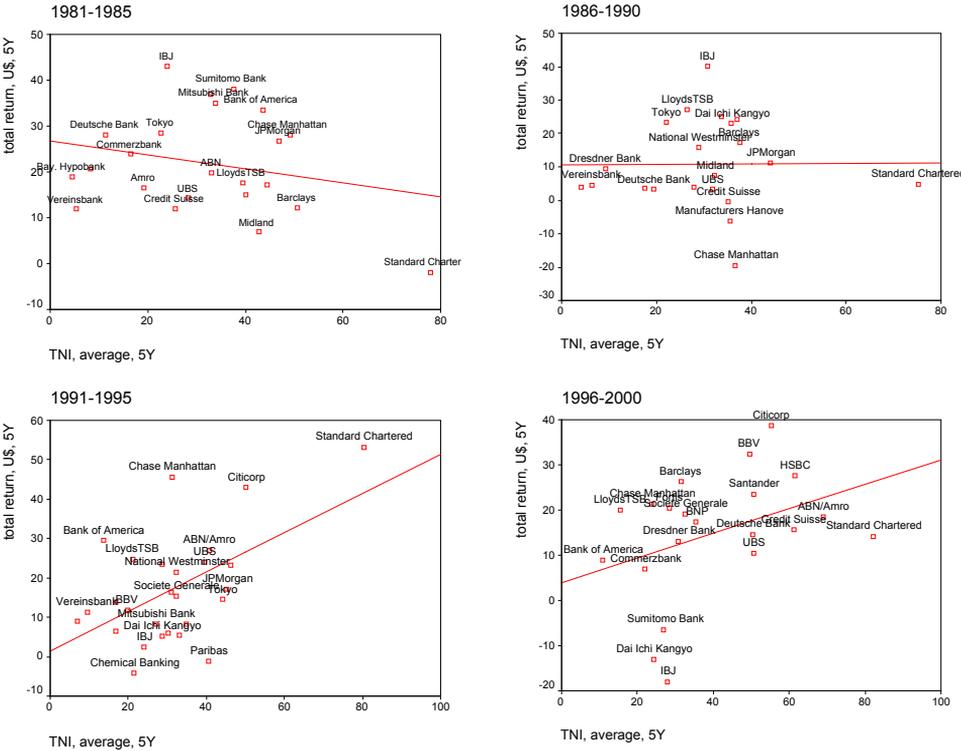
Both *Net income* and *Provisioning* have the expected signs and also p values < .05. For 1990-2000, two other variables add to the explanatory power: *Change in Exports* and *Change in GDP per capita*. While 4 out of 6 TSR measures have the expected signs for *Exports*, only 1 out of 6 have the expected sign for *GDP per capita*. *Change in yield curve differential* shows negative signs for the 1980-1989 period, contrary to what was expected. For the 1990-2000 periods positive signs for the six TSR measures are reported. The estimated values for the *PE ratio* are positive, in line with expectation, and *capitalization* shows more positive than negative estimates (a positive relationship was hypothesized). The estimated values for the *change in asset position* showed positive values for the 1980-1989 (a negative relationship was expected), while the 1990-2000 period shows mixed results. *Change in asset position*, *PE ratio*, *Capitalization*, *Change in yield curve differential* in general do not have p values < .05.

For robustness, other tests have been done. First, the period of analysis has been varied. The presented analysis is based on one year observations; 2 to 5 year periods have

also been calculated, yielding similar results. Figure 22.2 shows the relationship between TNI and Total Shareholder return in US dollar (TSR4), calculated as five year averages and shown for five year averages.

A regression line has been fitted into the graphs; the slope of the line is influenced in 1981-1985 and 1991-1995 by outliers such as Standard Chartered. Otherwise, no clear relationship can be determined from the graph. It is non-existent between 1986 and 1990; for 1996-2000 a positive relationship is visible, albeit with a large dispersion of observations.

Figure 22.2. Relationship between TNI and Total Shareholder return, US dollar



Summarizing, based on the adjusted R Square for 1980-1989 and 1990-2000, three measures for shareholder return of banks are best explained by the model: total return in local currency (TSR1), country adjusted total return in local currency (TSR2), and total return in US dollar (TSR4). The model provided the least explanatory power for the TSR measures treating the banks as one sample, TSR adjusted for world index return in local currency (TSR3) or US dollar (TSR6). TNI, and TNI change have a positive relationship with shareholder return as expected, especially between 1990-2000. However, the estimates are in general non-significant for  $p < .05$ . Therefore, there is weak support for hypotheses HYP22.1 and HYP22.2 for 1990-2000, and no support for 1980-1989.

Variables with significance levels of  $p < .05$  and expected signs were *Net income* (positive relationship with TSR measures) and *Provisioning* (negative relationship with TSR measures).

The previous analysis showed a weak direct relationship between TNI and shareholder return on a yearly basis. However, the relationship could also be indirect: efficiency gains and/or additional profitability might be achieved and recognized by shareholders some time after the increase in internationalization. Also, while a direct relationship for the whole sample is weak could it be that such a relationship exists for different levels of internationalization? Therefore, the next analysis considers the relationship between shareholder return and the degree of internationalization for different time periods and levels of internationalization.

Do levels of TNI and changes in TNI influence subsequent shareholder return? To examine this, the difference of TSR for two subsequent periods is calculated. With this ratio, two hypotheses are checked: does an increase in TNI in the first period lead to a relative increase of TSR. Second, if the degree of internationalization reaches a certain level, is the relative shareholder return lower because of geographic earnings surprises (HYP22.3). In order to do this, the following time series are created:

$$\text{RETLEAD}(n)_{i,t} = \prod_{T=t}^{t+n} (1 + \text{TSR}_{iT})^{1/n} \quad (3)$$

$$\text{RETLAG}(n)_{i,t} = \prod_{T=t-1}^{t-n} (1 + \text{TSR}_{iT})^{1/n} \quad (4)$$

$$\text{RETDIF}(n)_{i,t} = (\text{RETLEAD}(n)_{i,t} / \text{RETLAG}(n)_{i,t}) - 1 \quad (5)$$

where  $n = 1..4$  represents the time window used and suffix  $i = 1..6$  the different types of shareholder return. The difference in return (RETDIF) is measured using four different time windows of returns:

1. *One year window*: effect of return measured in  $t$  compared to the return in  $t-1$  given the level of TNI in  $t-1$  or the change of TNI in  $t-1$ .
2. *Two year window*: effect of average return measured from  $t$  through  $t+1$  compared to the return from  $t-1$  through  $t-2$  given the average level of TNI or average change in TNI between  $t-1$  and  $t-2$ .
3. *Three year window*: effect of average return measured from  $t$  through  $t+2$  compared to the return from  $t-1$  through  $t-3$  given the average level of TNI or average change in TNI between  $t-1$  and  $t-3$ .
4. *Four year window*: effect of average return measured from  $t$  through  $t+3$  compared to the return from  $t-1$  through  $t-4$  given the average level of TNI or average change in TNI between  $t-1$  and  $t-4$ .

For each of the return generating window, four different returns are used: TSR1 (total return, local currency), TSR4 (total return, US dollar) and TSR5 (total return, country adjusted, US dollar). The results for TSR2 and TSR3 were very similar to TSR1, and have been left out to presentation purposes. Although the previous analyses showed that adjusting returns for the world bank index yielded less explanatory power, TSR6 (total return, world index adjusted, US dollar) has been added as a check. Next, ratio's are created for the average level of TNI and the change in TNI:

$$\text{TNI}(n)_{\text{AVG},t} = \frac{1}{n} \cdot \sum_{T=t-1}^{t-n} \text{TNI}_T \quad (6)$$

$$\text{TNI}(n)_{\text{CHG},t} = \frac{1}{n} \cdot (\text{TNI}_{t-1} - \text{TNI}_{t-n}) \quad (7)$$

As a first analysis, the general trends of RETDIF and  $\text{TNI}_{\text{AVG}}$  are examined. If the level of TNI has been higher in previous years, does this lead to higher performance in the next period? The hypothesis is examined by calculating variable RETDIF for the different time windows and returns. Next, T-test values are calculated with zero as the test value, analyzing if the RETDIF differs significantly from zero. The values for RETDIF are not independent when calculated for successive years. Therefore, not all values for RETDIF are used but a selected number of years depending on the time window used.<sup>3</sup>

Table 22.5 presents the average values for RETDIF, split by the four time windows, the four different measures of relative return and the levels of TNI. The one-year time window yields the most negative results (13 out of 20), while the results with raw return have the largest number of positive results (13 out of 18). Negative results are concentrated in the 40-60% TNI bracket; the least negative results are found in the 0-20% TNI bracket. All calculated values do not differ from zero, the lowest p value recorded in the table is .13 but most are higher than .50.

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<sup>3</sup> To measure the difference for four year periods before and after, the first year chosen in 1997, then 1993 etc. The purpose of this is to exclude trailing effects: if the variable is calculated for 1993, and then for 1994, the earliest observation is deleted and the latest added, creating on average a variable in 1994 closely resembling the one for 1993. For example, for a time window of four years RETDIF for 1984, 1988, 1992 and 1996 as benchmark years are used.

Table 22.5. *Difference in TSR for different time windows and levels of TNI*

TNI level in previous period	period: -1, 1 year			period: -2, 2 year			period: -3, 3 year			period: -4, 4 year		
	mean difference	p value T-test	N	mean difference	p value T-test	N	mean difference	p value T-test	N	mean difference	p value T-test	N
<b>Raw return, local (TSR1)</b>												
0 - 20%	2.3413	0.6563	112	0.3439	0.9433	45	2.0131	0.6497	25	-0.9147	0.8048	20
20 - 40%	-0.2729	0.9419	233	2.2737	0.5427	106	0.9849	0.8012	60	-2.3801	0.5141	40
40 - 60%	-3.6924	0.4616	105	-1.5655	0.6976	47	1.4388	0.6738	21	-1.0422	0.7084	17
60 - 80%	-4.2761	0.7606	19	8.4773	0.5974	7	12.2476	0.5263	3	14.4160	0.4180	2
80 - 100%	-5.7557	0.8205	8	-4.5606	0.7940	4						
<b>Raw return, US (TSR4)</b>												
0 - 20%	2.0288	0.7293	112	0.5164	0.9402	45	4.5643	0.4905	25	1.5400	0.8018	20
20 - 40%	-1.4674	0.6799	233	1.7607	0.6563	106	1.3860	0.7454	60	-2.1560	0.6485	40
40 - 60%	-0.6097	0.8932	105	1.0522	0.8075	47	3.1206	0.4232	21	3.9819	0.3569	17
60 - 80%	-7.8131	0.5195	19	-3.9914	0.7720	7	16.8724	0.4251	3	22.0607	0.3972	2
80 - 100%	1.6214	0.9500	8	5.2820	0.8129	4						
<b>Country adjusted (TSR5)</b>												
0 - 20%	0.4630	0.8791	112	-2.7480	0.3443	45	0.6490	0.8316	25	0.9541	0.7479	20
20 - 40%	-1.1616	0.5845	233	1.0169	0.6192	106	0.3431	0.8531	60	-0.8702	0.6493	40
40 - 60%	0.1232	0.9627	105	-2.0838	0.4184	47	-4.3110	0.0880	21	-0.3469	0.8759	17
60 - 80%	-2.9315	0.7928	19	4.8904	0.6555	7	7.8535	0.5788	3	10.4546	0.5286	2
80 - 100%	-1.1589	0.9413	8	1.2291	0.9466	4						
<b>Market adjusted (TSR6)</b>												
0 - 20%	2.0817	0.7251	112	-1.6166	0.8298	45	0.1184	0.9815	25	3.3308	0.4431	20
20 - 40%	-0.0009	0.9998	233	2.7103	0.4722	106	2.2324	0.4728	60	0.4872	0.8862	40
40 - 60%	-1.7373	0.6809	105	-4.3441	0.3710	47	-5.9707	0.3195	21	-3.1291	0.6801	17
60 - 80%	-4.8781	0.6701	19	-1.8296	0.8850	7	14.2667	0.4445	3	24.6093	0.1302	2
80 - 100%	0.4111	0.9843	8	3.2207	0.8827	4						

Note: T-test calculated with test value 0.

In short, the level of TNI for 1 to 4 year time windows is no predictor for out or underperformance in the following periods. This applies to all different ways returns can be calculated. For 3 and 4 year time windows, the average returns for banks with TNI levels for 40-60% are in majority lower than banks with TNI levels between 0 and 20%, or 20 and 40%. On the other hand, shareholder return for banks with TNI levels between 60 and 80% is higher than banks with TNI levels lower than 60%. However, the number of banks with TNI levels between 60 and 80% is limited, at most 3. This suggests that a higher degree of internationalization is negatively related to additional shareholder return, albeit non significant.

In Table 22.5, the relationship between the level of TNI and the relative shareholder return was presented. The next step is to determine the relationship between changes in TNI and the ratio of relative shareholder returns. The results are displayed in Table 22.6.

For periods of 2 years and longer the difference in shareholder return is in general positive when TNI decreases; 18 out of 24 mean differences are larger than 1 with a TNI negative change. The return is in general negative when the TNI increases; 18 out of 28 mean differences are smaller than 1 with a positive TNI change. This is however not the case for the 1-year period: the larger the change in TNI, the more positive the additional return in return. In other words, if the increase of TNI is considered as an announcement effect, it generates additional return in the year of announcement, but the additional return

is not sustained or indicative of longer term additional shareholder return (cf. Sirower, 1997, p. 167).

Table 22.6. *Difference in returns for different periods and changes in TNI*

TNI level in previous period	period: -1, 1 year			period: -2, 2 year			period: -3, 3 year			period: -4, 4 year		
	mean difference	p value T-test	N	mean difference	p value T-test	N	mean difference	p value T-test	N	mean difference	p value T-test	N
<b>Raw return, local (TSR1)</b>												
< -10%	-20.9489	0.4245	8	21.2869	0.0554	9	6.7243	0.2273	12	5.4686	0.3063	9
-10 - 0%	-3.6420	0.3520	198	-0.3304	0.9331	80	-1.3225	0.7918	32	-0.9473	0.7978	21
0 - 10%	1.7764	0.6113	258	0.4016	0.9047	110	-0.7362	0.8378	58	-4.1430	0.2221	39
10 - 20%	14.6413	0.2928	12	-4.7287	0.7286	7	8.5351	0.1534	6	0.3419	0.9687	9
> 20%				9.0322	0.4446	3						
<b>Raw return, US (TSR4)</b>												
< -10%	-3.1463	0.8795	8	26.6017	0.0170	9	5.3178	0.4301	12	10.5535	0.1151	9
-10 - 0%	-0.6193	0.8764	198	3.4169	0.4689	80	-1.3133	0.8057	32	4.4779	0.3869	21
0 - 10%	-1.0960	0.7478	258	-2.2833	0.5320	110	2.3744	0.5942	58	-3.3511	0.4941	39
10 - 20%	11.6131	0.2684	12	-6.9561	0.6397	7	7.3014	0.2852	6	-1.7342	0.8723	9
> 20%				5.8613	0.6616	3						
<b>Country adjusted (TSR5)</b>												
< -10%	-9.8406	0.3740	8	3.9923	0.5483	9	-1.7642	0.6696	12	5.4701	0.1390	9
-10 - 0%	-1.9654	0.4103	198	1.2418	0.6015	80	0.0795	0.9762	32	-0.9994	0.6830	21
0 - 10%	0.7721	0.6973	258	-1.3314	0.5103	110	-0.9017	0.6792	58	-0.9330	0.6905	39
10 - 20%	4.7654	0.3608	12	-4.6330	0.3206	7	-4.0094	0.1781	6	-1.5087	0.7430	9
> 20%				-7.0022	0.3357	3						
<b>Market adjusted (TSR6)</b>												
< -10%	-3.5325	0.8633	8	23.1356	0.0705	9	3.0766	0.6812	12	6.6839	0.5961	9
-10 - 0%	0.2638	0.9439	198	2.7414	0.5784	80	1.7135	0.7306	32	2.8072	0.6183	21
0 - 10%	-0.8506	0.7892	258	-3.6372	0.3261	110	-3.1387	0.3324	58	-2.0479	0.5211	39
10 - 20%	15.5958	0.0683	12	-6.5989	0.4488	7	7.1804	0.3085	6	2.0878	0.7715	9
> 20%				2.9243	0.7774	3						

Note: T-test calculated with test value 0.

Therefore, the panel data estimation showed weak support for hypotheses HYP22.1 and HYP22.2 for 1990-2000, and no support for 1980-1989. Extension of time periods and considering different levels of internationalization yielded no further supporting results for the hypotheses: no support was found that the level of TNI for 1 to 4 year time windows is a predictor for out or underperformance in the following periods. This applies to all different ways shareholder returns have been calculated. If differences in TNI levels and differences in shareholder return are considered, then a higher degree of internationalization is negatively related to additional shareholder return, albeit non significant.

For time windows of 2 years and longer the difference in shareholder return is in general positive when TNI decreases, and in general negative when the TNI increases. Here too, the results are statistically non significant. For 1 year periods, the relationship between the difference in TSR and change in TNI seems different: the larger the positive change in TNI, the more positive the additional shareholder return. If the increase of TNI is considered as an announcement effect, it generates additional return in the year of

announcement, but the additional return is not sustained or indicative of longer term additional shareholder return.

#### 22.4.2. TNI, risk and return / risk

In chapter 20, examining the relationship between profitability, standard deviation of the past return on capital and reserves was used as a measure to assess risk taking by banks. With TSR, the standard deviation is a commonly used risk measure; changes in the standard deviation of the TSR are calculated for each bank security for the different time windows:

$$\text{RISKDIF}(n)_{i,t} = \frac{\sigma_{t,t+n-1}}{\sigma_{t-1,t-n}} \quad (8)$$

The variable RISKDIF is calculated for two measures, based on total shareholder return in local currency (TSR1) and country adjusted return (TSR5)<sup>4</sup>. RISKDIF is calculated as ratio of the standard deviation of TSR before, and after a certain time period. The standard deviation has been calculated using monthly returns. A T-test with test value 1 is used to determine if risk before and after the period has significantly changed. The results are presented for different levels in TNI (Table 22.7) and changes in TNI (Table 22.8).

Table 22.7. *Difference in risk for different periods and levels of TNI*

TNI level in previous	period: -1, 1 year			period: -2, 2 year			period: -3, 3 year			period: -4, 4 year		
	risk ratio	p value T-test	N	risk ratio	p value T-test	N	risk ratio	p value T-test	N	risk ratio	p value T-test	N
<b>Raw risk</b>												
0 - 20%	1.1199	0.0928	109	1.1198	0.2167	42	1.0390	0.7841	23	1.1131	0.4488	18
20 - 40%	1.0851	0.0380	165	1.1332	0.0644	69	1.1830	0.0222	37	1.2273	0.0726	24
40 - 60%	1.1408	0.0049	104	1.1635	0.0691	44	1.1744	0.0217	21	1.2271	0.0201	17
60 - 80%	1.2510	0.1092	20	1.0389	0.8503	7	1.1234	0.5280	3	1.1530	0.6532	2
80 - 100%	1.1677	0.4451	8	1.2834	0.4034	4	1.0000					
<b>Country adjusted risk</b>												
0 - 20%	1.2248	0.0126	109	1.0652	0.3951	42	1.0610	0.6886	23	1.0743	0.6368	18
20 - 40%	1.0949	0.0115	165	1.0213	0.4815	69	1.0197	0.6192	37	1.0046	0.9220	24
40 - 60%	1.2504	0.0207	104	0.9995	0.9849	44	0.9802	0.4891	21	0.9789	0.5524	17
60 - 80%	1.0769	0.3671	20	1.0624	0.5284	7	1.1041	0.3748	3	1.1663	0.4884	2
80 - 100%	1.1529	0.4907	8	1.1438	0.4453	4						

Note: T test values testing for risk ratio = 1.

In nearly all cases, the raw risk in the successive period is higher than the risk in the previous period for each level of TNI. Most T-test values, testing if the ratio of risk differs from zero, are insignificant with the exception of banks in the 40-60% region of TNI.

<sup>4</sup> Using the other measures for TSR yielded similar results to either TSR1 or TSR2 and have been left out.

Here, for different time windows, the risk significantly increases for 1 year, 3 year and 4 year time windows. Using country adjusted returns decreases the differences and the possible significances. Table 22.8 presents the results for the relationship between changes in TNI and the test values to determine if risk before and after the period has significantly changed.

Table 22.8. *Difference in risk for different periods and changes of TNI*

TNI change	period: -1, 1 year			period: -2, 2 year			period: -3, 3 year			period: -4, 4 year		
	Risk ratio	p value T-test	N	Risk ratio	p value T-test	N	Risk ratio	p value T-test	N	Risk ratio	p value T-test	N
<b>Raw risk</b>												
< -10%	1.0721	0.5290	5	1.0101	0.9509	3	1.0083	0.9436	8	1.0655	0.6482	5
-10 - 0%	1.1117	0.0054	168	1.1259	0.0749	68	1.1642	0.0460	25	1.1852	0.1110	17
0 - 10%	1.1164	0.0087	221	1.1042	0.0851	88	1.1293	0.1398	45	1.2015	0.0705	31
10 - 20%	1.2759	0.1293	12	1.0816	0.7384	5	1.2703	0.2227	6	1.1716	0.4756	7
> 20%					0.0118	2						
<b>Country adjusted risk</b>												
< -10%	1.2384	0.2902	5	1.2360	0.1509	3	0.9164	0.1215	8	1.0255	0.8260	5
-10 - 0%	1.1557	0.0095	168	1.0361	0.4635	68	1.0017	0.9693	25	1.0044	0.9269	17
0 - 10%	1.1893	0.0012	221	1.0210	0.4255	88	1.0554	0.4903	45	1.0477	0.6212	31
10 - 20%	0.9792	0.6917	12	1.0031	0.9749	5	1.1056	0.4044	6	1.0313	0.5231	7
> 20%				1.0545	0.4895	2						

In short, risk, measured as the standard deviation of TSR, does not have a relationship with the level of TNI, or change significantly when TNI changes. The outliers, banks whose TNI have decreased or increased with more than 10%, show different patterns. Risk on average decreases when TNI decreased, while it increased when TNI increased, but to a lesser extent. Hypothesis HYP22.3, a higher degree of internationalization lowers the volatility of total shareholder return of the bank, is therefore rejected.

After examining the relationship between return and internationalization, and risk and internationalization separately, the relationship between the return-risk ratio and the degree of internationalization of banks now considered. Applying the ratio similar to the Sharpe ratio<sup>5</sup>, the ratio shows the return per unit of risk, and is calculated as follows:

$$\text{RETRSKLEAD}(n)_{i,t} = \frac{\text{RETLEAD}(n)_{i,t}}{\text{RISKLEAD}(n)_{i,t}} \quad (9)$$

$$\text{RETRSKLAG}(n)_{i,t} = \frac{\text{RETLAG}(n)_{i,t}}{\text{RISKLAG}(n)_{i,t}} \quad (10)$$

<sup>5</sup> The Sharpe ratio is defined as  $(R_p - R_f)/\sigma_f$  where is the  $R_p$  total return of the portfolio,  $R_f$  is the risk free rate of return and  $\sigma_f$  the standard deviation of the portfolio

$$\text{RETRSKDIF}(n)_{i,t} = (10) - (9) \tag{11}$$

Table 22.9 presents the results for differences in the return-risk ratio (RETRSKDIF) for different levels and changes in TNI, a T test has been included to determine if the value differs from zero.

Table 22.9. *Difference in return/risk measures for different periods, and levels of TNI*

TNI in previous period	period: -1, 1 year			period: -2, 2 year			period: -3, 3 year			period: -4, 4 year		
	difference	p value	N	difference	p value	N	difference	p value	N	difference	p value	N
TNI level												
0 - 20%	-0.1459	0.3717	103	-0.1769	0.3416	45	0.0207	0.9041	25	0.2307	0.2331	22
20 - 40%	0.0137	0.8760	158	0.0382	0.8034	73	0.0791	0.5685	39	-0.0113	0.9461	28
40 - 60%	0.0104	0.9241	98	0.1224	0.3834	46	0.1460	0.4578	21	0.1328	0.5059	19
60 - 80%	-0.0997	0.7509	19	0.4965	0.3100	7	-0.1936	0.8076	3	0.2295	0.8296	2
80 - 100%	-0.0307	0.9506	8	-0.0292	0.9709	4						
TNI Change												
< -10%	-0.1000	0.8474	5	0.6571	0.2171	5	0.1714	0.4007	8	0.0787	0.8308	6
-10 - 0%	-0.0810	0.4483	160	-0.0059	0.9713	70	0.0171	0.9077	25	-0.0664	0.8047	19
0 - 10%	-0.0004	0.9968	210	0.0403	0.7321	93	0.1051	0.4706	48	0.0625	0.6712	38
10 - 20%	0.0616	0.7935	11	-0.1591	0.4660	5	-0.2534	0.3144	6	0.5655	0.0207	7
> 20%				-0.6938	0.0650	2						

Note: T test value with test value = 0.

In the year that TNI changes, the return-risk ratio does not change much. However, when TNI decreases the return/risk profile improves, if compared to the difference in return-risk ratio for an increase in TNI for the next years. As with the previous analyses for return and risk, almost all values however are not significant at a  $p < .05$  level. Hypothesis HYP22.4 is therefore rejected: a higher degree of internationalization of banks is not positively related to the return-to-risk ratio's; furthermore the analysis does not indicate the existence of an optimal degree of internationalization for the return-risk ratio of banks.<sup>6</sup>

### 22.4.3. Large changes in TNI, risk and return

If large changes in TNI are considered separately, does this change the results found with the analyses of the relationship between risk, return and the degree of internationalization of banks? As a robustness test, it is examined if the tails in the TNI change distribution influence the results. Large changes in TNI are defined here as yearly increases or

<sup>6</sup> The concept is derived from investment portfolio management (see for example Bodie, Kane & Marcus, 1996, p. 200; Maginn & Tuttle, 1990, p.2-22). With a correlation of less than one between foreign and domestic activities, the weight of foreign activities might be increased to a) create a combination with the lowest variance of earnings (minimum-variance) with higher earnings or b) create a combination where the earnings are higher than a) and the variance of earnings remains the same as in the initial situation. Both combinations then lie on the efficient frontier: a line showing the highest earnings at a given level of risk.

decreases in TNI of more than 10%.<sup>7</sup> Table 22.10 lists the large TNI changes of banks in the sample.

Table 22.10. *Large changes in TNI in the sample between 1980 and 2000*

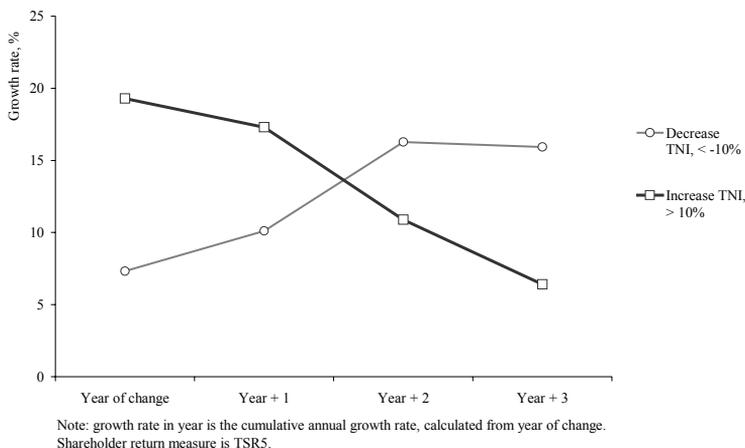
Year	Bank	Change	Year	Bank	Change
1990	Midland	-20.05	1999	Deutsche Bank	10.40
1994	Santander	-19.55	1993	Deutsche Bank	10.41
1985	Barclays	-17.39	1995	SBC	10.77
1991	Barclays	-16.78	1997	Credit Suisse	10.83
1985	Sumitomo Bank	-13.17	1993	Westdeutsche Landesbank	10.87
1999	Credit Lyonnais	-12.72	1996	BBV	11.51
1995	LloydsTSB	-12.43	1997	BBV	11.53
1999	Dai Ichi Kangyo	-10.93	1982	Midland	11.93
1998	National Westminster	-10.70	2000	UBS	12.09
1998	Sumitomo Bank	-10.57	1989	Barclays	12.31
2000	Citicorp	-10.14	1981	Midland	12.38
			1990	Credit Suisse	14.28
			1995	Westdeutsche Landesbank	14.63
			1998	ING Bank	15.75
			1992	HSBC	16.87
			2000	HypoVereinsbank	17.34
			1997	ABN/Amro	18.61
			1997	Santander	19.55

There have been more large TNI increases than decreases in TNI in the sample between 1980 and 2000. From 737 observations, 18 have increased with more than 10% in one year, while 11 have decreased with more than 10% in one year. The increases mostly took place between 1990 and 2000. Also, with the exception of Midland, these increases mainly stem from banks that have been classified as “accelerating”, increasing their degree of internationalization by foreign acquisitions. The decreasing banks on the other hand cannot be easily grouped; these banks decreased TNI by either divesting foreign, or acquiring domestic activities.

The observations are divided into a group with decreasing TNI, and a group with increasing TNI. The TNI change and the subsequent years is calculated, as well as the additional TSR adjusted for the country bank index in US dollar (TSR5). Next, the annualized cumulative growth rate for TSR5 for 1, 2, 3 years after the change in TNI took place has been calculated; this is shown in Figure 22.3.

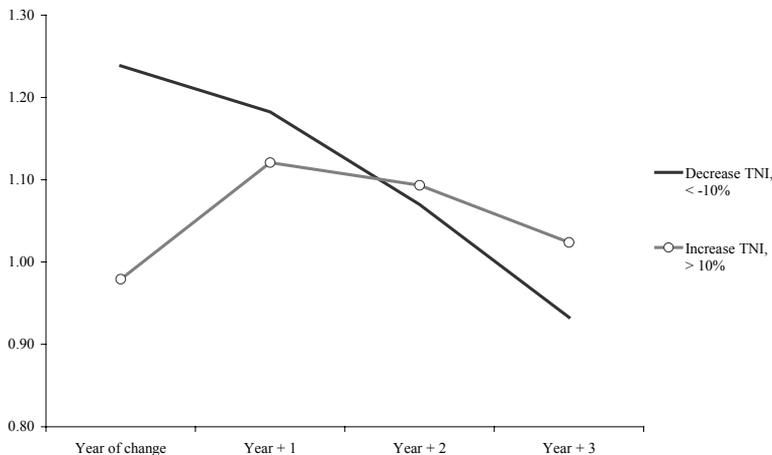
<sup>7</sup> Additional requirement for the selection was that the change in TNI has not been caused by exchange rate movements.

Figure 22.3. Additional return generated by large changes in TNI



For the banks that increased their TNI with more than 10%, almost 20% shareholder return was generated in the year of the change. This effect persisted in the year after. However, for years 2 and 3 the average additional growth rate declined, in the third year after the increase in TNI, a yearly additional 7 percent was generated. A decrease in TNI showed an opposite trend, especially creating additional shareholder return from year 2 onwards, almost 17% on a yearly basis.

Figure 22.4. Change in risk generated by large changes in TNI



To measure the change in risk, the change in risk for the year of change and 1,2,3 years afterwards are compared to the risk in the previous time windows, analogous to the analysis in 22.4.2. To correct for different levels of risk that might persist between

countries, the risk is calculated as the standard deviation of the return in US dollar adjusted for the country bank index in US dollar. A ratio of one indicates no change in risk, while a higher (lower) ratio indicates a relative increase (decrease) in risk. This is presented in Figure 22.4

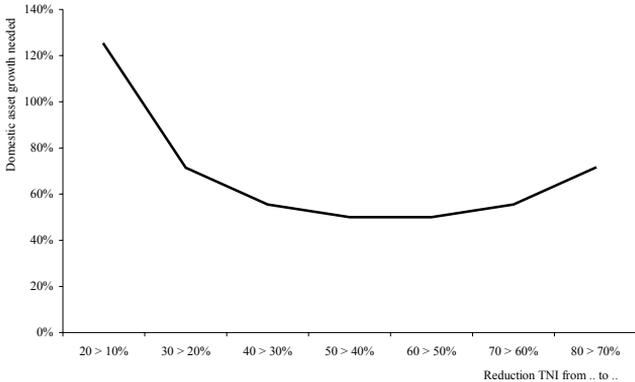
A large decrease in TNI tends to increase risk in the year of change, decreasing the years after. One reason for the initial increase of risk might be that large decreases in TNI are the result of foreign divestments caused by financial distress, which in itself might be the reason for a relative higher risk. However, Table 22.10 shows that most decreases in TNI took place between 1990 and 2000, and only 5 out of 11 foreign divestments could be marked as “distress” related. The other ones concern domestic acquisitions: shareholders either discount for the reduction of international diversification benefits, if there are any, or are concerned for the risks in general when the banks acquires another bank.<sup>8</sup>

Finally, the difference in the return-risk ratio is also calculated, where the value of zero for the year of change, one, two or three years afterwards indicated that the return-risk ratio is not different from the return-risk in the preceding time period.

A decrease in foreign activities tends to improve the return risk-ratio, especially in the year after the change. On the other hand, an increase in foreign activities tends to increase the return risk ratio compared to earlier time periods slightly in the second and third year.

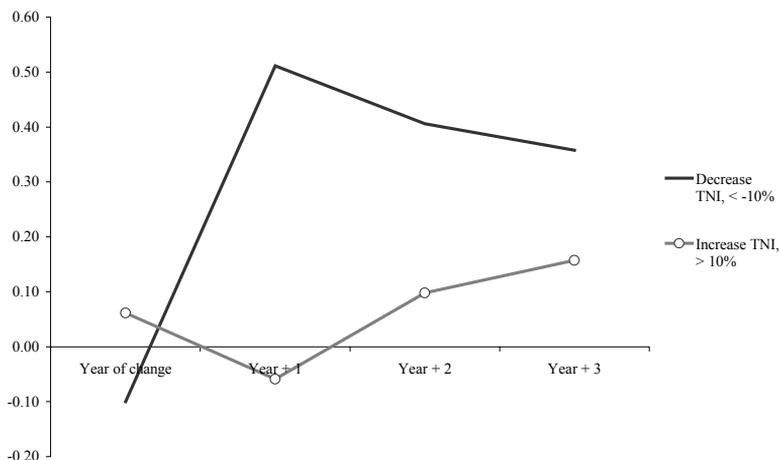
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<sup>8</sup> A reduction in TNI of 10% through domestic asset growth requires relatively large domestic acquisitions, compared to higher levels of TNI. In the next figure, the horizontal axis shows the reduction in TNI from a certain level (“from .. to..”) while the vertical axis indicates the percentage the domestic assets then must increase to achieve the reduction.



In all cases, at least 45% additional domestic assets must have been acquired to achieve the reduction, which could reasonably be interpreted by shareholders as being risky.

Figure 22.5. *Difference in return-risk with large changes*



Summarizing, the banks with a decrease of more than 10% in TNI, of which 11 were identified in the table, generate on average increasingly more shareholder return in the years after the change. The volatility of returns in the year of the decrease is relatively high, declining in the years afterwards. This implies that the risk-return ratio of the banks with decreasing TNI's improves the most in the years after the change in TNI.

Banks who have increased their internationalization activities with more than 10%, of which 18 cases have been identified, have shown the opposite: shareholder return has been relatively high in the year of change, steadily decreasing but still positive. The volatility of the returns increased in the year of change, remaining at broadly the same level for the subsequent years. This implies that the risk-return ratio of the banks with increasing foreign activities has only slightly improved. Hypothesis HYP22.5, large increases lead to above average shareholder return and improving return-risk ratios, is therefore rejected for banks with large increases in TNI and supported by banks with large decreases in TNI.

## 22.5. Summary

The relationship between shareholder return and the degree of internationalization has been investigated in this chapter. The first two hypotheses stated that the degree of internationalization, or a change in internationalization was positively related to shareholder return (HYP22.1 and HYP22.2). To analyze the relationship between total shareholder return and TNI, a simple model was estimated. Based on the adjusted R Square for 1980-1989 and 1990-2000, three measures for shareholder return of banks are best explained by the model: total return in local currency (TSR1), country adjusted total return in local currency (TSR2), and total return in US dollar (TSR4). *TNI*, and *TNI change*

were found to have a positive relationship with shareholder return as expected, especially between 1990-2000. However, the estimates are in general non-significant.

To examine whether the relationship existed for longer periods, the difference in return for 1 to 4 years was compared to the difference in return for 1 to 4 years earlier, for different levels of TNI. No support was found that the level of TNI for 1 to 4 year time windows is a predictor for out or underperformance in the following periods. This applies to all different ways returns can be calculated. If differences in TNI levels and differences in shareholder return are considered, then a higher degree of internationalization is negatively related to additional shareholder return, albeit non significant. Therefore, hypotheses HYP22.1 and HYP22.2 are not supported.

The next analyses considered the relationship between risk, return and the degree of internationalization. Risk, measured as the standard deviation of TSR, does not have a relationship with the level of TNI also, or change significantly when TNI changes. The outliers, banks whose TNI have decreased or increased with more than 10%, show different patterns. Risk on average decreases when TNI decreased, while it increased when TNI increased, but to a lesser extent.

The investigated return-risk ratio did not produce substantial different results. In the year that TNI changed, the return-risk ratio did not change much. However when TNI decreased then the return/risk profile improved, if compared to the difference in return-risk ratio for an increase in TNI for the next years. As with the previous analyses for return and risk, the results are not statistically significant. This also implies that no support has been found for hypothesis HYP22.3 and HYP22.4.

Finally, it was considered what the impact of large changes in TNI was on risk and return (HYP22.5). Banks with a decrease of more than 10% in TNI generated on average increasingly more shareholder return in the years after the change, while the risk steadily declined after an initial increase. This implies that the risk-return ratio of the banks with decreasing TNI's improves the most in the years after the change in TNI.

Opposite results were found for bank increasing their internationalization activities with more than 10%. The shareholder return was relatively high in the years of the TNI change, steadily decreasing but still positive. The volatility of the returns increased in the year of change, remaining at broadly the same level for the subsequent years. This implies that the risk-return ratio of the banks with increasing foreign activities has only slightly improved. Hypothesis HYP22.5, large increases lead to above average shareholder return and improving return-risk ratios, is therefore rejected for banks with large increases in TNI and supported by banks with large decreases in TNI.



## 23 Realized Strategy and Performance

The previous two chapters investigated the relationship between the degree of internationalization and performance measures for the whole sample. This chapter revisits chapter 19, where five types of realized internationalization strategies were identified based on the case study analyzed in chapters 12-18. First, have the realized internationalization had different incentives to internationalize, and is a difference in realized shareholder return detectable? Also, what role has home bias played for the different banks and can herding be observed?

### 23.1. Hypotheses

The first two tests examine the relationship between the degree of internationalization and incentives (chapter 20), shareholder return (chapter 22) and strategic types (chapter 19).

**Incentives (HYP23.1):** The relationship between incentives and TNI is better explained when banks are clustered by strategic type than by country of origin.

**Shareholder performance (HYP23.2):** In general, *Retreating* banks have created the highest total shareholder return, while *Accelerating* and *Imploding* banks have delivered the lowest results.

The next three hypotheses deal with the characteristics of different strategies: is there a home bias visible (HYP23.3), and do different strategies exhibit different financial ratio's (HYP23.4). Also, how do these ratio's change over time. Specifically, if assets or income initially were generated outside the home country due to fiscal reasons or the lack of financial product knowledge, then deregulation and financial innovation should have alleviated the difference in domestic and foreign ratio's over time (HYP23.5).

**Home bias (HYP23.3):** The relationship between staff, assets and gross income is more stable in the home country than in the foreign country

**Support strategy (HYP23.4):** The ratio of assets and/or income per staff is higher for *Moderate* banks throughout the period and *Accelerating* banks in the 1980s.

**Convergence (HYP23.5):** The ratio of assets and/or income per staff for foreign activities converges over time to the ratio for domestic activities.

Next, changes in strategy are addressed. Do banks in general tend to change their strategic activities simultaneous with other banks, suggesting a form of herding (HYP23.6). Also, if the degree of internationalization decreases substantially, what triggers it (HYP23.7)?

**Herding (HYP23.6):** Changes of strategy in the bank sample are concentrated in time.

Regionalization has also been identified as one of the drivers for internationalization, specifically the development of the European Union where banking activity intensified in several phases (1986, 1991, 1998), and the NAFTA from 1995. From that viewpoint it is likely that regional strategies are specific to European banks (HYP23.8).

**European regional strategies (HYP23.8):** Internationalization in the geographic home regions is specific for European banks.

## 23.2. Results

### 23.2.1. Strategy and incentives

To determine if banks with different strategy types also have different incentives to internationalize (HYP23.1), the regression analyses set up in chapter 20 to test the relationship between TNI and incentives for banks to internationalize are repeated. Instead of estimating different models per country, they are now estimated per strategic type. The definition and construction of the variables, the size and construction of the sample are identical to variables and dataset used in chapter 20. In chapter 19, five different strategic types of internationalization have been identified: *Accelerating*, *Moderate*, *Imploding*, *Retreated* and *Established*. Table 23.1 presents the model summary results for the estimations per strategy type; the coefficients are listed in Table 23.2.

Table 23.1. Model summary, dependent variable TNI

Strategy	1980-2000			1980-1989			1990-2000		
	Adjusted R Square	F statistic	df	Adjusted R Square	F statistic	df	Adjusted R Square	F statistic	df
Accelerated	0.6159	28.1178	(11,175) **	0.8985	55.7409	(11,57) **	0.5606	14.5707	(11,106) **
Moderate	0.7034	31.1849	(11,129) **	0.6817	12.8751	(11,50) **	0.8381	37.7108	(11,67) **
Condensed	0.5225	4.1831	(11,21) **	0.9266	22.8128	(11,8) **	0.9985	707.1634	(11,1) *
Retreated	0.5916	24.4435	(11,167) **	0.6813	18.0983	(11,77) **	0.4648	8.0264	(11,78) **
Established	0.7280	39.1990	(11,146) **	0.9167	76.0732	(11,64) **	0.7648	24.9491	(11,70) **

\*\* p values &lt; .01, \* p values &lt; .05

Table 23.2. Coefficients

	Accelerated		Moderate		Condensed		Retreated		Established	
	Coefficient	p value								
1980-2000										
FDI	1.8270	0.0001 **	-0.5254	0.1438	1.1755	0.3932	-0.4044	0.0980	0.4610	0.1354
Exports	-0.4336	0.0072 **	0.1819	0.0679	0.5025	0.7250	1.3097	0.0029 **	-1.3326	0.0000 **
Net interest margin	-0.1274	0.9444	-3.1613	0.0007 **	0.3203	0.9511	-0.2527	0.8358	3.6860	0.0035 **
Fee income	3.4724	0.1335	3.6605	0.0000 **	-0.4398	0.9418	-6.3349	0.0000 **	-0.6258	0.6303
Profitability	0.1131	0.5261	0.0228	0.7862	0.0860	0.6681	-0.0725	0.0918	-0.1886	0.0160 *
Capitalisation	1.8476	0.0355 *	-0.0976	0.8085	4.7833	0.1307	-2.9448	0.0000 **	1.0868	0.0601
Efficiency	0.1265	0.2763	0.0268	0.5720	0.9052	0.0990	0.1016	0.1383	-0.2826	0.0211 *
Market concentration	0.2238	0.0113 *	0.1272	0.0253 *	0.8695	0.3386	-0.1299	0.2427	0.7041	0.0000 **
Banking assets	0.0375	0.0488	0.0470	0.0007 **	0.1857	0.1539	-0.0436	0.0351 *	-0.0494	0.0002 **
Foreign stock market	-2.0001	0.0994	-0.5630	0.0000 **	1.0413	0.7304	-0.3450	0.0000 **	-0.1080	0.1481
Exchange rate	0.0448	0.2734	0.2067	0.7613	-7.5392	0.0014 **	6.0831	0.0760	1.2522	0.1570
1980-1989										
FDI	0.0280	0.9482	-0.0081	0.9958	-0.2709	0.8641	-2.3407	0.0049 **	-1.2228	0.0498 *
Exports	-0.2849	0.0359 *	0.4932	0.0194 *	-1.6165	0.0409 *	2.8049	0.0000 **	-0.0506	0.8194
Net interest margin	4.3864	0.0048 **	4.0348	0.1582	0.5234	0.9073	-4.6462	0.0146 *	0.5789	0.7452
Fee income	-0.5466	0.6999	7.5601	0.0066 **	0.3910	0.9358	3.9661	0.0444 *	-3.6665	0.0552
Profitability	-0.0788	0.4884	-0.2666	0.2049	0.0575	0.5699	0.0561	0.2062	0.1839	0.0110 *
Capitalisation	0.8826	0.2406	-2.2613	0.2413	3.5371	0.1464	-4.1253	0.0001 **	-1.3940	0.0384 *
Efficiency	0.1216	0.0972	-0.0564	0.5072	-0.1256	0.8219	-0.0844	0.4598	0.0137	0.9234
Market concentration	0.1634	0.0164 *	-0.0098	0.9238	1.1483	0.0332 *	-0.3650	0.0197 *	0.1122	0.3453
Banking assets	0.0865	0.0000 **	0.0319	0.4275	0.2484	0.0343 *	-0.0341	0.1254	0.0248	0.1231
Foreign stock market	0.9257	0.2560	-0.9342	0.0000 **	-7.9459	0.0033 **	-0.5652	0.0000 **	0.1079	0.1206
Exchange rate	-9.6185	0.0115 *	16.3298	0.0798	-35.1112	0.0014 **	17.0912	0.0000 **	37.9059	0.0000 **
1990-2000										
FDI	1.1562	0.0501	-0.4513	0.1216	-1.9243	0.7722	0.0398	0.8772	0.7517	0.0189 *
Exports	0.4105	0.1226	-0.0858	0.4263	-3.0505	0.7791	0.0221	0.9742	-0.9679	0.1393
Net interest margin	-5.3068	0.0333 *	-7.0925	0.0000 **	-29.3336	0.7793	-4.0555	0.0097 **	5.5572	0.0002 **
Fee income	6.0991	0.0509	5.5293	0.0000 **	-14.9738	0.7760	-0.7339	0.7103	-2.9752	0.1127
Profitability	0.0713	0.7623	0.0496	0.6109	0.0431	0.9141	-0.0945	0.1947	-0.2947	0.0514
Capitalisation	1.7127	0.1887	-0.6122	0.1111	-15.2897	0.7748	-2.3499	0.0004 **	-1.5390	0.0846
Efficiency	-0.4026	0.0324 *	0.1154	0.0504	0.4448	0.8020	0.2132	0.0043 **	-0.6328	0.0022 **
Market concentration	-0.0882	0.5618	0.2830	0.0001 **	3.4287	0.7749	-0.0227	0.8714	0.6403	0.0000 **
Banking assets	0.0300	0.3034	0.0337	0.0194 *	0.9207	0.7712	-0.0359	0.3328	-0.0681	0.0035 **
Foreign stock market	-0.1062	0.9599	-0.4106	0.0000 **	-13.8490	0.7785	-0.0366	0.7735	-0.3790	0.0271 *
Exchange rate	0.0751	0.1069	-0.8653	0.1072	-4.5049	0.7731	3.3354	0.5553	0.5202	0.5814

\*: p value &lt; .05, \*\*: p value &lt; .01

If the model summary with the TNI of strategy types as dependent variables (Table 23.1) is compared to the model summary of with TNI as dependent variable by country (Table 20.4), then the “strategy type” model summary shows high levels of adjusted R Squares compared to the “country type” model summary, the lowest in .46 for retreating banks in 1990-2000. This can partly be explained by the change in number of groups: in chapter 20 data was split up for 8 different countries, and here data is split up for 5

different strategy types. Most strategic types groups have more than 50 observations per decade. Exception here is the “*Imploding*” type: there are only two banks in this category, Midland and Crédit Lyonnais. The coefficients are presented in Table 23.2.

When formulating the hypotheses in chapter 19 to test the relationship between incentives and the degree of internationalization, it has not been specified if these relationships are different for the strategic types. At the very least, the estimated values can be compared with the following groups of banks: *Moderate* and *Established* banks for the whole period, and *Accelerating* banks in the period before accelerated growth takes place. For the *Imploding* type banks, retreating banks the relationship between incentives and their internationalization activities might be different, simply because different strategies were chosen.

Some variables gain in weight while others decline, compared to the results in chapter 19. The traditional incentives, *FDI* and *Exports*, are relevant for *Accelerating* and *Established* banks, with p values < .05 for 6 out of 12 observations.<sup>1</sup> In the country analysis, both variables were found to have no explanatory power.<sup>2</sup> Another observation is the increased importance of *Efficiency* as independent variable. As a litmus test to see which estimations are similar for pairs of strategic type, a table with the number of different sign directions of the 11 variables between two strategic types is constructed. Based on this, *Accelerating* and *Moderate* banks have the most signs in common, while *Moderate* and *Established* differ the most, together with *Imploding* and retreated.

Table 23.3. Number of differing direction of signs for estimation model incentives per strategic type

	Accelerating	Moderate	Imploding	Retreated	Established
Accelerating	-				
Moderate	3	-			
Imploding	5	6	-		
Retreated	7	4	8	-	
Established	5	8	6	6	-

In short, estimating the relationship between incentives and TNI grouped for banks per strategic types yields better results than estimation per country, partly supporting hypothesis HYP23.1. A shift in the relevance of independent variables is visible, increasing the explanatory role of Efficiency, FDI and export but not with the expected signs (in line with the results in chapter 19). *Accelerating* and *Moderate* banks have the most in common, while *Moderate* and *Established* differ the most.

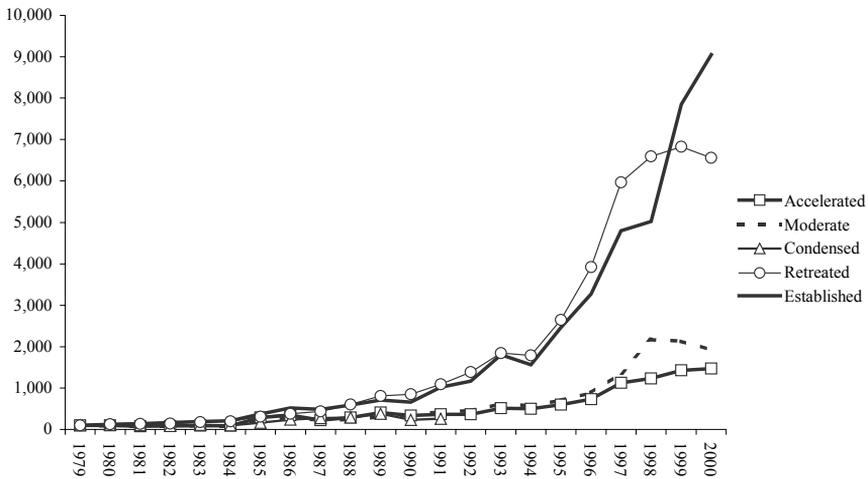
<sup>1</sup> 2 variables, observed for 3 periods, for 2 different types of banks

<sup>2</sup> Finding that FDI and Exports are relevant with models per strategic types and not per country is contrary to what might be expected since FDI and Export are “country bound”.

### 23.2.2. Shareholder return and strategy

If shareholders - with hindsight - had made baskets for the different strategic types, what would have been the result? Hypothesis HYP23.2 states that *Retreating* banks have created the highest total shareholder return, while bank with *Accelerating* and *Imploding* internationalization have delivered the lowest results. This will now be investigated. First, Figure 23.1 presents the cumulative return in US dollar per type re-based at 100 in 1979. The yearly return is weighted by market value, results do not change when banks are equally weighted. A substantial difference over time emerges between two groups: the *Established* (25.2% yearly return) and the *Retreating* (23.2%) on the one hand and the *Moderate* (15.9%) and the *Accelerating* (14.3%) on the other hand. An investment in banks with *Established* internationalization compared to banks with *Accelerating* internationalization over a period of 20 years would have resulted in a total return 6 times as large, or an additional 9.5% per year.

Figure 23.1. Total shareholder return, (TSR4, US dollar) per strategic type



Note: Total return in US dollar, rebased at 31 december 1979=100, return weighted by market value in US dollar  
Source: Datastream, own calculations

The large differences in total return urge a closer examination of the underlying data. The differences might simply be caused by a country bias: most banks classified as *Retreating* and *Established* are American or British; banks in these countries have in general shown higher shareholder returns than other countries. To correct for this, the cumulative shareholder return adjusted for the country's bank index needs to be calculated. Another point of examination are the Japanese banks. Since 1990, their equity prices have been steadily falling, and classifying them all into one category might give biased results. Table 23.4 presents the bank per strategic type, and shows the number of banks that are American/British, Continental European, and Japanese. Most of the Japanese banks fall

either in the *Retreating* or *Established* category, more likely dampening the results for the *Accelerating* and *Moderate* type banks which were already substantially higher.

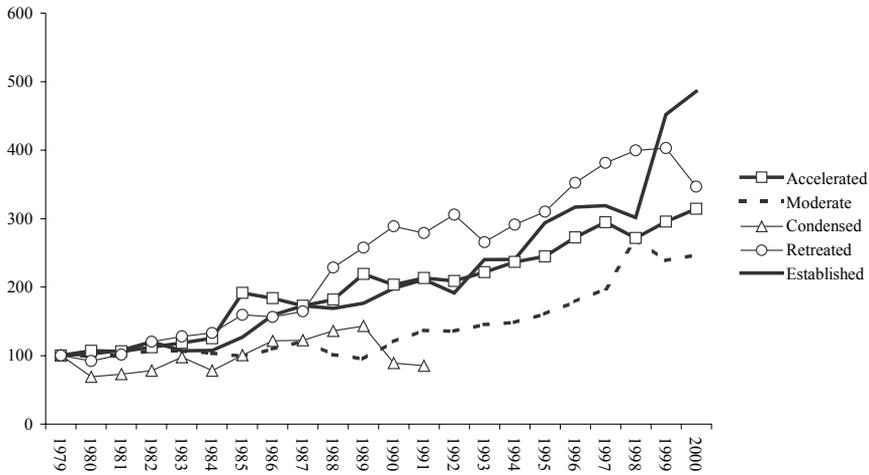
Table 23.4. *Classification banks per region and strategic type*

Type	United States, United Kingdom	Continental Europe	Japan	Banks
Accelerating	0	9	0	ABN Amro, BBV, Credit Suisse, Deutsche Bank, Dresdner Bank, HypoVereinsbank, Paribas, Santander, UBS
Moderate	0	6	1	Amro, Argentaria, BayerischeHypobank, Commerzbank, Fortis, IJB, Vereinsbank
Imploding	0	2	0	Crédit Lyonnais, Midland
Retreating	7	0	3	Bank of America, Barclays, Chase Manhattan, Chemical Banking, Dai Ichi Kangyo, Lloyds TSB, Manufacturers Hanovers, Mitsubishi Bank, National Westminster, Sumitomo Bank
Established	4	3	2	ABN, BNP, Citicorp, HSBC, J.P. Morgan, Société Générale, Standard Chartered, Tokyo-Mitsubishi, Bank of Tokyo

The yearly returns are recalculated, adjusting the yearly bank return for the country return represented by the Datastream country bank index in US dollar. The cumulative figure then represents the additional return one would have achieved by investing in the individual banks instead of the country index. This is shown in Figure 23.2.

The substantial differences in returns per strategy are mitigated to a large extent. Adjusting for country shows that retreating banks had most to gain between 1987 and 1998. *Accelerating* banks fared consistently worse than retreating banks between 1987 and 2000, while in turn *Accelerating* banks showed lower returns than *Moderate* banks. Overall, the division in returns between *Accelerating* and *Moderate* banks on the one hand and retreated and *Accelerating* banks on the other hand is upheld.

Figure 23.2. Total shareholder return adjusted for country return (TSR5) per strategic type



Note. Total return in US dollar +/- total return Datastream country bank index (TSR5), rebased at december 31 1979=100, weighted by market value in US dollar. Source. Datastream, own calculations

The case studies in part II also have shown that (foreign) acquisitions have been a substantial element of the strategic activities of the bank. As a proxy for the external capital needed from shareholders to finance these transactions, the increase in the amount of shares is approximated for each strategic type. Which types have attracted the largest amounts of external equity, and did this influence returns?

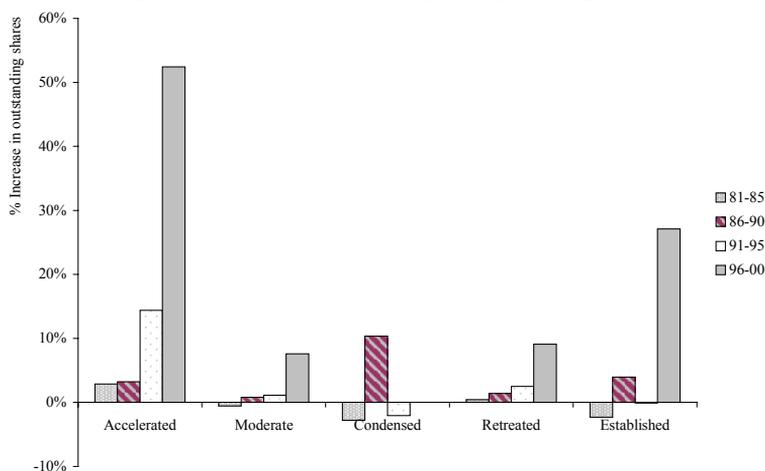
Using a price index adjusted for stock splits in US dollar (PI) and the end-of-year market value in US dollar (MV), then the change in outstanding shares value can be calculated as

$$\left( \frac{MV_t}{MV_{t-1}} \right) \left( \frac{PI_t}{PI_{t-1}} \right) - 1 \tag{1}$$

Using a price index circumvents issues like the redenomination of shares: they are assumed to be constant throughout the period. The change can be negative as well as positive: negative values indicate a) share buy back activities, or b) changes in accounting principles or c) deconsolidation of activities. In general, extreme large changes in the amount of outstanding shares have only taken place in two instances where a reverse takeover took place: Nationsbank who in effect acquired Bank of America but retained the listing and the name; similar cases are Chemical Banking who acquired Chase Manhattan, and SBC who acquired UBS.

Figure 23.3 presents the average increase in outstanding shares; banks have increased their outstanding shares but *Accelerating* banks clearly have been the most active in increasing their share-base throughout the 1990s. Retreated and *Moderate* banks have asked their shareholder for far lesser issues.

Figure 23.3. Increase in outstanding shares per strategic type



*Accelerating* banks have needed the most capital for their increase in activities, but have been unable to create additional shareholder return with this, if or not adjusted for the country average return. This is in sharp contrast with the other banks: *Moderate* banks have needed a fraction of the capital but achieved similar returns as *Accelerating* banks, while *Established* banks have achieved higher returns than *Accelerating* banks, especially since 1994. From 1987 to 1997 shareholders would have profited most from investing in retreating banks.

In short, if indices are created for the different strategy types, then *Established* and retreating banks would have generated the highest return 1980 and 2000, if this is measured in absolute returns, or adjusted for country averages. *Moderate* and *Accelerating* banks would have generated the least returns, in spite of *Accelerating* banks having attracted relatively large amounts of capital to fund their activities. Hypotheses HYP23.2 is therefore not rejected.

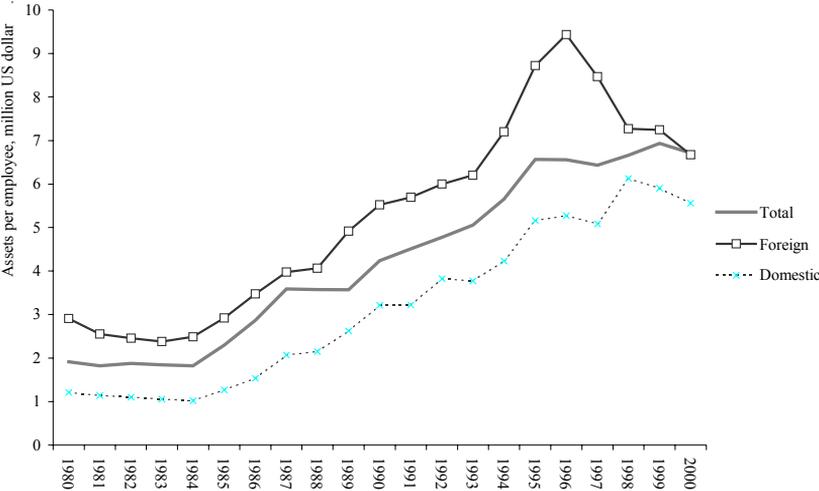
### 23.2.3. Home bias, support strategy and convergence of ratio's

The next analyses examine the characteristics of different strategies: is there a home bias visible (HYP23.3), and do different strategies exhibit different financial ratio's (HYP23.4). Also, how do these ratio's change over time. Specifically, if assets or income initially were generated outside the home country due to fiscal reasons or the lack of financial product knowledge, then deregulation and financial innovation should have alleviated the difference in domestic and foreign ratio's over time (HYP23.5).

A home bias exists when domestic activities are more stable than foreign activities: ratio's such as assets per employee should show lower variability for domestic activities than for foreign activities. This might be expected on political reasons: a bank has more

stakeholders in the home country than outside the home country. Changes in activities are therefore more easily executed outside the home country, leading to a higher variability. Also, if banks have concentrated corporate banking or investment banking activities outside the home country, then these activities might have a higher correlation with economic cycles than for example domestic retail activities.

Figure 23.4. Foreign assets per employee, weighted per employee



Foreign, domestic and total assets per employee are calculated for the total sample per year (Figure 23.4). The average assets per employee increased from about 2 million US dollar in 1980 to 7 million in 2000. Domestic assets were on average one million lower. Throughout the period, foreign assets per employee were higher than domestic assets, with a deviation between 1993 and 1996 where a strong increase and decrease took place. The growth in 1993-1996 for foreign assets is not easily explained; the decrease after is partly 1996 might be explained by an increase in foreign retail banking acquisitions, lowering the assets per employee ratio. Similar results are found when income per employee ratio's are calculated.

The next questions are: do these financial key ratio's differ for the five strategies, and are these ratio's more stable for domestic activities than for foreign activities? In Table 23.5, assets per employee are grouped for the different strategic types. A first observation is that *Accelerating* banks are truly asset seekers, with an average of 7.3 million dollar assets per employee, compared to almost 5 for *Established* banks. For all banks and periods, foreign assets per employee are higher than for domestic assets.

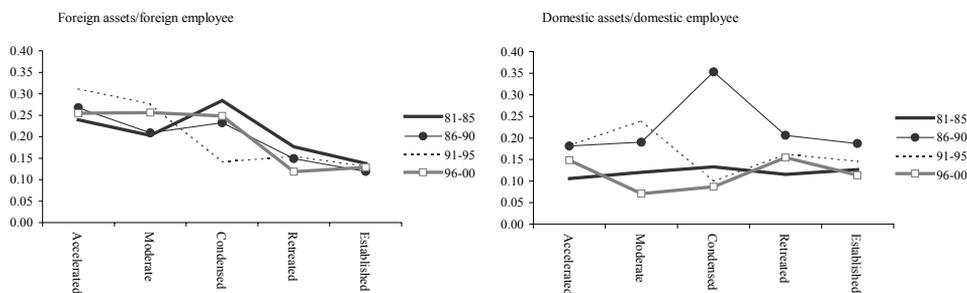
Table 23.5. Foreign assets per employee for different strategic types

Period	Accelerated		Moderate		Condensed		Retreated		Established	
	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N
<b>Total</b>										
1981-85	2.1662	25	1.7851	12	1.3228	10	0.9868	20	1.8895	30
1986-90	4.1539	37	3.4635	18	2.3698	10	2.1105	22	2.8398	29
1991-95	5.6534	52	6.1128	28	4.4202	6	4.0428	26	4.0015	32
1996-00	7.3955	49	7.0204	29	4.9178	5	5.9184	17	4.9916	29
<b>Domestic</b>										
1981-85	1.6415	25	1.3026	12	0.8531	10	0.6361	20	1.6801	30
1986-90	3.3156	37	2.8062	18	1.7543	10	1.6032	22	2.7553	29
1991-95	4.3325	52	5.6271	28	3.6137	6	3.2295	26	3.6232	32
1996-00	6.1420	49	6.2939	29	3.8573	5	5.1253	17	4.8032	29
<b>Foreign</b>										
1981-85	10.9048	25	14.1369	12	4.1941	10	1.8439	20	2.1322	30
1986-90	9.6579	37	15.6134	18	5.2350	10	4.0164	22	2.9440	29
1991-95	9.9963	52	10.6674	28	6.0573	6	7.6820	26	4.4279	32
1996-00	8.7186	49	11.2646	29	7.4723	5	10.3818	17	5.1738	29

Note: N is the number of yearly observations of banks reporting foreign assets as well as foreign staff in the period. The means are weighted by employees. Unweighted averages yield similar results.

The different trends of assets per employee in Figure 23.4 suggest that domestic assets per employee have been more stable than foreign. To measure the variability of these indicators, the average variance coefficient (standard deviation divided by mean) is calculated for the banks per strategic type and different periods.<sup>3</sup>

Figure 23.5. Variance coefficient for foreign and domestic assets per employee, per strategic type



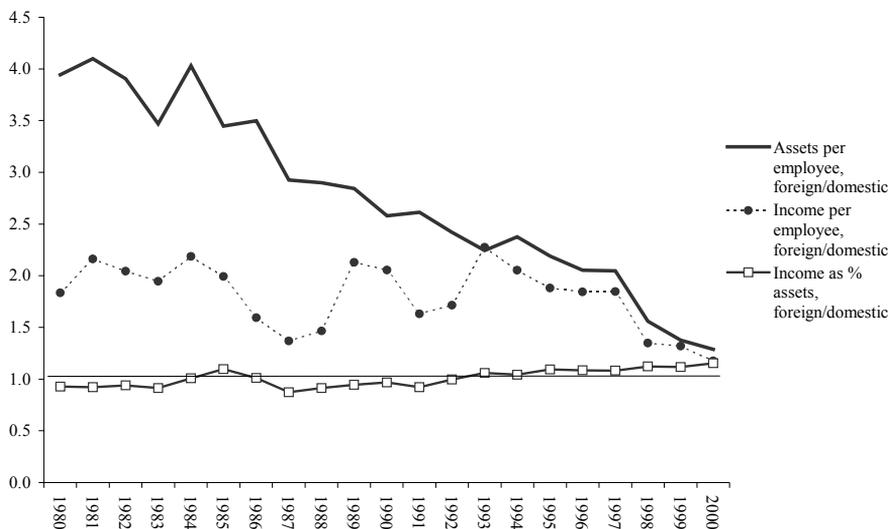
A lower variance coefficient value indicates a more stable ratio of assets per employee. For all periods, the variance coefficient for foreign assets per employee is

<sup>3</sup> The variance coefficient, dividing standard deviation by the mean, has no dimension, and is a better than only the standard deviation since a finding was that the ratio of foreign assets per employee is higher than the domestic ratio.

highest for *Accelerating* banks and *Moderate* banks, while lowest for retreated and *Established* banks (Figure 23.5). Domestic assets per employee on the other hand show more variation. The domestic variance coefficient is lower than the foreign for *Accelerating* and *Moderate* banks, for all periods. Retreated banks show a higher domestic variance coefficient from 1986 onwards, while for *Established* banks this is true between 1986 and 1995. This indicated that on average *Accelerating* and *Moderate* banks maintained more stable domestic activities than foreign activities, while *Established* banks and retreating banks maintained more stable foreign activities than domestic activities. The home bias hypotheses (HYP23.3) is therefore partially rejected, while support is found for the support strategy hypothesis (HYP23.4): the ratio of assets per staff is higher for certain periods in the bank's strategy compared to other banks, indicating a support strategy.

*Accelerating* and *Moderate* banks have a relatively high degree of foreign assets compared to domestic, especially in the 1980s. Retreated banks on the other hand show an opposite direction: foreign assets per employee compared to domestic steadily increases. *Established* banks have on average maintained a stable balance between foreign and domestic activities. Assuming that corporate banking and investment banking activities tend to have high assets to employee ratio's, the following might be suggested. First, for *Accelerating* and *Moderate* banks foreign activities in the 1980s tended to be support investments. For the 1990s, *Moderate* banks upheld this function for foreign banks to a large degree. The opposite can be observed with retreating banks: the increase in the foreign ratio for the 1990s indicates that the foreign activities are more concentrated on corporate and investment banking than before.

Figure 23.6. Foreign to domestic ratio's

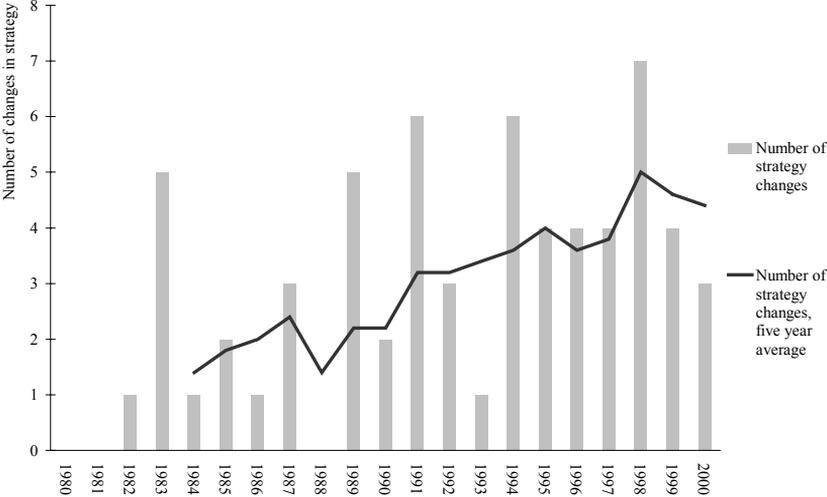


Assets per employee have been steadily converging, this supports hypothesis HYP23.5. This may be due to a number of reasons: fiscal deregulation has effectively reduced the number of off shore havens and finance companies of banks outside the home country, activities with a high asset per employee ratio. Also, banks might have re-centralized activities from the 1980s, bringing back corporate banking or investment banking activities to the head office. Finally, the acquisitions of foreign retail banks have increased in the 1990s, lowering the ratio. Income per employee is volatile, but foreign income is structurally higher than domestic. On the other hand, income as percentage of assets is similar for foreign and domestic activities.

23.2.4. Herding and exit strategies

Have changes in internationalization activity been concentrated in time for the banks in the sample between 1980 and 2000? An approach would be to count the number of strategic changes for the banks between 1980 and 2000. In part II, the realized internationalization activities was grouped into one or more periods for each bank. For example, Deutsche bank expanded its foreign activities between 1980 and 1985. However, from 1986 the pace of international expansion increased considerably, when the bank started acquiring retail banking operations in Europe and capital market activities in the United Kingdom and the United States. The year 1986 is here considered a change in realized strategies. For 44 banks, 61 large strategic changes have been identified between 1980 and 2000, the yearly occurrence is shown in Figure 23.7.

Figure 23.7. Number of strategic changes between 1980 and 2000



The number of strategic changes has structurally increased in the 1990s. The five years with most changes are 1983, 1989, 1991, 1994 and 1998. Some of these years are

readily interpretable: in 1983, banks changed their internationalization strategy as a result of the LDC crisis, in 1991 renewed strategies were set out after domestic consolidation (Netherlands, United States); in 1998 banks reassessed their investment banking activities and their commitment to domestic banking after the Asian crisis.

The numbers of strategic changes in internationalization activities for these five years add up to 29, almost half of the 61 strategic changes in total. This supports the hypothesis of herding activities among banks (HYP23.6). Most of the strategic changes were initiated by accelerating and retreating banks, each accounts for approximately one-third of all changes in strategy. To give an idea of the underlying numbers for Figure 23.7, Table 23.6 presents the number of strategic changes for the five strategy types between 1980 and 2000.

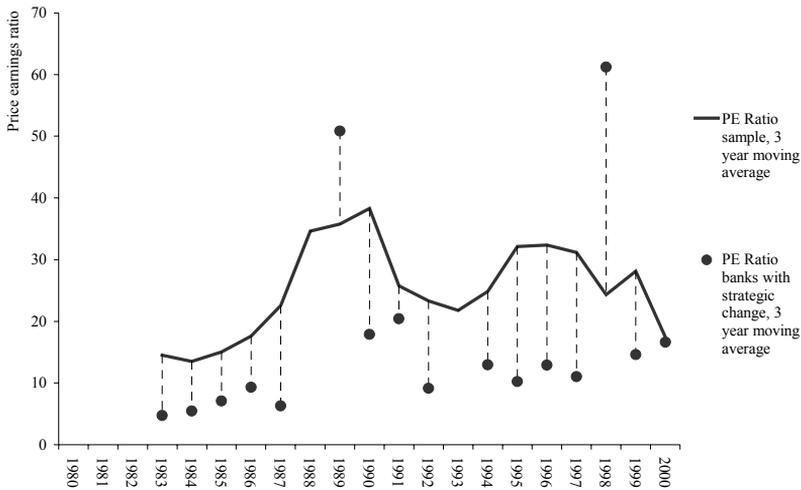
Table 23.6. Changes in internationalization strategy per strategy type, 1980-2000

Type	Successive internationalisation phase	Previous internationalisation phase								Total	
		Entry		Expansion			Consolidation		Restructuring		
		Entry	Entry, broad expansion	Broad	Focused	Focused & broad	Balanced growth	Restructuring	Exit & focused expansion		Exit
Accelerated	Expansion, broad	5									5
	Expansion, focused	2		8	1						10
	Consolidation, restructuring			1	4						5
Moderate	Expansion, focused		6								6
	Consolidation, restructuring		2		2						4
Condensed	Consolidation, restructuring					2					2
	Restructuring, exit							2			2
Retreated	Consolidation, balanced growth								1		1
	Consolidation, refocus								4		5
	Restructuring, exit & focused expansion						1		1		2
	Restructuring, exit						9		1		10
Established	Expansion, broad				1						1
	Expansion, focused			2							3
	Expansion, (re)focused				1						2
	Consolidation, balanced growth			1							1
	Restructuring, exit			1	1						2
Total		7	8	13	9	2	11	2	1	8	61

The columns in Table 23.6 show the different internationalization phases previous to the strategic changes, while the rows show the internationalization phases following the strategic change. Most of the strategic changes were initiated by accelerating and retreating banks, where the banks changed their focus on expansion. As might be expected, an important aspect for retreating banks has been the shift from balanced growth to restructuring, exiting foreign banking activities: each accounts for approximately one-third of all changes in strategy.

To determine what variables were different leading to the changes in strategy, the average values of the indicators used in chapter 20 (incentives) were calculated, and a comparison was made between the banks having no change in strategy and the banks engaged in strategic changes. Only one variable stands out to some extent, the average price earnings ratio in the three years leading to the strategic change.

Figure 23.8. Price earnings ratio of banks with strategic change compared to the sample



In most years where strategic changes took place, the price-earnings ratio was below that of the 3-year average of the sample. The years 1989 and 1998 are exceptional because of their relative low earnings, inflating the ratio. While individual ratio's do not differ substantially, the price-earnings ratio does. With this ratio shareholders price-in their expectations of future earnings. This would suggest that most strategic changes have been for defensive reasons: a low price-earnings ratio compared to competitors increases the risk of being acquired. Especially in the 1980s the lower price-earnings ratio is the balance of restructuring of American and English banks, while the low price-earnings in the 1990s is more the result of a shift to European changes in strategy, where general market valuation is lower than in the United States or England.

### 23.2.5. Regional strategies

Internationalization developments since the 1980s could be better described by *regionalization* rather than the *globalization* within three main economic regions Europe, Japan and Asia-Pacific, and the United States (Ruigrok and Van Tulder, 1995, p. 289). Internationalization of banks between 1995 and 2000 has shown uneven patterns across regions (De Nicoló et al., 2003); the share of foreign controlled assets increased significantly in the United States, several countries in Western Europe and non-Asian emerging countries. In other continents the increase of internationalization was limited, or decreased as in Africa (De Nicoló et al., 2003, p. 18). Are internationalization activities mainly focused in the region where the bank is located, or is it more broadly based? The analysis here focuses on regional strategies, i.e. internationalization activities mainly focused in the geographic region where the bank is located, hypothesizing that they are specific to European banks (HYP23.7). General trends of regionalization within the sample are examined, recognizing the limitations the data provides. What have been the

geographic areas of growth, and have they differed between American, Japanese and European banks? Have banks shifted their activities from one region to another?

In earlier analyses, it was observed that banks have not always fully disclosed geographical information.<sup>4</sup> This is also valid for the regional breakdown of assets. In this study, regional breakdown by assets reported by banks has been supplemented with additional sources, such as the publication of foreign owned assets in the Federal Reserve Structure data, or annual reports from separately reporting subsidiaries. To construct continuous series, regional asset growth in the sample is represented in an index where regional asset information per bank is grouped for American, European and Japanese banks. To construct such an index, the asset weighted growth rate for the banks in the sample is calculated per region.<sup>5,6</sup>

The composite growth of domestic and foreign assets is shown for European banks (Figure 23.9), American banks (Figure 23.11) and Japanese banks (Figure 23.13), as well as a regional decomposition for European and American banks. For Japanese banks, regional information was not sufficiently available.

For the European banks as a group, Figure 23.9 indicates that there are two periods in internationalization: 1980-1991 and 1992-2000. In the first period, foreign and domestic assets grew evenly (11.0% and 9.7%): over a period of 12 years, assets had increased almost threefold. After 1991, the annual growth rate of European banks' domestic assets was slower than in the previous period (6.4 versus 9.7%), while the size of foreign assets quadrupled in eight years: an average foreign growth rate of 16.0% compared to 6.4% domestically. Regional difference must therefore have had a more pronounced effect after 1991. To assess in which regions the activities were directed, regional growth indices have been constructed for European banks. Based on the information banks published in annual reports and other available sources, regional assets in a number of cases have been determined. These have been used to calculate asset weighted growth rates, and serve as a dynamic indicator of growth in that region (Figure 23.10).

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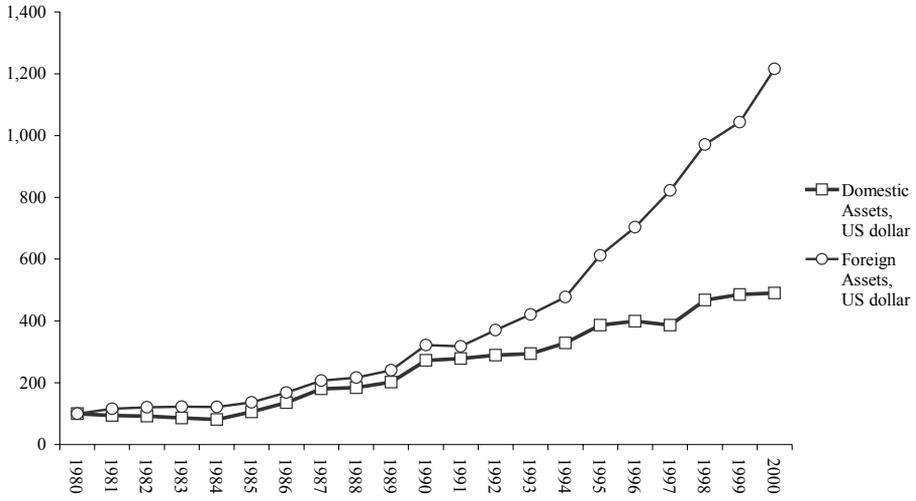
<sup>4</sup> In recent years, disclosure of geographical information has substantially improved. De Nicoló et al. (2003, p. 17) investigated internationalisation patterns of banks between 1995 and 2000; the recent time period of their study (5 years compared to 20 years in this study) allows a more detailed analysis of changes in foreign ownership per country.

<sup>5</sup> The index shows the yearly change of reported assets in the region, and is constructed as follows:

- Year-on-year percentage change for assets in each reported region, if available, is calculated. For comparison, all data is converted in US dollar.
- To prevent distortions in the data, large changes due to a change in data availability have been deleted (for example, from 0 in  $t$  to 100 in  $t+1$  or vice versa unless there is an indication that these assets have been completely divested).
- For each region, weighted average of these percentage changes are calculated and then indexed.

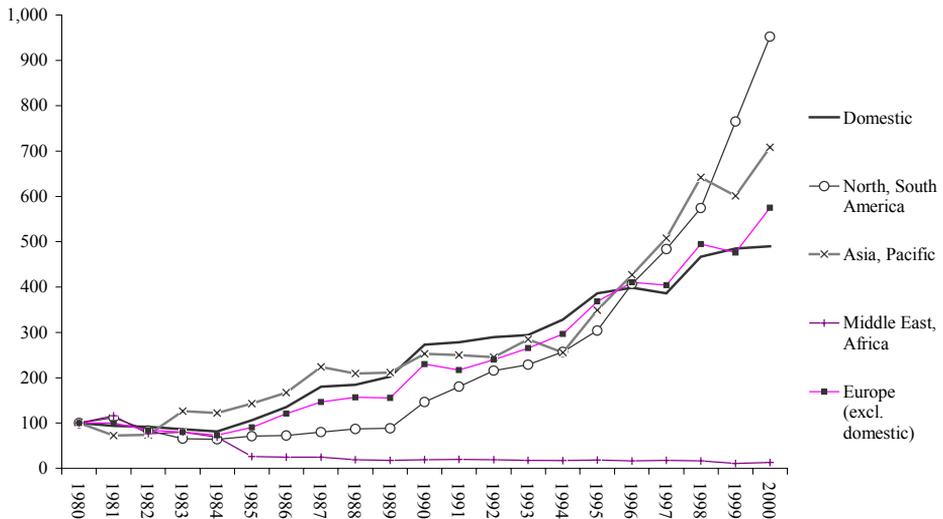
<sup>6</sup> On an individual bank level, there are too many gaps to form a general understanding of the trends.

Figure 23.9. Indexed growth domestic and foreign assets European banks



Note: growth rates indexed at 1980=100. Growth rates calculated in US dollar, and weighted by domestic, foreign assets in US dollar. N varies; N(1980)=22, increasing to N(1991)=26, and decreasing to N(2000)=23.

Figure 23.10. Indexed growth regional assets for European banks



Note: growth rates indexed at 1980=100. Growth rates calculated in US dollar, and weighted by domestic, foreign assets in US dollar. N varies per region.

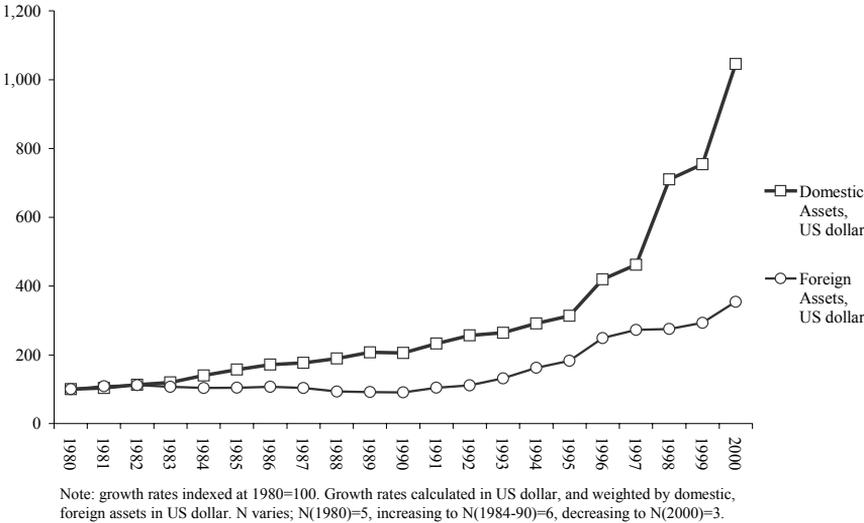
During 1980 and 1995, growth rates in all regions except the Middle East/Africa have been similar, circa 10% per year. Asset growth in America stayed stable during the 1980s, increasing faster than the other regions from 1989 to 1995 onwards. From 1995,

growth rates diverged; the pace further increased for European banks acquiring Asian and American assets, while for domestic and European assets similar – pre 1995 – growth rates were upheld. Activities in the Middle East and Africa were reduced, especially between 1980 and 1985. Part of this is related to the international boycott of the South Africa government by the United Nations between 1984 and 1986 forcing banks to sever their links with their South African subsidiaries. Also, reduction of project finance after the 1979 oil crisis and the reducing economic importance of the African region contributed to the permanent reduction.

The growth of European assets show a consistent rise from 1985, there are no different growth periods between 1985 and 2000. In light of European integration, European asset growth has not been a distinguishing feature for European banks. If European asset growth was the most important element of internationalization of banks then growth opportunities for this must have been limited during that period, for example because of regulation.

American banks as a group have shown developments contrary to the European banks (Figure 23.11). Foreign asset growth has been slightly negative until 1991 (-0.9% annually), increasing since then (14.5%). Domestic asset growth on the other hand has increased steadily until 1995 (7.9%), showing a strong increase from 1995 onwards (27.2%). The strong increase reflects the increasing amount of domestic acquisitions; correcting for the acquisitions within the sample, the growth rate would still be 18.4%, almost twice the growth rate of European domestic asset growth.

Figure 23.11. Indexed growth domestic and foreign assets American banks



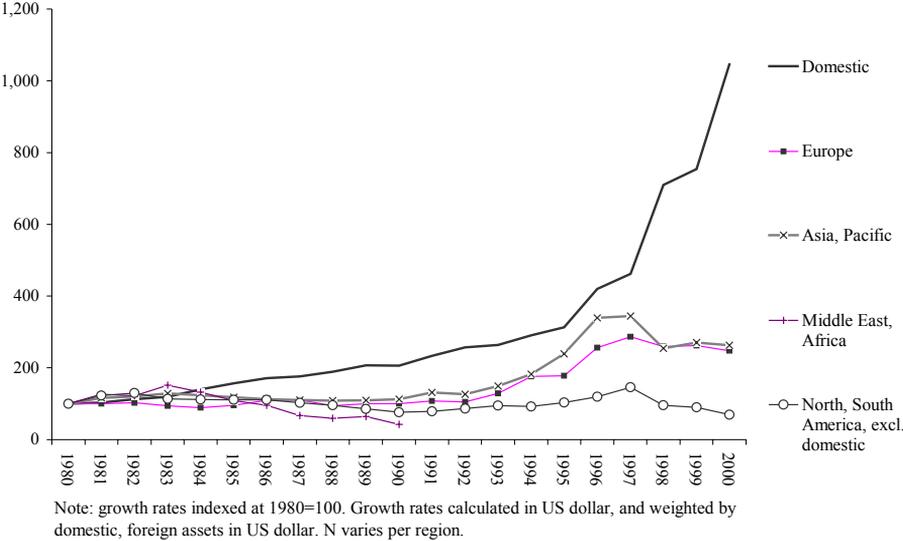
American banks also have shown a different regional growth rates than European banks. Between 1980 and 1990, the banks as a group show slight negative growth for most

regions, with the exception of assets in the Middle East/Africa that steadily declined until 1990, the last year when such information was available.<sup>7</sup> Growth in regional assets took place between 1991 and 1997, especially for the European and Asian region. After 1997, growth declined. While this can be attributed to the effects of the Asian crises, such an effect has not been visible with the European banks.

The growth rate of American assets, especially Central and South American assets, remained far behind that of European and American assets. While a slight growth set in from 1991, growth also declined from 1998 onwards. The declining growth rate has been partly attributable to American banks, and on the other hand devaluation of the American currency has reduced the asset holding in US dollar.

Comparing Figure 23.12 and Figure 23.11, foreign assets as a whole steadily have grown from 1995, while this growth is not displayed in the regional asset growth from 1998 onwards. This difference is caused by the steadily increasing amount of unspecified foreign assets, tipping the scale towards foreign asset growth. Unspecified assets usually include investment banking activities.

Figure 23.12. Indexed growth regional assets for American banks

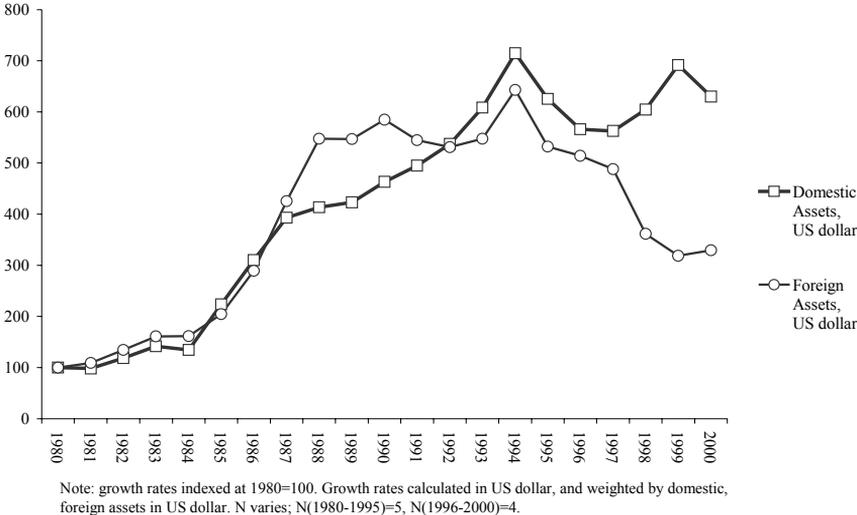


For Japanese banks as a group, foreign assets increased strongly between 1984 and 1988, and broadly stayed on the same level until 1997 in US dollars (Figure 23.13). After 1997, foreign assets decreased strongly. Domestic assets on the other hand enjoyed a stable growth between 1984 and 1994, decreasing until 1996, rising again between 1997 and

<sup>7</sup> From that period onwards, banks started to report the European region as “EMEA”: Europe, Middle East and Africa. Since for most banks their assets in the Middle East and Africa assets had become small (usually below 5% of total assets), the contribution to the European growth rate must have been limited also.

1999. There is a strong correlation between the US dollar/Japanese Yen exchange rate and growth of domestic assets, between 1980 and 1996.<sup>8</sup>

Figure 23.13. Indexed growth domestic and foreign assets Japanese banks



Japanese banks have reported limited geographical information, especially if compared to European and American banks. European banks formed a larger group, while American banks had to comply regulatory to provide such information. Japanese banks on the other hand did not have to report geographical information and formed a much smaller sample; Table 23.7 presents the available data. Japanese banks' assets in the United States declined between 1981 and 1985 but showed high growth rates between 1986 and 1990, leveling off the period after. Foreign asset growth rates were higher than American growth suggesting that European assets must have enjoyed high growth rates also.

Table 23.7. Average growth rate regional assets for Japanese banks

Period	Domestic	Foreign	Europe	North, South America	Asia, Pacific*	Middle East, Africa
1981-85	17.48%	15.38%	na	-10.46%	na	na
1986-90	15.66%	23.38%	na	16.21%	na	na
1991-95	6.18%	-1.85%	1.17%	4.38%	-7.67%	na
1996-00	0.15%	-9.17%	na	na	na	na

Note: \* excluding domestic assets. Average growth rates, geometric mean.

<sup>8</sup> For 1980-2000, the bivariate correlation coefficient between the indexed exchange rate and indexed domestic growth rate is .94, and .79 between the indexed exchange rate and indexed foreign growth rate.

Summarizing, there are different trends for banks as a group when considering the regional dimension of internationalization. Another issue to consider is substitution: how have banks over time shifted their regional dependence? To illustrate this, the banks have again been treated as three groups (American, Japanese and European), and the available regional distribution of assets has been calculated, weighted by total assets for five year periods (Table 23.8).

Table 23.8. *Average regional bank assets for different time periods and bank groups*

Bank group	Region	1981-85	1986-90	1991-95	1996-00
Europe	Home	63.46	66.75	63.42	53.74
	Europe*	1.06	4.03	10.89	14.11
	North,South America	9.37	5.87	7.99	13.10
	Asia, Pacific	0.90	1.17	3.54	5.15
	Middle East, Africa	1.25	0.17	0.11	0.34
	Rest of World	23.96	22.01	14.05	13.56
	Total	100.00	100.00	100.00	100.00
United States	Home	52.62	64.54	65.23	68.06
	Europe	20.62	17.89	16.86	12.38
	North,South America*	8.86	5.83	5.41	3.41
	Asia, Pacific	9.55	7.84	9.14	7.03
	Middle East, Africa	0.98	0.29	0.14	0.06
	Rest of World	7.36	3.61	3.22	9.05
	Total	100.00	100.00	100.00	100.00
Japan	Home	74.16	72.48	70.23	78.40
	Europe	na	1.74	2.59	3.82
	North,South America	11.92	5.36	3.47	6.12
	Asia, Pacific*	na	1.40	1.73	3.67
	Middle East, Africa	na	na	na	na
	Rest of World	13.93	19.02	21.99	7.99
	Total	100.00	100.00	100.00	100.00

\*: Excluding domestic assets

Note: average of asset weightings for bank sample, five year average, weighted by total assets in US dollar.

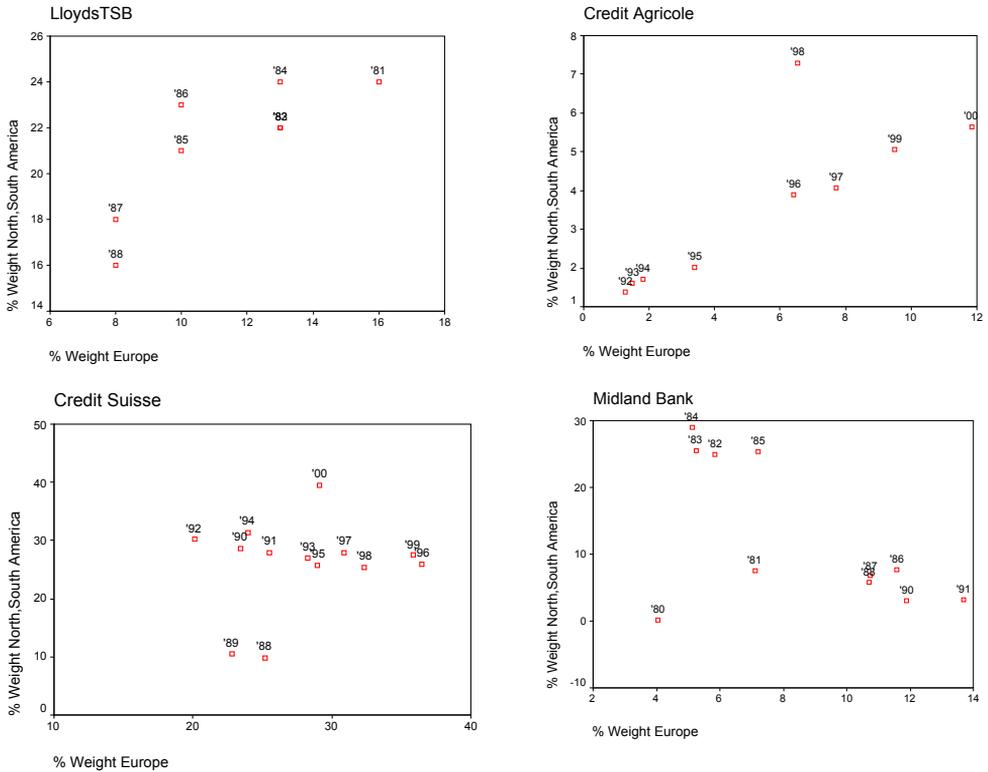
na: not available. For Japanese banks American, Asian and European assets the 1996-00 figures are based on 1996-1998.

European banks have decreased the relative weight of their domestic assets, especially in 1996-2000. Benefactors were European activities, increasing to 14.1% between 1996 and 2000. The expansion was relatively focused on American assets, gaining an average 10% in asset weight if 1996-2000 is compared to 1986-1990 (cf. De Nicoló et al., 2003, p. 17). On a bank level, exceptions can be found to this general trend.

For example, a bank like Cr dit Agricole consistently expanded both European and American activities. Lloyds on the other hand did the opposite between 1981 and 1988, decreasing its European and American activities. Midland bank's activities showed a consistent increase in European activities, while its American activities with the exception of 1982-1985 remained below 10% of total assets. The main growth in foreign banking

activities of Credit Suisse took place in Europe, where the bank systematically expanded its activities from 20 to 40% of total assets while keeping its share of American assets relatively stable.

Figure 23.14. *European and American assets of Lloyds, Cr dit Agricole, Credit Suisse and Midland Bank*

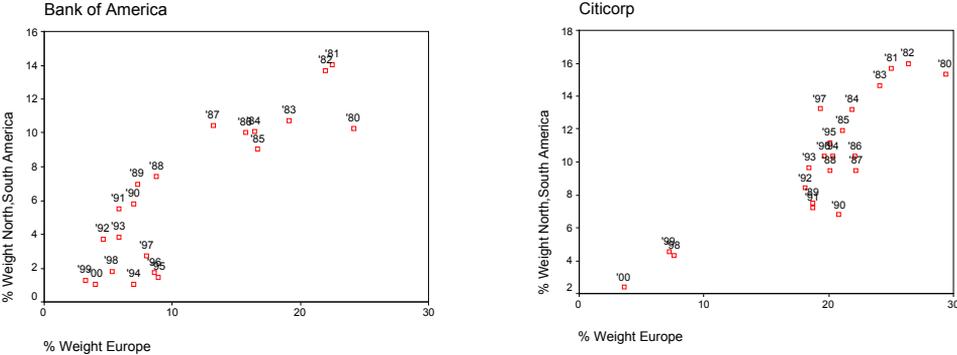


American banks took another approach, decreasing their assets in all regions. Although American banking activities were acquired by American banks in the 1990s, the regional importance of these banking activities actually decreased to an average 3.4% between 1996-2000, half the percentage of 1981-1985. Based on Table 23.8, Japanese banks in the sample did not expand to a great degree in the Asian region. Most activities were concentrated in the American region, while Europe steadily gained influence. However, this observation might be influenced by the currency movements.

In short, European banks have been most active in their own geographic region, while this has been the case to a far lesser degree for Japanese and American banks. While American banks expanded their activities in Europe and vice versa, both banking groups have also expanded activities in the Asian region, while Japanese banks may have done

this reciprocally in the 1980s but reduced the foreign activities over time. This pattern supports hypothesis HYP23.7; internationalization in the geographic home regions is specific for European banks.

Figure 23.15. European and American assets of Bank of America and Citicorp



**23.3. Summary**

The analyses in this chapter set out to examine the relationship between the different types of realized internationalization strategies, performance and TNI. Also, home bias, herding and regionalization, were examined. The first analyses established the relevance of strategy types with regard to incentives to internationalize; estimating the relationship between incentives and TNI grouped for banks per strategic types yielded better results than estimation per country, supporting hypothesis HYP23.1. A shift in the relevance of independent variables was visible, increasing the explanatory role of Efficiency, FDI and export but not with the expected signs (in line with the results in chapter 19). *Accelerating* and *Moderate* banks were found to have the most in common in terms of similar directional signs in the estimation, while *Moderate* and established differed the most.

If shareholders - with hindsight - had made baskets for investments in banks with different strategic types, what would have been the result (HYP23.2)? If indices are created for the different strategy types, then established and retreating banks would have generated the highest return between 1980 and 2000, if this is measured in absolute returns, or adjusted for country averages. *Moderate* and *Accelerating* banks would have generated the least returns, in spite of *Accelerating* banks having attracted relatively large amounts of capital to fund their activities.

The next analyses examined the characteristics of different strategies: is there a home bias visible (HYP23.3), and do different strategies exhibit different financial ratio's (HYP23.4). Also, how do these ratio's change over time. Specifically, if assets or income initially were generated outside the home country due to fiscal reasons or the lack of

financial product knowledge, then deregulation and financial innovation should have alleviated the difference in domestic and foreign ratio's over time (HYP23.5).

A home bias exists when domestic activities are more stable than foreign activities: ratios such as assets per employee should show lower variability for domestic activities than for foreign activities. For *Accelerating* and *Moderate* banks, more stable domestic activities were maintained than foreign activities, while established banks and retreating banks maintained more stable foreign activities than domestic activities. The home bias hypotheses (HYP23.3) is therefore partially rejected, while support is found for the support strategy hypothesis (HYP23.4): the ratio of assets per staff is higher for certain periods in the bank's strategy compared to other banks, indicating a support strategy.

Herding was included as an incentive to internationalize in chapter 20, but did not yield sufficient results. Another approach was taken by analyzing the number of strategic changes. For the sample, this has structurally increased in the 1990s. The five years with most changes are 1983, 1989, 1991, 1994 and 1998. Almost half of the 61 strategic changes are concentrated in those years, supports the hypothesis of herding activities among banks (HYP23.6).

Finally, the geographical dimension of internationalization has been examined in more detail, focusing on regional strategies, i.e. internationalization activities mainly concentrated in the geographic region where the bank is located, and hypothesizing that they are specific to European banks (HYP23.7). Constructing composite geographical asset allocation trends and distributions, a finding was that European banks have decreased the relative weight of their domestic assets, especially in 1996-2000. Benefactors were European activities, increasing to 14.1% between 1996 and 2000. The expansion was especially focused on American assets. American banks took another approach, decreasing their assets in all regions. Japanese banks in the sample did not expand to a great degree in the Asian region.

This suggests that European banks have been most active in their own geographic region, while this has been the case to a far lesser degree for Japanese and American banks. While American banks expanded their activities in Europe and vice versa, both banking groups have also expanded activities in the Asian region, while Japanese banks reduced the foreign activities over time. This supports hypothesis HYP23.7.



## 24 General discussion

The aim of this study was to examine the patterns and effectiveness of internationalization of the world's largest banks coming from eight countries between 1980 and 2000. This was investigated in three steps: Part I presented a review of the literature; Part II investigated realized internationalization strategies and identified five different patterns banks have taken to internationalization; Part III tried to determine the relationship between incentives to internationalize, the resulting performance and shareholder return.

This chapter summarizes and discusses the general findings of this study. First, methodological issues are discussed with regard to the design of the study, the sample and the variables used to measure the degree of internationalization (24.1). Then, an overview of the main findings of the study is presented (24.2), and its relevance for current theory discussed (24.3). Implications for future internationalization of banking are considered (24.5), as well as the limitations of the study and topics for further research (24.6).

### 24.1. Methodological issues

Four methodological issues have influenced both the design of the study and the scope of its findings: the composition of the sample, the use of a Transnationality Index (TNI) as measure of internationalization, the period of investigation and the availability of data.

#### *Sample*

For the sample, the 3 to 5 largest banks for 8 countries in 1995 have been selected; in total 37 banks located in the United States, the United Kingdom, Japan, Germany, France, Spain, Switzerland and in the Netherlands. The sample was then expanded for mergers and acquisitions prior to 1995, increasing the number of banks in the sample from 37 to 44. For Switzerland, the Netherlands and Spain, the high degree of banking concentration in 1995 limited the number of relevant banks in the sample to respectively 3, 4 and 4. The choice for the largest banks is warranted for three reasons: first, they all have been active in international banking between 1980 and 2000 which was confirmed by the case studies. Second, being the largest banks, they were more likely to disclose foreign and domestic

information, in contrast to smaller banks. Thirdly, as large actors these banks can be considered important in influencing the international institutional setting in which international banking has developed.

The representativeness of the sample was investigated in chapter 8. For selected years, nearly all banks in the sample were among the 100 largest banks in the world, covering for example more than 48% of total assets for the Top 100 banks between 1980 and 2000. Banks from other countries, for example emerging countries, have been left out but this has no effect on the representativeness of the sample. Size and internationalization has been mainly reserved to OECD countries. Only very recently did banks of developing countries start to internationalize on any noticeable scale.

### *Degree of internationalization*

This study contributed to the internationalization studies of banks, by applying the Transnationality Index (TNI) as a measure of internationalization for banks. Three single item indicators are combined in a composite TNI index to analyze the degree of internationalization of a bank. These indicators are 1) foreign assets to total assets ratio, 2) foreign gross income to total gross income ratio and 3) foreign employment to total employment ratio. The TNI is used as one of the most cited indicators for internationalization (Van Tulder et al., 2001, p. 47), used for example in studies of the UNCTAD (United Nations Conference on Trade and Development).

Besides the general appeal of presenting one scale for the degree of internationalization, the TNI measure has some other attractive characteristics. The TNI dampens the effect finance companies of banks, or off shore constructions have on internationalization measures if one were to construct a ratio only based on foreign assets to total assets. For example, a substantial amount of assets can a priori be expected to be located in tax havens or countries with lenient fiscal regimes. Such reported assets would be accompanied by low number of employees. Combining both employees and assets in the TNI would then create a more balanced view. The substantial location of assets of German banks in Luxembourg in the early 1980s therefore led to a lower TNI calculation than would have been expected on the foreign assets to total assets ratio, presenting a more realistic representation of internationalization.

Another (technical) advantage is that the use of TNI allows for the creation of meaningful time series when one of the three internationalization measures is not available. Estimating one missing value out of three (or in a very limited number of cases two out of three) and then calculating TNI probably reduces potential estimation errors of the "true" TNI measure.

### *Period of investigation*

The internationalization of banks was investigated between 1980 and 2000; 1980 as the starting point for the analysis was chosen for two reasons. The first reason concerns data availability; a large number of banks in the sample started disclosing geographical information from the 1980s onwards. Exceptions were American and British banks that

had a longer tradition of information disclosure. Second, 1980 as a starting year is a natural demarcation point in the internationalization strategies of banks. In particular, the emerging market loans crises initiated for banks a decade of reorientation on the role of their international activities. Arguably, the reorientation also has substantially influenced internationalization activities of banks in the 1990s.

In part II, different periods of internationalization within the total investigated period were identified for banks. An implicit assumption when using a long time period is that banks (their management) have to some extent a long term memory: what the bank did in 1980 has relevance for their activities in 1990 or even later. In other words, banks (as well as institutions regulating banks) have a long term memory. A long time period is not uncommon in management studies (cf. Peters and Waterman, 1982; Collinas and Portas, 1993); the assumption of a long term development has been validated with the discussion of the case studies.

#### *Data availability*

The final methodological issue concerns the use of the data. The sample consists of 44 banks. A number of banks have published geographic distribution of assets, income, profitability and staff while other banks have not published such information. The approach taken in the analyses has been to use as much reported data as possible. For some analyses the use of reported data limited general conclusions for the whole sample. With those analyses a two step approach was taken. First, the analysis was performed with reported data. To check whether the findings from the analyses with reported data applied for the whole sample, a second (similar) analysis was set up using proxies for the investigated variables. The advantage of this approach is that there is a clear separation in the analyses between reported data and estimated data. A disadvantage has been the use of different model designs.

A consequence of using several analyses has been that the research design has been kept as simple as possible: basically a combination of regression models, and T tests for the event studies.

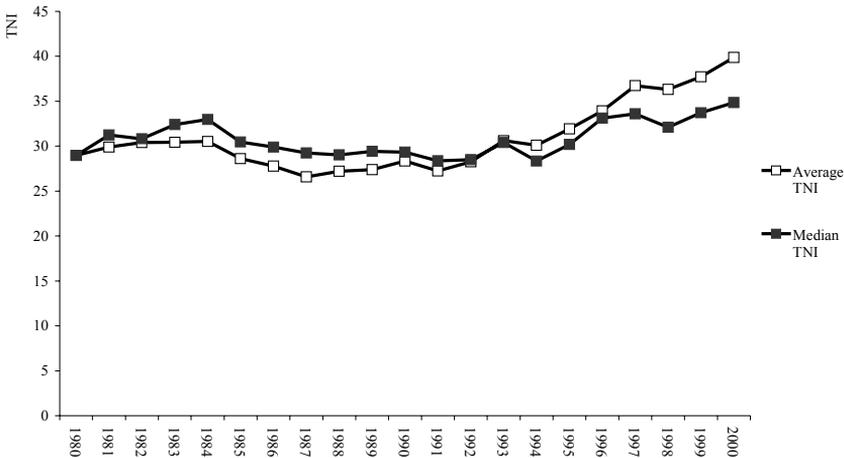
#### **24.2. Overview of findings**

Part II centered on the internationalization patterns of the banks in the sample. In part III, the effectiveness of internationalization of banking was investigated aiming to answer four research questions. First, has there been a relationship between the incentives to internationalize and the degree of internationalization? Second, has internationalization improved the performance of the bank? Third, has internationalization been one of the factors influencing shareholder return? Finally, is there a relationship between the realized internationalization strategies, shareholder return and performance?

### 24.2.1. Internationalization of banks

This study has demonstrated that the largest banks as a group have not pursued a uniform internationalization strategy between 1980 and 2000. Banks that retreated from international activities were identified as well as banks that increased their internationalization activities. Roughly one quarter of the banks remained internationalized, one quarter retreated, while one quarter slowly and one quarter strongly internationalized.

Figure 24.1. *Internationalization of banks, 1980-2000*

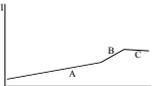
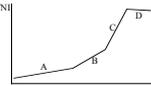
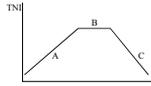
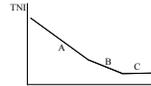
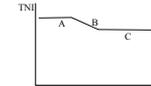


The overall picture has been that in the 1980s the degree of internationalization for the sample, i.e. the largest banks in the world, basically did not change (Figure 24.1). In the 1990s, the degree of internationalization systematically increased, but as the difference between average and median TNI indicates, the increase was concentrated with a small number of banks. For the sample as a whole, the banks' internationalization activities have not led to higher profitability, suggesting that even though these have been the largest banks, most have not been in a situation to profit from it.

If banks in a country are considered as separate groups, then the development of internationalization activities of banks has differed between countries. There is a certain country-of-origin effect in banking. At the beginning of the 1980s, American and British banks showed the highest degree of internationalization. In the 1980s, the degree of internationalization decreased systematically for American banks, while this applied to British banks from the mid 1980s. The ascent of Japanese banks in the late 1980s in the international banking arena also filled a relative void created by American and British banks in the 1980s. The internationalization activities of Japanese banks increased until the early 1990s, their descent followed from the mid 1990s. Continental European banks showed the strongest increase in degree of internationalization between 1980 and 2000; the

largest banks from the Netherlands, Germany, Spain, France and Switzerland steadily increased internationalization in the 1980s, which accelerated in the mid 1990s.

Table 24.1. *Realized internationalization strategies*

	Moderate	Accelerating	Imploding	Retreating	Established
<i>Description</i>	Banks with generally stable growth of internationalization patterns, consistently increasing their TNI over time, with a short periods of acceleration.	Banks who start internationalization at a moderate pace, increasing the degree of internationalization in one or more step, after which a period of consolidation sets in.	A strong rise and decline of internationalization activities in a short period, where the decline is forced by financial distress.	Bank who have built up their foreign activities in an earlier period, the decline is triggered by a crisis, foreign activities are disinvested, domestic activities are increased.	Banks who have built up their foreign activities in earlier period and continue their commitment to international activities.
<i>Patterns</i>					
<i>Banks</i>	<p>A. Expanding branch network in main financial, economic and off shore centers.</p> <p>B. Broad expansion, mainly by acquisitions, to maintain relative position to <i>Accelerating/established</i> banks</p> <p>C. Consolidation or restructuring: shedding activities acquired in B., resuming stable growth.</p>	<p>A. Expanding branch network in main financial, economic and off shore centers.</p> <p>B. Broad expansion, mainly by acquisitions, relatively smooth integration except capital market activities</p> <p>C. Focused expansion, a number of relatively large acquisitions</p> <p>D. Consolidation or restructuring: integration activities in organization, focus on internal growth, divestments</p>	<p>A. Expanding branch network in main financial, economic and off shore centers, acquisition of branch retail networks, to maintain relative position to <i>Accelerating, Established</i> banks</p> <p>B. Restructuring: stop loss making activities and streamline organization</p> <p>C. Exit: divestment of foreign activities, focus on domestic activities, combined with capital injection</p>	<p>A. Focus and exit: divestment of foreign activities, focus on domestic activities, forced by financial distress</p> <p>B. Consolidation: share of TNI further decreases because of further domestic expansion</p> <p>C. Balanced growth: Re-orientation role of foreign activities relative to larger domestic base</p> <p>D. Renewed expansion: selective foreign investments, supporting domestic activities</p>	<p>A. Balanced growth of foreign and domestic banking activities</p> <p>B. Increase in domestic activities, or selective foreign disinvestments, either first mover or reaction to domestic consolidation</p> <p>C. Balanced growth</p> <p>D. Increase in foreign activities, focused on regions/activities</p>
	-Amro, Fortis, Rabobank -Bayerische Hypobank, Vereinsbank, Commerzbank -Crédit Agricole -Argentaria -IBJ	-NMB Bank, ING Bank, ABN Amro -Paribas -Deutsche Bank, Dresdner Bank, Westdeutsche LB -Santander, BBV -UBS, Credit Suisse	-Crédit Lyonnais -Midland Bank	-Manufacturers Hanover, Chemical Banking, Bank of America, Chase Manhattan -Mitsubishi Bank, Dai Ichi Kangyo, Sumitomo Bank -Barclays, Lloyds TSB, National Westminster	-ABN -Tokyo-Mitsubishi, Bank of Tokyo -HSBC, Standard Chartered -SBC -J.P. Morgan, Citicorp -BNP, Société Générale

### 24.2.2. Realized internationalization strategies

An analysis of the banks' internationalization activities clustered per country is too coarse. For example, Chase Manhattan and Bank of America retreated from internationalization activities in the 1980s, while Citicorp and J.P. Morgan remained committed to international banking activities. To analyze the pattern of realized internationalization strategies, the internationalization activities of 44 banks were reviewed individually to determine commonalities in realized strategies. The degree of internationalization was

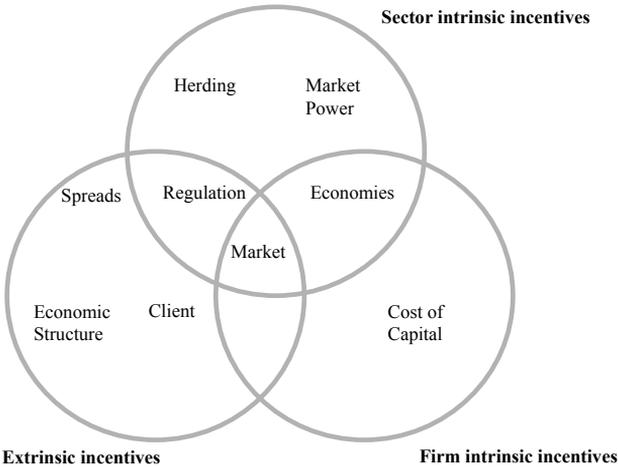
measured per bank; in combination with the internationalization patterns several phases in realized internationalization activities were identified. The similarity in phases for different banks was then used to identify different realized internationalization strategies. Introducing stylized internationalization strategies ignores some specific and unique choices that a bank might have made, but offers the advantage of general insights.

Table 24.1 summarizes the stylized characteristics of the five realized internationalization strategies: *Moderate* expansion, *Accelerating* expansion, *Imploding* expansion (i.e. fast expansion and retreat), *Retreating* and *Established*.

24.2.3. Incentives to internationalize

The relationship between incentives to internationalize and the degree of internationalization of banks was investigated in chapter 20 and 23. The incentives were clustered in three groups: *Extrinsic*, *Bank intrinsic*, and *Sector intrinsic* incentives (Figure 24.2).

Figure 24.2. Investigated incentives to internationalize



*Extrinsic* incentives to internationalize stressed relationships with host governments, and its effects on host economies. These incentives related to “following clients” strategies to foreign export markets and differences between countries in net interest margins, economic growth, financial development and regulation. *Bank intrinsic* incentives to internationalize centered on the transaction cost approach, encompassing minimizing costs, maximizing efficiency, optimizing competitiveness in combination with the internalization of markets. Hypothesized intrinsic incentives in this study related to economies, profitability and capitalization as incentives to internationalize. Finally, *Sector intrinsic incentives* represented common ground between extrinsic motives and intrinsic motives such as the relative position a bank wants to attain relative to competitors, achieved by market power

or visible through herding. Hypothesized relationships in this study were herding, market power and concentration.

### *Extrinsic incentives*

A number of hypotheses for the relationship between incentives and the degree of internationalization were not supported, this applied to a large degree for extrinsic incentives to internationalize. For the whole sample the estimated relationship between exports and the degree of internationalization was positive. This was in line with the hypothesis but the coefficient showed no statistical significance. The model was also re-estimated per country. For most countries a negative relationship between exports and TNI was found between 1980 and 1989, on average changing to a positive relationship between 1990 and 2000.

Trade as an incentive to internationalize has been one of the traditional explanations in internationalization theories. It could be that this "traditional" explanation had some weight prior to 1980, lost its explanatory power in the 1980s as banks began to develop internationalization strategies for other reasons in the 1980s, but export became important again in the 1990s when regional integration such as the European Union led to a further intensification of trade relationships.

A relationship between outward foreign direct investments (FDI) and TNI, also a traditional incentive to internationalize, was not confirmed for the total sample. Re-estimating per country, even negative relationships between FDI and TNI were found. If the regression results of exports are compared to FDI, then exports have more explanatory power for the degree of internationalization than FDI. In other words, the (stable) trade relationships were more important incentives for banks to internationalize than the (volatile) foreign direct investments of firms. That FDI as incentive to internationalize does not carry much weight is not a new finding; Miller and Parkhe (1998, p. 380) do not find a positive relationship between FDI and the amount of foreign assets – but only for United States banks.

Two other variables to measure the relationship between the degree of internationalization and extrinsic incentives were the bank's net interest margin and fee income, i.e. non interest income as share of gross income. Fee income has been especially relevant to internationalization activities of banks in financial centers, where investment banks were set up or acquired. Both variables showed negative estimates in 1980-1989 and positive estimates in 1990-2000. In other words, a low net interest margin as an incentive to internationalize was confirmed for 1980-1989 but rejected for 1990-2000 while a higher degree of domestic fee income as an incentive to internationalize was rejected for 1980-1989 and supported for 1990-2000. This might suggest that fee income has taken over the role of net interest margin as incentive to internationalize: the decline of net interest margin in the 1980s positively influenced the degree of internationalization, while fee income in the 1990s was positively related to the degree of internationalization. This finding supports the increased role of (foreign) investment banking activities of banks, especially in the 1990s.

Financial structure and financial development of countries influence the internationalization of banks. While the level in GDP per capita in the home country is positively related to the degree of internationalization, the growth in GDP in the home country on the other hand is negatively related to the degree of internationalization. This seems paradoxical to some degree, but these different findings can be reconciled: relatively richer countries (with a high GDP per capita) tend to have banks with a higher degree of internationalization, *unless* there are domestic economic growth opportunities.

The relationship between financial development of a country and the degree of internationalization was further investigated. Similar to Demirgüç-Kunt and Levine (2001), additional financial development indicators were introduced: bank assets to GDP, non bank assets to GDP and market capitalization to GDP. A finding was that there is a stronger relationship between financial development indicators and TNI calculated *per country*, than between financial development indicators and TNI for *individual banks*.

The relationships between TNI and bank assets, GDP per capita, and market capitalization market were expected to be positive, and have been confirmed for France, Germany, Spain, Switzerland and the Netherlands. On the other hand, relationships between financial development of a country and the degree of internationalization were rejected for American, British and Japanese banks. Also, the negative (and weak) relationship has more similarities for Japan and the United Kingdom than for the United Kingdom and the United States. These countries have in common that they harbor the largest financial centers: the natural domestic base for generating fee income might explain the negative relationship between market capitalization and TNI. For bank assets to GDP ratio, Non bank assets to GDP ratio, the coefficient might have been negative because domestic growth opportunities for banks have increased substantially between 1980 and 2000, compared to the other countries.

To assess the effect of changes in regulation on the degree of internationalization of banks, changes in TNI before and after major regulatory events were calculated: the liberalization or deregulation of major financial markets, the implementation of the Basle capital adequacy rules and United States regulation for foreign banking activities. In general, mixed results were found. There was no relationship visible in changes in TNI of banks (in the country of regulatory change) before and after major financial deregulation events such as the liberalization of financial markets in the United Kingdom in 1986 or France. Similar, the implementation of the Basle capital adequacy rules for all countries in the sample effective in 1993 showed no specific change in the TNI for banks in the country before and after the implementation. In the United States, two regulatory changes (that could be characterized as defensive regulation) aimed directly at international activities. The International Banking Facility in 1981 was designed to attract off shore funds back to the United States. The implementation had a positive effect for foreign banks and a negative for domestic banks. Second, the Foreign Banking Supervision Act in 1991 established a common competitive framework for foreign and domestic banks. After the implementation, the increase in foreign bank share in the United States leveled off.

### *Sector intrinsic incentives*

Sector intrinsic hypotheses to internationalize were supported by the estimations. A higher degree of market concentration was positively related to the degree of internationalization. Expected limited domestic growth opportunities in terms of banking market share are supported as an incentive to internationalize. Market concentration was also found to have a negative relationship with GDP Growth or GDP per capita. This indicates that market concentration in itself is an independent incentive to internationalize, and not directly tied to the size of the economy.

The degree of internationalization of the total sample, approximating a herding effect, also had a positive relationship with the degree of internationalization. When banks were clustered by realized internationalization strategy and country, herding was also observed. Japanese, American and British banks have tended to show *Established* and *Retreating* internationalization strategies between 1980 and 2000; German, Dutch, Swiss and Spanish banks were inclined to have *Moderate* and *Accelerating* internationalization strategies. French banks could not easily be clustered in one of the categories. With the exception of Japan, this clustering could also be interpreted as a dichotomy between bank oriented and market oriented financial systems. Banks in market oriented financial systems (the United States and the United Kingdom) tended to develop *Established* and *Retreating* internationalization strategies; continental European banks on the other hand leaned towards *Moderate* and *Accelerating* international expansion strategies.

### *Bank intrinsic incentives*

For the whole sample, support was found for bank intrinsic incentives to internationalize: efficient banks (i.e. with a lower cost to income ratio) show a higher degree of internationalization, and so do banks that have a higher profitability and are better capitalized. Cost-to-income, capitalization and profitability are variables that a bank can influence; they tended to have more explanatory power in the 1990s than in the 1980s. When the relationship between incentives and the degree of internationalization was grouped per realized strategy type, an observation was that cost-to-income, capitalization and profitability had more explanatory power for banks with *Established* and *Retreating* internationalization strategies, than for banks with *Moderate* and *Accelerating internationalization* strategies.

Two additional analyses were introduced. First, is there a country specific effect; does the country of origin matter for the degree of internationalization. Second, if the relationships between the degree of internationalization and incentives are re-estimated per strategy type instead of per country, how do the results compare?

To determine whether there is a country specific effect, the model for the relationship between incentives and the degree of internationalization was estimated for the different countries. These country specific results were compared to the estimations for the total sample; the results indicated a 'country of origin effect': for several periods there were more differences than commonalities found between the signs of the coefficients per

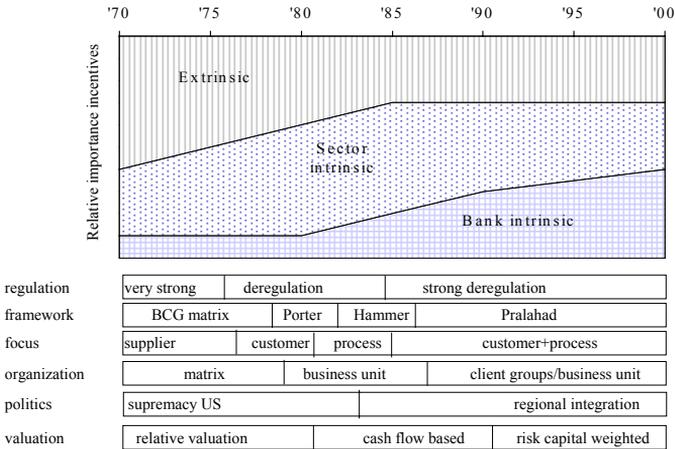
country estimation. If country of origin would not have mattered, then the results per country should have been broadly in line with the results of the total sample. However, for a country like Switzerland only three banks were in the sample, so estimation per country would not include a large number of observations, limiting the country of origin effect to some extent.

Additionally, the relationships were estimated between the degree of internationalization of banks and the incentives to internationalize, the estimations were done by strategy type instead of by country. Estimating the relationship between incentives and TNI grouped for banks per realized internationalization strategy yielded similar results as with the estimation per country. This supports the notion of 'globalization' of banking: the choice of strategy is just as important as the country of origin as for incentives to internationalize.

When estimating the relationship between the degree of internationalization and incentives grouped per realized strategy type, a shift in the relevance of independent variables was visible, increasing the explanatory role of Efficiency, FDI and Exports but not with the expected signs. *Accelerating* and *Moderate* banks had most in common in terms of similar directional signs in the estimation, while *Moderate* and *Established* realized strategies differed the most.

Another remark about incentives concerns the relative importance of *Extrinsic*, *Sector Intrinsic* and *Bank Intrinsic* incentives. A shift in relative importance of these three groups has not explicitly nor in any qualitative measure been tested. However, estimations of the relationship between incentives and the degree of internationalization for different periods indicated that shifts in importance have taken place between 1980 and 2000. In Figure 24.3, a likely shift between incentives over time is shown, as well as possible explanations.

Figure 24.3. Relative importance of incentives and possible explanations



First, *Extrinsic* incentives may have been declining in importance over a longer period. While they did explain internationalization well in the 1970s, their explanatory power decreased, especially in the 1990s. On the other hand, *Bank intrinsic* incentives (capitalization, performance) might have increased substantially in importance. The Basle Accord marked the development towards a regulatory framework where banks had to be adequately capitalized; growing dependence on capital markets meant that banks increasingly focused on performance as a driver for shareholder performance. *Sector intrinsic* incentives to internationalize, such as herding, might have played an important role in the 1970s and 1980s. The increasing role of *Bank intrinsic* incentives meant that herding as an incentive shifted from an organizational level to a product-client level. In other words, fewer banks in the 1990s set themselves goals in terms of asset size or market share compared to competitors, but this might well have taken place in specific markets for specific clients.

Summarizing, when the relationship between incentives to internationalize and the degree of internationalization was investigated, mixed results were found for *Extrinsic* incentives to internationalize. Exports as a client incentive to internationalize had explanatory power in the 1990s but not in the 1980s. No relationship with foreign direct investments was found. Net interest margins were a determining factor to internationalize in the 1980s, shifting towards fee income in the 1990s. Financial development was found to be positively related to the degree of internationalization for continental European banks, but negatively related to the United States, Japan, and the United Kingdom, the countries with the world's largest financial centers and securities markets.

Market power and herding, *Sector intrinsic* incentives, also had explanatory power and expected signs. A higher degree of market concentration was positively related to the degree of internationalization and; furthermore individual banks international tended to be sensitive to the overall degree of internationalization. Finally, *Bank intrinsic* incentives to internationalize - profitability, capitalization and efficiency - also explained the degree of internationalization. The explanatory power tended to be higher in the 1990s than in the 1980s, and was higher for banks that followed *Retreating* or *Established* internationalization strategies, than for *Moderate* or *Accelerating* strategies.

#### 24.2.4. Performance

The next step was to determine the relationship between the degree of internationalization and performance, where performance was analyzed from the perspective of the bank (chapter 21) and from the perspective of the shareholder (chapter 22).

First, the relationship between the degree of internationalization and profitability, measured as profit before tax as a percentage of assets, was examined. To this end the difference in reported domestic and foreign performance was calculated, showing that profitability of foreign activities on average has been lower than profitability of domestic activities. This negative difference in profitability is mainly concentrated between 1983 and 1990, indicating that the years of entry and exit matter to total profitability.

Between 25% of the banks in 1980 and 50% in 2000 reported foreign and domestic profitability and assets, so the results do not apply for the whole sample. To establish analyses that applied to the whole sample two analyses were set up. First, the relationship between total profitability, measured as profit before tax as a percentage of capital and reserves, and the degree of internationalization was examined. For most banks and most time periods, there is a negative relationship between total profitability and the degree of internationalization. An exception was between 1981 and 1985 when there was a positive linear relationship between profitability and TNI; 1986-1990 showed on the other hand an opposite relationship. Between 1991 and 2000 the linear relationship between profitability and TNI broke down: profitability decreased with an increase in TNI and subsequently increased again with further increases in TNI, resembling a weak V-shaped form.

The second analysis estimated realized foreign and domestic profitability for each individual bank, based on the accounting definition that asset weighted foreign and domestic profitability adds up to total profitability, where profitability is profit before tax as a percentage of total assets. Using foreign and domestic asset weights and benchmark profitability for foreign and domestic profitability, the estimated differences between foreign and domestic profitability were calculated. Initially, the difference in foreign and domestic profitability as reported by banks was on average negative. Here, the estimated difference for the whole sample became systematically negative.

The different analyses therefore support the conclusion that foreign profitability on average has been lower than domestic profitability for banks in the sample between 1980 and 2000. In the annual reports banks usually indicated that for reported figures, the allocation of foreign and domestic profitability is to some extent arbitrary because some financial services generated are consumed in more than one place. Examining the relation between the degree of internationalization and total profitability took this objection into consideration, but here overall a negative relationship between the degree of internationalization and total profitability was found, supporting the previous conclusion that foreign profitability on average has been lower than domestic profitability.

The variability of profitability, measured as the five year standard deviation of profit before tax as a percentage of capital and reserves, increased with a higher degree of internationalization. These findings, consistent with De Nicoló et al. (2003), suggest that the banks in the sample were on average not able to generate additional profitability (reaping internationalization advantages) and neither to generate more stable earnings (profit from geographical diversification).

Another hypothesis was that geographical diversification advantages should allow a bank to generate more stable results and improve its return-to-risk ratio, i.e average profitability (return) as a ratio of the standard deviation of profitability (risk). Having established that foreign activities do not structurally generate more return, the burden of proof lies with the reduction of risk. However, no relationship exists between TNI and risk. Combining the results for risk and return, internationalization in general is negatively related to the level of the return-risk ratio.

In short, the relationship between performance measures and the degree of internationalization has been investigated. Between 1980 and 2000, the banks in the sample showed lower profitability on foreign banking activities than on domestic banking activities, reported a decrease in total profitability when their degree of internationalization was higher, and also showed higher variability of profitability. If banks had intended to increase their profitability by serving new foreign banking markets and clients, or profit from geographical diversification, then on average they seem not to have succeeded.

#### 24.2.5. Shareholder return

To analyze the relationship between total shareholder return (TSR) and degree of internationalization (TNI), a simple model was developed and estimated. TNI, and change in TNI were found to have a positive relationship with shareholder return in line with the hypothesis, especially between 1990 and 2000. However, the estimates are in general non-significant.

Shareholders attached different valuations for changes in the banks' realized internationalization strategies. *Retreating* and *Established* banks generated the highest total shareholder return, whether this is measured in absolute returns or adjusted for country averages. These groups include relatively many American and British banks. *Moderate* and *Accelerating* banks would have generated the least returns, in spite of *Accelerating* banks having attracted relatively large amounts of capital to fund their activities. Between 1963 and 1989, shareholders experienced negative abnormal returns when foreign acquisitions were announced (Waheed and Mathur, 1995). The high TSR for *Retreating* banks seems to support this finding, with this type of realized internationalization strategy on average more foreign divestments than acquisitions have been announced.

The analyses considered the relationship between risk, return and the degree of internationalization. No support was found that the level of TNI is a predictor for out or underperformance in the consecutive periods. If differences in TNI levels and differences in shareholder return are considered, then a higher degree of internationalization is negatively related to additional shareholder return, albeit non significant. On the other hand, performance had significant explanatory power for shareholder return.

When TNI decreased, a finding was that the bank share's return/risk profile improved. The return to risk ratio was calculated as annualized TSR (return) as a ratio of annualized standard deviation of TSR (risk). Similar to the previous analyses for return and risk, the results are not statistically significant though. It was also considered what the impact of large changes in TNI was on risk and return. Changes were defined as large when TNI increased or decreased with more than 10% compared to a year earlier; these large changes have always been caused by a large acquisition or divestiture. Banks who decreased their TNI with more than 10% generated on average more shareholder return in the years after the change, while the risk steadily declined after an initial increase. The return-risk ratio of banks with decreasing TNI's improved the most in the years shortly after the change in TNI.

When banks increased their internationalization activities and raised TNI with more than 10%, shareholder return was relatively high in the years of the TNI change, steadily decreasing in the years afterwards but still remaining positive. The volatility of the shareholder return increased in the year of change, remaining at broadly the same level for the subsequent years. On average, the return-risk ratio of the banks with a large increase in foreign banking activities improved slightly.

Summarizing, shareholders did not consider the degree of internationalization, nor changes in the degree of internationalization a factor that influenced shareholder return, in contrast to performance. However, shareholders valued *large* foreign acquisitions and foreign divestitures differently. Large changes in the degree of internationalization led to additional positive shareholder return. While with a decrease in TNI additional shareholder return increased over time, with an increase in TNI additional shareholder return decreased over time. The return-risk ratio improved most with large decreases in the degree of internationalization.

#### 24.2.6. Realized internationalization strategies

Finally, a number of additional analyses were specified in chapter 23, which explored the characteristics of the realized internationalization strategies in more detail. Also, the regional geographical dimension of internationalization activities was examined.

The first analysis examined the relationship between staff, assets and gross income: were they more stable in the home country than in foreign countries for different realized strategies and did they indicate the existence of a home bias? A home bias exists when the relationship is more stable for domestic activities than for foreign activities. Stability here was defined as the variance coefficient of the ratio, i.e. standard deviation as a ratio of the average assets per staff.

For *Accelerating* and *Moderate* banks, domestic activities were more stable than foreign activities, while *Established* banks and *Retreating* banks maintained more stable foreign activities than domestic activities. The existence of a home bias was therefore partly confirmed by the analysis, and also pointed towards a support strategy (Dunning, 1992). With a support strategy, the purpose of the foreign bank activity is to support activities of the rest of the bank. This could be supported by the ratio of assets per staff, which is higher for certain periods in the bank's strategy compared to other banks. For example, relatively few employees managed a large amount of assets in Luxembourg for German banks in the 1980s; these assets were primarily located there for capital market activities and fiscal reasons, supporting the total profitability of German banks.

Finally, two additional issues were addressed that applied to the whole sample: herding and the regional dimension of internationalization. A simple approach to herding was considered, examining whether major changes in internationalization in internationalization activities have been concentrated in time. For each bank, the realized internationalization activities between 1980 and 2000 were grouped into several phases<sup>1</sup>,

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<sup>1</sup> See Table 19.4 on page 412 for a summary of the different phases.

and a major change in internationalization activities is here considered as a change from one phase to another. For the sample, the number of major changes has structurally increased in the 1990s. The five years where banks showed the largest number of major changes in internationalization activities are 1983, 1989, 1991, 1994 and 1998. Almost half of the observed major changes are concentrated in those years, affirming the existence of herding activities among banks.

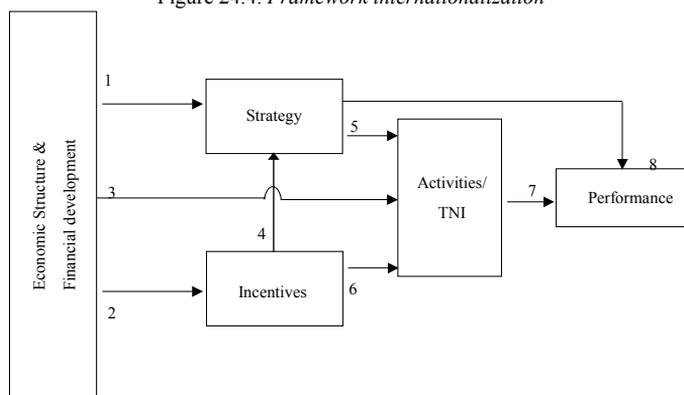
The final analysis focused the geographical dimension of internationalization: for a limited number of banks, assets can be broken down per region or country. Regional strategies were defined as internationalization activities mainly concentrated in the geographic region where the bank is located; regional strategies were expected to be specific to European banks. Existing data was limited but to get more information American, European, and Japanese banks were treated as three different groups; composite indices were set up to determine asset growth in several regions. A finding was that European banks have decreased the relative weight of their domestic assets, especially in 1996-2000, expanding on American and European activities. The degree of expansion of European banks in their home region was not found for American or Japanese banks.

Summarizing, the existence of a home bias was confirmed when comparing ratio's of foreign and domestic assets and income per employee; domestic ratio's were more stable than foreign ratios, an indication of more stable domestic banking activities than foreign banking activities. Major changes in internationalization activities were examined, the number of major changes increased in the 1990s. Five years accounted for half the major changes in internationalization activities between 1980 and 2000, indicating that major changes are concentrated in time. This is supportive of herding behavior among the banks (although more extensive research should establish more systematic patterns). Finally, international banking activities were broken down into different geographic regions. European banks expanded in the European region and the United States, especially between 1996 and 2000. American and Japanese banks were less active in their geographic home region, indicating that regionalization is a specific phenomenon for European banks.

#### 24.2.7. Summary

The findings presented in the previous section are clustered, based on the relationships within the framework, and presented in Table 24.2. For each relationship, the found direction has also been specified. The number of the relationship corresponds with the relationship in Part I to analyze internationalization activities of banks (Figure 24.4).

Figure 24.4. Framework internationalization



The lines indicate the theoretical relationships reviewed in Part I, and subsequently investigated in Part II and Part III. The previously discussed findings can be summarized in the following conclusions:

- Overall, the study established a relationship between incentives to internationalize and the degree of internationalization. *Extrinsic* incentives showed mixed results. Export as a client incentive to internationalize had explanatory power in the 1990s but not in the 1980s. No relationship with foreign direct investments was found. Net interest margins were a determining factor to internationalize in the 1980s, shifting towards fee income in the 1990s. Financial development was found to be positively related to the degree of internationalization for continental European banks, but negatively related to the United States, Japan, and the United Kingdom, the countries with the world's largest financial centers and securities markets. Market power and herding, *Sector intrinsic* incentives, also had the explanatory power and expected signs. A higher degree of market concentration was positively related to the degree of internationalization and; furthermore individual banks tended to be sensitive to the overall degree of internationalization, an indication of herding. *Bank intrinsic* incentives to internationalize - profitability, capitalization and efficiency - also explained the degree of internationalization. The explanatory power tended to be higher in the 1990s than in the 1980s, and was higher for banks who followed *Retreating* or *Established* internationalization strategies, than for *Moderate* or *Accelerating* strategies.
- Between 1980 and 2000, the banks in the sample showed lower profitability on foreign banking activities than on domestic banking activities, reported a decrease in total profitability when their degree of internationalization was higher, and also showed higher variability of profitability. If banks had intended to increase their profitability by serving new foreign banking markets and clients, or profit from geographical diversification, then on average they seem not to have succeeded.

- The degree of internationalization, or changes in the degree of internationalization a factor has had no influence on shareholder return, in contrast to performance. However, shareholders valued *large* foreign acquisitions and foreign divestitures differently. Large changes in the degree of internationalization led to additional shareholder return. While with a decrease in TNI additional shareholder return increased over time, with an increase in TNI additional shareholder return decreased over time. The return-risk ratio improved most with large decreases in the degree of internationalization.
- The existence of a home bias was found in the study; domestic financial ratio's were more stable than foreign ratio's, an indication of more stable domestic banking activities than foreign banking activities. Major changes in internationalization activities were examined, the number of major changes increased in the 1990s. Five years accounted for half the major changes in internationalization activities between 1980 and 2000, indicating that major changes are concentrated in time. This is to some extent supportive of herding among the banks. Finally, international banking activities were broken down into different geographic regions. European banks expanded in the European region and the United States, especially between 1996 and 2000. American and Japanese banks were less active in their geographic home region, indicating that regionalization is a specific phenomenon for European banks.

Table 24.2 summarizes the hypotheses and analyses that have been tested; the found relationships are mapped to the general framework presented in Figure 24.4.

### **24.3. Relevancy conclusions for current theory**

There are four discussions where the findings of this study might provide relevant results: 1) the relationship between foreign profitability and total profitability within a bank, 2) absent economic advantages from internationalization, 3) the relationship between TNI, performance and shareholder return. Finally, some remarks can be made about the relationship between financial systems, financial development and TNI.

#### *Foreign profitability versus total profitability*

For most banks and most periods, the highest performance and highest return-risk ratio has been achieved with the lowest levels of TNI. In other words, banks achieved their best performance when they had a low degree of internationalization. It was also found that foreign profitability has been in general lower than domestic profitability. The combination of these two finding support the concept of a support strategy (see Dunning, 1992). With a support strategy, the foreign activities support the rest of the bank, without specific profitability goals. In other words, the bank chooses a low level of TNI and accepts a lower foreign profitability.

Table 24.2. Relationships of internationalization of banks

Relationship <sup>1</sup>	Direction <sup>2,3</sup>	Finding	Analysis <sup>4</sup>
1: Structure → strategy	na <sup>N</sup>	Retreating strategy type applies to American and British banks, accelerating strategy type applies to Continental European banks.	Chapter 19
2: Structure → incentives	na <sup>N</sup>	There is a country of origin effect explaining differences in TNI and incentives	Chapter 20
3: Structure → activity	+ <sup>S</sup>	A higher GDP per capita is related to a higher TNI	HYP20.3
	+ <sup>S</sup>	A higher market concentration related to a higher TNI	HYP20.4, HYP20.8
	+ <sup>S</sup>	A higher TNI is related to higher domestic financial assets (banking assets to GDP, stock market value to GDP)	HYP20.5
4: Incentive → strategy	na <sup>N</sup>	Incentives are better explained when split by strategic type than per country	Chapter 20, Chapter 23.1
5: Strategy → activity	na <sup>N</sup>	Strategy types have shown markedly different TNI developments	Chapter 19
	+ <sup>N</sup>	Changes in strategy are concentrated in time	HYP22.6
	0/+ <sup>N</sup>	<i>Accelerating</i> and <i>Moderate</i> banks have a home bias, the other banks don't.	HYP22.3
	+ <sup>N</sup>	Foreign and domestic banking activities converge over time.	HYP22.5
	+ <sup>N</sup>	European banks expand most in the European region	
6: Incentive → activity	-/+	Higher TNI is related to higher TNI of other banks	HYP20.7
	0 <sup>S</sup>	TNI is not related to FDI	HYP20.1
	+ <sup>S</sup>	TNI is positively related to exports	HYP20.1
	+ <sup>S</sup>	Higher TNI is related to higher cost efficiency	HYP20.9
	+ <sup>S</sup>	Higher TNI is related to higher profitability	HYP20.10
	+ <sup>S</sup>	Higher TNI is related to net interest margin, fee income financial centers	Chapter 20
	+ <sup>S</sup>	Higher TNI is related to higher capitalization	HYP20.11
7: Activity → performance	- <sup>S</sup>	Higher TNI is negatively related to profitability	HYP21.1
	- <sup>N</sup>	Foreign profitability is lower than domestic profitability	HYP21.2
	0 <sup>S</sup>	A higher TNI does not influence variability of profitability	HYP21.4
	- <sup>NS</sup>	A higher TNI worsens return-risk ratio	HYP21.3
	0 <sup>NS</sup>	A higher level of TNI, or a change in TNI does not create additional shareholder return	HYP21.1 HYP21.2
	+ <sup>NS</sup>	Large decreases in TNI increase additional shareholder return, and improve the return-risk profile	HYP21.4
	- <sup>NS</sup>	A low degree of TNI shows the best return-risk ratio.	HYP21.5 HYP21.6
8: Objective → performance	+ <sup>N</sup>	Retreating, Established banks generate the highest TSR	HYP22.2
	- <sup>N</sup>	<i>Moderate</i> , <i>Accelerating</i> banks generate the least TSR	HYP22.2

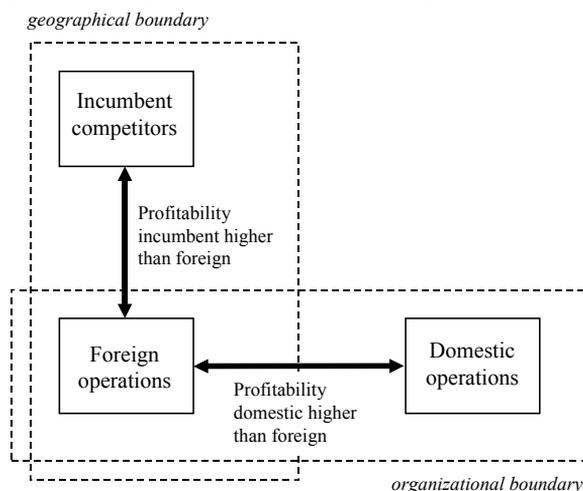
Note 1: The numbers in the column "relationship" correspond with the numbers of the lines in Figure 24.4.

Note 2: The symbols in the column "direction" are: na (not applicable), + positive relationship, - negative relationship, 0 no relationship.

Note 3: "S" in the column "direction" indicates whether the direction has been statistically supported; "NS" indicates that the relationship has been tested but yielded non significant results; "N" indicates that the found direction has not been statistically tested.

Note 4: The column "analyses" refers to the hypotheses and chapters where the relationship was investigated.

Figure 24.5. *Foreign activities, competitors and organizational boundary*



A research finding is that profitability of foreign owned banks in the United States is lower than their domestic peers (see chapter 6). An explanation of this finding is that while the profitability of foreign owned banks might be lower, the performance should be interpreted as part of the total profitability of the bank. A lower foreign profitability might enhance total profitability when foreign activities provide services that significantly increase the range of financial services of a bank which is valued by clients (the support strategy is based on this notion). This study has pursued the second line of research, analyzing the relationship between foreign profitability within the bank organization. The study established that domestic profitability in general was higher than foreign profitability. In other words, foreign banking activities may not only be lower than its foreign competitors, but is also lower than the home country activities.

#### *Absent economic advantages from internationalization*

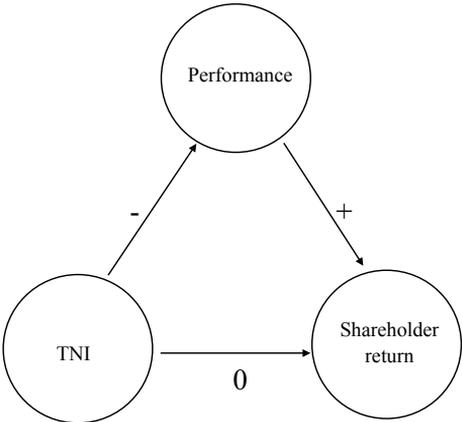
In this study, internationalization of banks has not created more profitability; it also increased the variability of profitability. A number of bank intrinsic incentives to internationalize were not substantiated (economies, risk/return, cost of capital), as well as extrinsic ones (client, net interest margin). In this study, only publicly reported and available information has been used for the analyses. It is therefore reasonable to assume that banks must have known beforehand the limited opportunities to generate additional profits. This assumption supports the herding argument: banks accept a sub-optimal performance in reaction to uphold their relative market position. On the other hand, it also leads to another explanation - international activities need a long period to generate additional profitability, and this is beforehand known to management and stakeholders. This can be substantiated by the results shown by *Established* banks: these banks already had built up their international activities prior to 1980, and continued to do so in the next

decades. They have generated additional shareholder return for their stakeholders, albeit with a long time horizon.

*TNI, performance and shareholder return*

There is a relationship between TNI and performance, there is no relationship between TNI and shareholder value, and there is a positive relationship between performance and shareholder value. The relationship between performance and shareholder return is stronger than between TNI and performance. An increase in TNI in general decreases shareholder value. This applies especially to *Accelerating* banks: they managed on average the largest capital market issues to fund international expansion, but failed to generate additional shareholder return. A decrease in TNI in general has increased profitability, and this in turn has led to a higher shareholder return. This conclusion is also contrary to announced expectations of banks when expanding their international activities. A typical expansion of foreign banking activities was announced as increasing successful activities and broadening the geographical presence. The combination should potentially generate additional shareholder value<sup>2</sup>; a claim that has not been substantiated by this study.

Figure 24.6. Direction of relationship between internationalization, performance and shareholder return



*Financial systems, development and TNI*

The role of financial systems and financial development has been addressed at various points in this study. In chapter 2, three different financial systems were identified: bank oriented, market oriented and government directed financial systems. With market oriented financial system, the allocation process is mainly determined by the price process, and a substantial part of the banks' main activities, is performed by capital markets. With bank oriented financial systems, the price process still is important, but the bank also plays an

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<sup>2</sup> Cf. the announcement of Bankers Trust by Deutsche Bank in the bank's annual report (1998, p. 7)

important part in the allocation process. Finally, in government oriented systems, banks can be instrumental in achieving the government's objectives.

Within the framework of internationalization, results of the study however suggest the existence of two different financial systems: continental European banks versus the United States, the United Kingdom and Japan. This grouping is based on three observations, this is displayed in Table 24.3. The classification of banks in different strategic types showed that there is a relatively large concentration of British and American banks, representing the market based system, in the *Retreating* and *Established* strategy types. On the other hand, European continental banks were relatively well represented in the *Moderate* and *Accelerating* strategy types, representing the bank based system. Japanese banks were evenly distributed over most categories. At first sight, this dichotomy would indicate that the realized strategy types support the notion of a market versus bank based orientation in the internationalization strategies.

Table 24.3. *Difference in financial development and internationalization*

United Kingdom, United States, Japan	Continental Europe	Source
<ul style="list-style-type: none"> <li>• Relatively many <i>Retreating</i> internationalization strategies</li> </ul>	<ul style="list-style-type: none"> <li>• Relatively many <i>Accelerating</i> internationalization strategies</li> </ul>	Chapter 19
<ul style="list-style-type: none"> <li>• Home of the world's largest financial centers</li> </ul>	<ul style="list-style-type: none"> <li>• Regional financial centers</li> </ul>	Chapter 8
<ul style="list-style-type: none"> <li>• Negative relationship between financial development indicators and internationalization of banks.</li> </ul>	<ul style="list-style-type: none"> <li>• Negative relationship between financial development indicators and internationalization of banks.</li> </ul>	Chapter 20

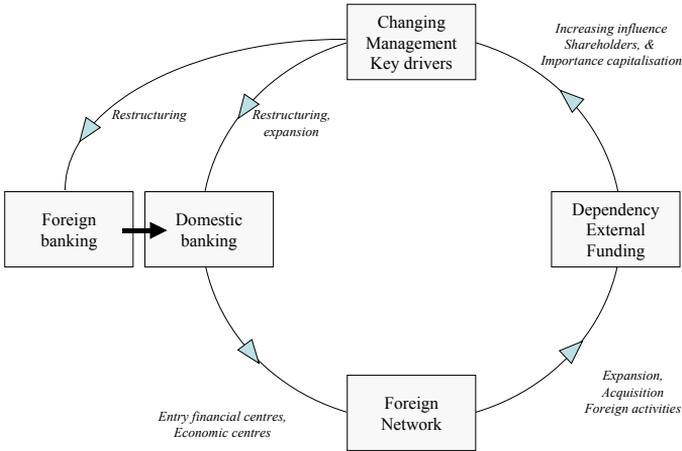
However, when considering internationalization, market oriented versus bank oriented may not be a useful distinction (cf. Scholtens, 1996; Demirgüç-Kunt and Levine, 2001). The investigation of the relationship between financial development indicators and TNI pointed to another direction: for the continental European banks, strong relationships between financial development indicators and TNI were found. These relationships broke down for the United States, Japan, and the United Kingdom, all in a similar fashion. These three countries share a number of similarities: they have or have had leading financial bank systems in the world and they have the largest financial centers. The United States and Japan share additional similarities, such as in the regulatory system (the Japanese regulatory system was initially designed by the Americans) or the low degree of banking concentration.

**24.4. The case studies revisited**

The findings and conclusions provide additional, to some degree speculative, insights in the patterns and strategic logic of internationalizing banks. Major internationalization

developments are shown in Figure 24.7. Starting in the 1980s, the "core" activities of bank internationalization in the 1980s were to set up banking activities in financial centers and economic centers. Part of this was related to incentives such as follow-the-client or overall profitability, discussed in earlier chapters. Additionally, restructuring and expansion in the domestic markets might have been cumbersome for some and impossible for others. Regulation might be one explanation for this, but also the existence of a home bias "inertia": restructuring the domestic retail networks in the early 1980s might have been more difficult with vested interests in the home country such as labor unions. Banks in particular in smaller countries had to expand abroad for fear of anti-trust regulation at home.

Figure 24.7. Internationalization patterns of Accelerating and Moderate banks



Expansion is support strategy driven: whilst its performance is lower than domestic, expansion is easier to achieve. For most banks during the 1980s, this expansion is small, and the bank need not attract additional capital. When banks initiated larger acquisitions in the late 1980s and 1990s, external capital became more important as a source of financing. (Domestic and foreign) shareholders not only provided additional capital to expand, they also followed management more closely, and pressed for changes when expected results were not delivered.<sup>3</sup> An increasing shareholder role and foreign profitability that was below expectations led bank management to change its objectives in the mid 1990s: profitability should be internally generated, the domestic base strengthened and foreign activities divested if they did not contribute satisfactorily to total profitability.

<sup>3</sup> For example, institutional investors raised objections in 1997 when BZW, the investment banking unit of Barclays continued to perform badly. Shortly after, management dismantled BZW.

## 24.5. Implications

This study has primarily been a contemporary analysis of realized internationalization strategies of banks between 1980 and 2000. In this section possible implications for internationalization of banks in the near future are considered: can something be said of future internationalization developments, and what consequences might this have for shareholders? Three future developments are considered. First, which banks are most likely to gain in the near future from internationalization (24.5.1). Next, what effects would the further European integration have on the internationalization of banks (24.5.2). Finally, what role will financial systems play (24.5.3).

### 24.5.1. Future internationalization

A finding of this study was that there appeared considerable changes in internationalization activities of banks between 1980 and 2000. In 1980, American and English banks were at the helm of internationalization, Japanese banks in 1990, and by 2000 many European banks had raised internationalization to new, unprecedented heights, perhaps only matched by the internationalization of banks in the colonial system at the start of the 20th century (cf. Jones, 1993; Born, 1983). The average degree of internationalization for the sample did increase, but not dramatically though: the TNI moved around 30% in the 1980s, and increased to 40% at the end of the 1990s.

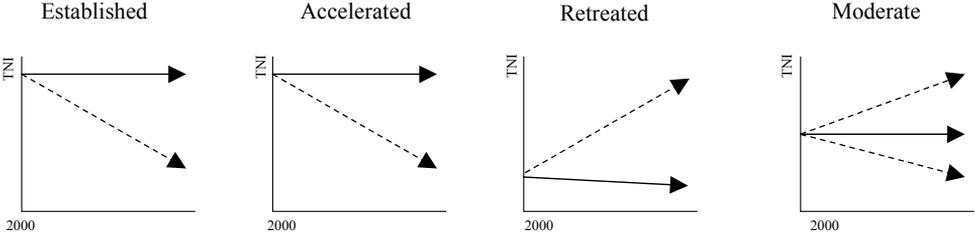
There are similarities observable between the early 1980s and the late 1990s. In the early 1980s, American and English banks had to make strategic choices with regard to their internationalization activities just as Dutch, German, Spanish and Swiss banks had to reconsider the role of their foreign banking activities at the end of the 1990s. In the early 1980s, banks were confronted with the decline of a smooth source of foreign income, the LDC loans; by the late 1990s banks were confronted with the decline of stockmarkets reducing both fee income and the attractiveness of the stock markets as a source of foreign acquisition financing. A large number of banks in the sample undertook some form of restructuring in 1999 and 2000, and continued this in the years after. While the decrease in stock markets from 2000 onwards might be alleviated, other triggers of strategic change are bound to follow, such as financial crises.

Ultimately, internationalization of banks has been a mixed blessing for shareholders over a longer period. Banks with long established foreign bank activities (the *Established* banks) generated in the long run as a group the highest shareholder return, similar to banks who substantially decreased the role of foreign bank activities (the *Retreating* banks). On the other hand, banks who either increased their internationalization activities steadily (the *Moderate* banks) or with increasing pace (the *Accelerating* banks) have generated the lowest shareholder return.

From the shareholder point of view, which banks' internationalization strategies are best positioned for the near future? Specifically, *Accelerating* banks have increased their foreign bank activities at the end of the 1990s to such an extent that these banks have become comparable in their degree of internationalization to *Established* banks throughout the 1980s and 1990s. Given the relative successful (shareholder) performance of

*Established* banks, what banks with *Accelerating* strategies are likely to emulate the success of *Established* banks? To answer these questions the possible future courses of realized internationalization strategies (*Moderate*, *Established*, *Accelerating*, *Retreating*)<sup>4</sup> are projected in Figure 24.8. For example, *Established* banks have a relatively high degree of internationalization; the solid line in the figure projects the current degree of internationalization into the future, assuming no fundamental change in the role of foreign activities in the bank. On the other hand, the dotted arrow shows a possible change in the degree of internationalization.

Figure 24.8. Future directions of internationalization



Note: —▶ degree of internationalization, assumption is stability from end of 2000 onwards  
 ----▶ possible change in degree of internationalization

If past experience provides any guidance, then an investment in banks with realized *Established* and *Accelerating* strategies for the coming decade might be worthwhile, while investments in banks with *Retreating* and *Moderate* strategies should be considered with more caution.

*Established* banks (such as Citicorp, HSBC) have found a durable balance in the 1980s and 1990s between foreign and domestic bank activities. These banks have in common that their foreign bank activities are broadly based, branching out in investment banking, corporate finance as well as retail banking (consumer finance) and asset management. Also, their foreign activities are geographically well diversified. *Established* banks have to maintain the right configuration to keep internationalization a relative profitable activity, or the bank might divest activities that do not contribute to the total profitability of the bank.

*Accelerating* banks (such as Deutsche Bank, ABN Amro, Credit Suisse, UBS, Santander) have increased their internationalization activities significantly during the 1990s and are at a position in the early years of the new millennium similar to *Established*

<sup>4</sup> The realized *Imploding* internationalization strategies are ignored here, this strategic type applies to only two banks and is therefore difficult to generalize.

and *Retreating* banks in the early 1980s. Either they have to find the right configuration to make internationalization a relative profitable activity, or the bank will divest activities because it has not found an opportunity for sustainable foreign profitability and refocus on domestic activities. In other words, *Accelerating* banks have to determine whether they soon will reach the stage of *Established* banks, or they have to reconsider their portfolio of foreign activities and become *Retreating* banks. In the past, both scenario's were rewarded by shareholders. This suggests a paradox: banks with *Accelerating* internationalization strategies have on average delivered the least shareholder return in the past but are best positioned to generate the most shareholder return in the near future.

The strategic choice banks with *Accelerating* strategies have between developing either *Established* or *Retreating* strategies leads to the question which banks with *Accelerating* strategies have characteristics more similar to banks with *Established* strategies or more similar to *Retreating* strategies. In other words, what banks with *Accelerating* strategies are likely to evolve into *Retreating* strategies and what banks are likely to develop *Established* strategies?

Naturally any future scenario is highly conjectural but to answer this, two criterions are introduced. The case studies first indicate that when domestic growth opportunities increase, banks favor domestic growth over foreign bank growth. For most banks, the first priority is to maintain the (relative) domestic market position, as well as seizing the best opportunities to achieve profitability growth or efficiencies. Expansion of domestic banking markets (mostly triggered by regulatory changes) led to a decrease in internationalization of banks; this applied for American banks, English banks and also Japanese banks. Naturally, this criterion does not apply for banks with small and/or highly concentrated domestic banking markets, such as the Netherlands and Switzerland. Future domestic growth opportunities are however relevant for French and German banks where de-mutualization, and (further) abolishment of separation between different banking types in the country might be future events.

Second, all major retreats from internationalization have been triggered by a financial crisis. While the timing of financial crises cannot be predicted as such, the banks that retreated the strongest or earliest were on average banks with large capital market/investment banking operations. In short, banks with more stable foreign funding bases such as foreign retail banks or banks with more stable foreign fee income base such as asset management and private banking are probably more likely to whither economic and financial adverse conditions than banks with volatile foreign activities in capital market/investment banking. This will be used as the second criterion, both criterions suggests following categorization of future development (Figure 24.9).

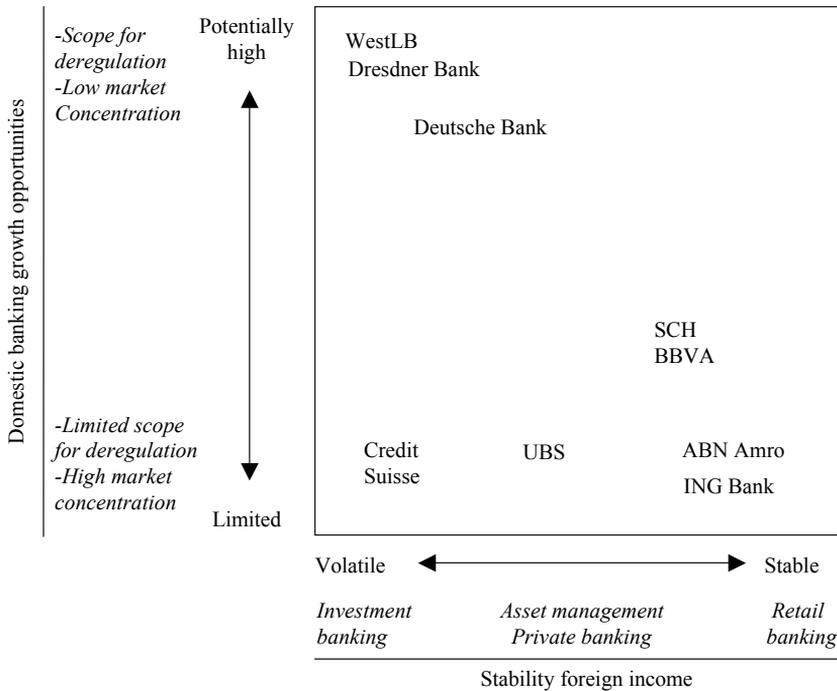
In other words, German banks with *Accelerating* strategies (Dresdner Bank, WestDeutsche Landesbank and Deutsche Bank<sup>5</sup>) are more likely to retreat from foreign bank activities and eventually develop *Retreating* internationalization strategies. Their

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<sup>5</sup> Notwithstanding the statement of Breuer, CEO of Deutsche Bank, in 2002 that Deutsche Bank would continue to expand its global mergers and acquisitions activities. (Cf. Breuer, R.E. (2002, January 31). *Annual Press Conference*. Frankfurt: Deutsche Bank).

potential domestic growth opportunities are relatively large; when regulation permits these banks might prefer domestic banking growth opportunities over foreign banking growth opportunities. Also, these banks are more sensitive to external shocks such as financial crises due to their high dependency on (foreign) capital market activities. On the other hand, the Swiss, Dutch and Spanish banks have no domestic growth opportunities; the Dutch banks ING and ABN Amro have acquired large stable funding bases (retail banking operations) outside the Netherlands. Credit Suisse and UBS have not acquired retail networks outside Switzerland; UBS has created a relatively stable source of foreign income through asset management and private banking while Credit Suisse has more focused on expanding in investment banking. In other words, ING, ABN Amro, UBS, Santander and BBVA may be the banks who have developed and expanded internationalization activities closest to banks with *Established* internationalization strategies.

Figure 24.9. Accelerating banks' sensitivity to domestic market developments, stability of foreign income



Similar to *Accelerating* banks, Banks with *Retreating* internationalization have two strategic alternatives: either to maintain or further decrease internationalization activities, or to increase them again: *re-internationalization*. Lloyds TSB, Barclays and JP Morgan Chase have re-internationalized or planned to do so. Lloyds TSB has publicly contemplated increasing their internationalization activities in 2000, while Barclays has re-internationalized in Spain but on a more subdued scale than its European and American

expansion activities in the 1980s.<sup>6</sup> Chase decreased its foreign bank activities since the mid 1980s but effectively re-internationalized when it acquired J.P. Morgan in 2000 which had more than half its operations outside the United States. Royal Bank of Scotland also (re-) internationalized by acquiring National Westminster. National Westminster decreased its foreign bank activities in the 1990s; after the acquisition in March 2000 Royal Bank of Scotland developed a specialized internationalization strategy, expanding its United States retail branch network with a series of modest acquisitions and developing foreign distribution channels for motor insurance activities.

The re-internationalization of Barclays or J.P.MorganChase is probably not a repetition of the internationalization activities in the 1980s. Compared to earlier periods, the banks have shown a strong focus on domestic banking activities. Also, bank capital has become scarcer than in the 1980s. At the end of 2003 the proposed structure and implementation of Basle II introduced a more sophisticated regulatory framework for banks and their capital. Whichever structure or implementation route is chosen, the allocation of capital to foreign bank activities is bound to be more closely monitored and evaluated than in the 1980s. Some internationalization incentives remain the same; the announced re-internationalization of Lloyds TSB could be interpreted as seeking growth opportunities after domestic expansion activities failed, when Lloyds TSB was not allowed to acquire Abbey National in 2000. The other *Retreating* banks have not re-internationalized; Bank of America autonomously expanded investment banking operations in London but substantially reduced the relative role of its foreign operations when it acquired FleetBoston in 2003. For the retreated Japanese banks, the climate for re-internationalization has become more favorable but the banks have largely been engaged in domestic mergers to absorb the large write off of bad loans, increase profitability and regain solvency.

Finally, question marks surround the future shareholder returns of *Moderate* banks: they have the widest range of strategic options available to them, and are probably the most diverse bank group of realized strategies. However, most of the *Moderate* banks have as yet sought to increase their degree of internationalization. Fortis for example has essentially stayed focused on the Benelux and Spain, consolidating and integrating its bank operations and striving for autonomous growth. Credit Agricole on the other boosted its foreign activities since its acquisition of wholesale bank Indosuez in 1994 but strengthened its domestic focus by acquiring Credit Agricole in 2002.

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<sup>6</sup> The bank acquired Banco de Zarazogano in 2003 for 1.14 billion euro, Barclays became the sixth-largest bank in Spain by assets. In comparison, the largest bank in Spain, SCH, had 20 times as many assets. Source: Levitt, J. (2003, October 8). How to make gains in Spain. In Special Report: Banking in Europe. *Financial Times*, p. 3.

Table 24.4. Possible changes in future internationalisation of banks

		Change from			
		Established	Accelerating	Retreating	Moderate
Change to	Established	Tokyo-Mitsubishi HSBC Standard Chartered Citicorp BNP Paribas Société Générale	ABN Amro ING Bank UBS Santander <sup>(1)</sup> BBVA		
	Accelerated				
	Retreating		Credit Suisse Deutsche Bank Dresdner Bank West LB HypoVereinsBank	Bank of America Mizuho <sup>(3)</sup> Lloyds TSB <sup>(4)</sup>	
	Moderate			JPMorgan Chase Barclays Royal Bank of Scotland <sup>(5)</sup>	Fortis Rabobank Commerzbank Crédit Agricole

The banks in the sample at the end of 2000 are included in this table.

Note 1: The bank has been renamed SCH.

Note 2: Credit Suisse could also be classified as retreating.

Note 3: Mizuho incorporates IJ and Dai Ichi Kangyo.

Note 4: Lloyds TSB announced a re-internationalization in 2000, this has not materialized between 2000 and 2003.

Note 5: Royal Bank of Scotland acquired National Westminster in 2000, and continued its foreign banking activities.

What road leads to a sustainable and equal profitability development of foreign and domestic banking activities? Table 24.4 summarizes the hypothesized changes in realized internationalization strategies for the near future. The number of banks with *Established*

strategies will increase, so will the number of banks with *Retreating* internationalization strategies.

#### 24.5.2. Regional integration: extension of the home market?

One observation in this study was that a large degree of foreign activities of European banks (as well as American banks) have taken place within European banking markets. Another implication to consider is then the consequence of regional integration such as the European Union, representing an economic and political extension of the home market and a regional uniformization of the regulatory regime. The European integration process accelerated in two periods, between 1988 and 1991 (in preparation of the Single Market) and between 1996 and 1999 (in preparation of the Eurozone). The economic integration programs liberalized capital markets, and the introduction of the Euro led to a convergence of monetary policies between the major EU countries. With European integration, will the extension of the home market imply similar high profitability as domestically, or should expansion in the Eurozone still be considered internationalization to a foreign country, with lower foreign performance than domestic as this study found?

Banks have dealt with European integration in several ways: pan-European strategies were formulated by National Westminster, Barclays, Deutsche Bank and Cr dit Lyonnais in the 1980s. They built up a branch network in the major European cities, and acquired retail or private banks in European countries, mainly in Germany, France and Spain. In the 1990s, a new concept was introduced: the "second home market" in Europe. These were acquisitions of foreign banking activities with the expected benefits enjoyed domestically (such as a large depositor base). Banks who followed this strategy were ING with its 1997 acquisition of Belgian BBL or HSBC who acquired French CCF in 2000. If banks view Europe as an extension of their home market, then the findings of this study would suggest that this extension in general lowers overall profitability. Is this finding also valid for European banks internationalizing in the (integrated) European banking market?

Supporting the concept that European integration extends the concept of home market are convergence of net interest margins in the Eurozone, the structural removal of regulatory barriers, reduction of fluctuations in GDP growth: economic cycles in the Eurozone converge. These developments have in common that differences between "domestic" and "foreign" economies within the Eurozone decrease.

Outwardly, one might interpret the process of European integration for the banking markets as following the path taken by American banks since the mid 1990s, where ongoing deregulation of interstate banking has led to a natural extension of the home market. Deregulation of interstate banking in basically has created new markets with similar customers, introducing opportunities for increased efficiency and higher profitability. However, European integration cannot be compared to the banking deregulation in the United States.

There are two arguments that do not support the concept of an extension of the home market within Europe. First, potential efficiency advantages may be difficult to exploit. Consolidation of the banking market moves at different paces in different

countries; European labor markets are considered to be rigid implying that part of the cost-to-income ratio levels for banks in a country are structural, especially for labor intensive retail banking. In other words, efficiencies might be difficult to gain by foreign banking acquisitions in Europe. Second, fiscal policies with regard to savings and pensions are not harmonized. They determine to a large extent the growth of the savings pool and the opportunities to be had. A scenario could be that further European banking consolidation follows along these lines: Capital market activities in Europe are to a large extent consolidated; dominated by a few American and European banks for the region, with complementary dominant positions for country based banks. Consolidation in the European banking market is then directed at acquiring foreign retail banks. Capital markets are less influenced by local tastes than retail banks, whether this is by a branch network or a virtual network.

#### 24.5.3. Financial systems and internationalization

The study found that there is a relationship between financial development of countries and internationalization of banks; there is a stronger relationship between financial development variables and TNI calculated *per country*, than between financial development indicators and TNI for *individual banks*. On the other hand, a mapping between financial systems, financial development indicators and the degree of internationalization of banks could not be determined in a straightforward manner. On the basis of the relationship between internationalization of banks and financial development indicators, two country groups could be established: continental European countries and countries with the largest financial centers (the United States, the United Kingdom, and Japan). In chapter 19, the different realized internationalization strategies were grouped by bank and country. Table 24.5 replicates this, adding the two groups to the table.

Table 24.5 shows that by and large, American, British and Japanese banks tend to have banks with predominantly *Retreating* and *Established* strategies. On the other hand, continental European banks have shown predominantly *Moderate* and *Accelerating* banks. This does however not imply that *Retreating* and *Established* strategies are specific to market oriented financial systems (Japan is here the exception), or that *Moderate* and *Accelerating* are specific to bank oriented systems (the Netherlands and Switzerland are classified as market based).<sup>7</sup> What are then possible implications of this dichotomy?

If one reconsiders the future implications of internationalization strategies, a case was made that most *Accelerating* banks (who had until the late 1990s expanded their foreign activities considerably) faced a strategic choice to become either *Established* banks or *Retreating* banks. Table 24.5 would then suggest that this would coincide with banks located in financial systems with large capital markets, in other words a shift from the continental European model to the large capital markets model. Such a shift is actually taking place, with the integration of the European banking markets and the continuous

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<sup>7</sup> See for a classification of countries and financial systems Table 2.6 on page 44.

integration process in the European capital markets (cf. the concentration of European securities markets in Eurex and Euronext).

Table 24.5. *Financial systems and realized internationalization strategies*

	United States	United Kingdom	Japan	France	Germany	Netherlands	Spain	Switzerland
Accelerating				Paribas	Deutsche Bank Dresdner Bank Hypo- Vereinsbank Westdeutsche Landesbank	ING Bank ABN Amro NMB Bank	BCH BBV Santander	Credit Suisse UBS
Moderate			IBJ	Agricole	Vereinsbank Commerzbank Bayerische Hypobank	Rabobank Fortis Amro	Argentaria	
Imploding		Midland		Credit Lyonnais				
Retreating	Chemical Banking Manufacturers Hanovers Bank of America Chase Manhattan	Barclays Lloyds TSB National Westminster	Mitsubishi Bank Dai Ichi Kangyo Sumitomo Bank					
Established	J.P.Morgan Citicorp	Standard Chartered HSBC	Tokyo- Mitsubishi Tokyo	BNP Societe Generale		ABN		SBC

In other words, two parallel developments might take place that have similar consequences and are bound to interact closely in the near future. Viewed from top down, for most European countries the integration of the capital markets may eventually emulate characteristics of the United Kingdom, the United States and Japan, countries where the banks in the sample showed *Retreating* and *Established* internationalization strategies. Viewed from bottom up, banks who accelerated their internationalization activities are likely to enter a re-orientation phase to developed either *Established* or *Retreated* internationalization strategies.

The study has also found implications for the role of changing financial systems, but more on an individual bank level. A (major) example in this case is Deutsche Bank. Its expansion in the 1990s in capital market activities in the United States and the United Kingdom was financed by equity issues. The bank increased its dependency on shareholders, and in the process compared itself to American and Swiss competitors. Transparency and comparability with other banks was improved by separating the differing characteristic of a German bank, its industrial shareholdings, were eventually moved

towards a different holding, clearly indicating that these were for sale. In other words, internationalization might create its own momentum to change bank based systems to market based systems.

There is also a cross over from bank oriented systems to market oriented systems though. American banks have moved from a specialized bank model in the 1970s to a European universal banking model in the 1980s and 1990s; and started to move towards the bank assurance model in the late 1990s, with the Travelers-Citicorp merger. If this trend were to be followed by more banks, it might support the earlier implication that domestic growth opportunities for American banks are further enlarged, shifting focus further from international to domestic activities, reducing the degree of internationalization.

#### **24.6. Limitations of the study and research recommendations**

Research directly linking the strategies of banks to internationalization developments is in a nascent stage and requires further research. Four broad lines of further research can be identified:

- Interrelationships between banks, firms and other financial services,
- Increase of in depth knowledge,
- Expand on negative performance differential, and
- Interaction between regulation, bank strategy and change.

*Interrelationships between banks, firms and other financial services.* This study considered the client incentive, following or leading firms to foreign markets, in the form of exports and foreign direct investments. The understanding of internationalization patterns would be enriched if the internationalization of banks would be linked to the internationalization patterns of their biggest customers at a firm level of analysis. Also, what is the interaction between internationalization of banks and internationalization of other financial service providers? Considering the patterns of internationalization in the specialized insurance, securities and asset management firms would complete the assessment for all financial services

*Increase of in depth knowledge.* The found relations in this study are on a broad level, and the knowledge of internationalization of banks could be complemented by more in-depth case studies, increasing the managerial relevance of the study. A more detailed approach is also necessary to further investigate herding. Herding is an important incentive to internationalize within banking literature, and several variables have been introduced to take account of this phenomenon. However, the study failed to develop clear support for herding as an internationalization incentive; a reason could be that either the time

dimension or aggregation level was too coarse (yearly TNI figures).<sup>8</sup> An in depth analysis on a geographical level, identifying different entry and exit moments for activities, combined with the client product matrix should provide more insight.

Similarly to herding, another limitation of the study concerns the role of client-product combinations in international banking, which was not examined in detail here. Here too, the findings might be enriched with a detailed analysis where exactly geographic profit or loss for different client-product combinations would have been achieved. It might lead to different conclusions on a product level, but a client-product analysis does not affect the overall conclusions, which apply for the total bank. If the relation between profitability and the degree of internationalization is not visible at a corporate level, the relationship probably is not there at a lower level also.

*Expand on negative performance differential.* A recommendation would be to further investigate the causes for one of the main findings in this study, the negative performance differential. A further line of research would be to develop matrices of activities and arenas for the banks in the sample, providing a further drill down of why these differences in profitability exist. Understanding of this negative performance differential could be enhanced by further including smaller and medium sized banks in the sample. Inclusion of these banks probably reaffirms the negative performance differential since it decreases the effect of survivorbias in the sample, especially for medium sized American banks in the 1980s who retreated in large numbers from foreign bank activities. Inclusion could also help answering the counterfactual argument: how have domestic banks differed in profitability, solvency, or strategies from banks that internationalized? Or is the main difference between banks that stayed at home and banks that internationalized simply size; was internationalization for most banks simply a phase to achieve size and grow in market value until deregulation permitted it to grow again at home?

If the lower performance of foreign activities is confirmed in a broader setting, then it also holds a strange paradox: take for example the mutual internationalization of Dutch banks into France and vice versa. In case both banks share lower profitability levels in their international activities, the consequence would be that the host-firms in France and the Netherlands systematically have a lower profit rate than their domestic competitors; this would hold even in case the subsidiary is the result of a cross-border acquisition. The combined effect is not welfare enhancing; this seems odd and more research needs to be given to this question. The view of the regulator could be an area for further research here: for instance, in case internationalization does not enhance profitability, what political stance should be taken by governments/regulators confronted by either internationalization

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<sup>8</sup> It is also possible that herding as a motive did not surface as a result of the selection of the sample: the banks were the largest banks in their countries, probably already prone to herding making it a non distinguishable trait. Another problem might be the time lag involved: when a leading bank acquired an activity, even banks who reacted swiftly might have taken a year to present their reaction, making it difficult in the sample to specify concentrations in time and place. On the other hand, distinguishing 5 different realized internationalization types for 44 banks could also be viewed as an interpretation of herding.

of their domestic banks, or the expansion of foreign banks in their home economy (with lower profitability ratios than the domestic banks).

*Interaction between regulation, bank strategy, financial systems and change.* The study touched upon the relationship between institutional change and banking strategy. The case studies emphasized the importance of the relationship between institutional change and change in bank strategy, while this finding could not be replicated in the empirical analysis. A reason could be that either the time dimension or aggregation level was too coarse (these limitations also applied to the failed support of herding as an incentive). In other words, the relationship between institutional change and (international) banking strategy could be expanded.

Also, the relationship between changes in financial systems and internationalization of banks has been addressed in this study but can be analyzed in more detail. Is there a causality observable; for example are banks with a high degree of internationalization catalysts for changes in the financial systems of their home countries?

Similarly, the impact of financial crises on internationalization strategies has been touched upon briefly in the study, but could be extended further. In generally, banks who retreated from internationalization were triggered by financial crises. However, the case studies also suggest that during financial crises some bank's loss has been another bank's gain: a considerable portion of mergers and acquisitions took place between the largest banks themselves. What specifically triggered changes in international bank strategies during crises? Also, what did banks "learn" from each financial crises and did they implement this incremental knowledge for their foreign bank activities as to become more resilient.

# **Appendices**



# Appendix A. TNI construction

## A.1 TNI construction

This appendix considers the construction of the TNI. This study applies three single item indicators, which can be combined in a composite index to analyze the degree of internationalization of a bank, the TNI. These indicators are 1) foreign assets to total assets ratio, 2) foreign gross income to total gross income ratio and 3) foreign employment to total employment ratio.

$$TNI = 100 \cdot \frac{1}{3} \cdot \left( \frac{FA}{TA} + \frac{FI}{TI} + \frac{FS}{TS} \right) \quad (1)$$

Where

FA: Foreign assets  
TA: Total assets  
FI: Foreign income  
TI: Total income  
FS: Foreign staff  
TS: Total staff

As discussed in chapter 3, the first internationalization indicator, foreign assets to total assets (FA/TA), can be classified by currency and residency, yielding the following 2-by-2 matrix (Bank for International Settlements, 2000, p. 17):

	Residents	Non-residents
Domestic currency	A	B
Foreign currency	D	C

with external or cross-border positions = B+C, foreign currency positions = D+C, international positions = B+C+D, and total positions = A+B+C+D (denoted as TOTAL). FA/TA is then defined as (B+C)/TOTAL. This implies a structural underestimation compared to the definition the BIS uses, (B+C+D)/TOTAL, since foreign currency held by residents (D) is then not accounted for. On the other hand, a simultaneous disclosure of all matrix cells would probably limit the number of usable financial information severely,

pleading for the use of  $(B+C)/TOTAL$  - assets of non-residents to total assets - as FA/TA ratio.

As one might deduce from the matrix above, banks can also only report the classification into domestic and foreign currency, which then serves as a second best alternative for FA/TA ratio. This ratio,  $(D+C)/TOTAL$  creates a potential error margin with the first ratio of  $[(D+C) - (B+C)]/TOTAL = (D-B)/(TOTAL)$ .

Other alternatives include using foreign loans versus total loans as a proxy for FA/TA. This proxy is also applied with the creation of the Global Top by the Banker, published each February. The approximation becomes more valid if the other items on the balance sheet of the bank are relatively minor (for example cash and due from banks, or securities/investments). In such a case, the publication of domestic interest earning assets versus foreign interest earning assets might be more useful, since this comprises not only loans but also cash and due from banks, or for example bonds. It still leaves out securities, which in the case of European banks might well be substantial. Also, it is only reported by American banks or European banks that have to comply with SEC filings.

Finally, in some cases a bottom up approach has to be used, aggregating assets reported to and published by regulators in foreign countries. The main advantage is the simultaneous release of regional data over a period for all banks in the sample. Disadvantage is that this might lead to an underestimation since not all assets might be reported:  $\alpha \cdot (B+C) / TOTAL$  where  $\alpha \leq 1$ . In conclusion, the variants to calculate the FA/TA ratio do not overestimate, but in some cases underestimate the foreign commitment. Combining these variants theoretically yields a correct estimation at best, and an underestimation is likely.

The second indicator for constructing the TNI is the foreign income tot total income ratio (FI/TI). Sullivan (1994) reviewed 17 studies on the degree of internationalization, finding that foreign income as a ratio of total income is a widely used measure for the degree of internationalization. In this study, the ratio of foreign gross income to total gross income is used. Gross income is here defined as the sum of net interest income and non-interest income, after expenses. This is in line with the OECD framework used in the Bank Profitability database.

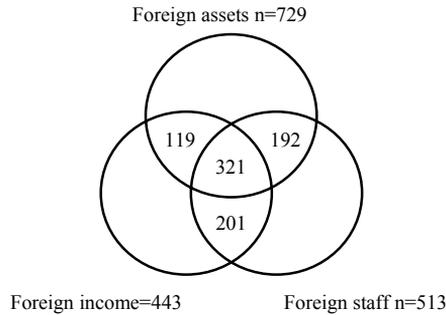
The third indicator for the TNI index is foreign staff to total staff (FS/TS). Wherever possible, the full time equivalent has been chosen. During most of the 1980s, such information has not been available for most banks.

## **A.2 Data availability**

Data for the creation of internationalization indicators has been collected from existing publications: annual reports, listings from the Banker Global Top reported assets by the Federal Reserve Board. From the outset it is not to be expected that all information needed is present and/or consistent. For 1990 to 2000 the following data availability is observed:

*Overlapping sets of internationalization indicators for sample between 1980-2000*

Total number of data n=729



An issue here is the missing values. The creation of a TNI with all three indicators amounts to 201 observations, substantially lower than the total number of observations (359). If the TNI based on 3 indicators would be used, information that is available, i.e. 2 out of 3 indicators might not be used. The following table shows the bivariate correlations between the indicators in the sample.

*Correlation between internationalization indicators and TNI*

		Foreign assets, % total	Foreign income, % total	Foreign staff, % total	TNI
Foreign assets, % total	Correlation N	1 729			
Foreign income, % total	Correlation N	.664 440	1 443		
Foreign staff, % total	Correlation N	.630 513	.796 321	1 513	
TNI	Correlation N	.869 729	.913 443	.912 513	1 732

Bivariate correlations, all correlations have p values < .01

Comparable averages, standard deviations and high correlations between the internationalization indicators suggest that creating a TNI based on two indicators might provide an adequate substitution where a TNI based on three indicators shows a missing value. A TNI based on the unweighted average of foreign assets and foreign gross income emulates the TNI best, the unweighted average of foreign staff and foreign gross income emulates the TNI to a lesser extent. This can be explained due to the fact that although the statistics of the indicators are comparable, gross income and assets have more closely aligned statistics.

So the TNI can be created for more observations using the available information to the best extent possible. Of the 729 TNI observations, 44% can be calculated with all 3 indicators available. An additional 43% is calculated by either a combination of foreign assets and foreign income, or foreign assets and foreign staff. This leaves 13% to be constructed with one TNI indicator, foreign assets. Foreign assets has been in generally widely publicized, either in secondary publications or in statistic reports, especially by the Federal Reserve. The 13% data with one TNI is concentrated in the early 1980s, especially with Japanese banks and European banks. For a large number of these European banks, the TNI when available with 2 or 3 measures from the mid 1980s remained relatively low, below 20%. This suggests that the margin of error for calculating TNI on one indicator before the mid 1980s has also remained relatively low. For Japanese banks, the margin of error is slightly higher. While a considerable degree of foreign assets and foreign staff was located in the United States (and thus subject to regulatory disclosure), the fluctuations in US dollar - Japanese Yen exchange rate since the mid 1980s had led to a somewhat more "unstable" pattern of TNI than for other countries in the sample. Additionally, mean and tendency characteristics of the TNI have been compared for the different TNI calculations. The general mean and tendency characteristics are not modified, validating the full use of TNI data.

### **A.3 Missing data and alternatives**

As was to expected beforehand, geographical segmentation was not always available, presented in a uniform manner, or presented for the key figures needed. Banks can report their information in different ways:

- By geographical origination or location.
- By business unit.
- A combination of both.

From 1995, a shift is visible in the annual reports to business unit, decreasing the geographical segmentation. This is not to say that purely geographical segmentation is preferable either. For example, American banks in the 1980s have reported categories like: "Western Hemisphere". Credit Suisse introduces "Financial Centres" while several banks make the distinction between "developing" and industrialized countries. These are difficult to classify, unless one makes additional assumptions.

In not all cases has data been available. Either it was not reported, or the reporting structure has changed, or the research did not result in finding the data needed. The latter is particularly the case with older annual reports, which are difficult to get by. For assets, three approaches were found. Wherever possible, the first approach has been applied. If not possible, the next approach was chosen and so forth:

- Reported assets at home and outside home.
- Reported risk weighted assets, at home and foreign.
- Reported loans at home and foreign.
- Reported assets in domestic and foreign currency.
- Reported loans in domestic and foreign currency.

For staff, two approaches were found:

- Foreign and domestic staff in bank *group*.
- Foreign and domestic staff in *main* bank within *group*.
- Staff of foreign consolidated companies in group as a proxy of foreign staff in bank group. This is a second best alternative, potentially leading to an underestimation of the real foreign staff of the bank. This concerns in particular the German and the French banks.

With regard to calculation of the foreign to total ratios, additional problems arise (see also Van den Berghe, 2003, pp. 320-321). Consider the following geographic income distribution:

Region	Income
Domestic	60
Region A	30
Region B	30
Elimination, intrasales	20
Total	140

A number of banks reported elimination items. For income, these could be securities bought in a London branch on behalf of a German bank's domestic client. If FI/TI is calculated without adjusting for eliminations, this would yield:

$$\frac{FI}{TI} = \frac{FI \text{ outside home country}}{\text{Total income}} = \frac{30 + 30 + 20}{140} = 57.1\% \quad (2)$$

However, there is no information available on the geographical segmentation of the eliminations, and calculated above implies that it has been fully classified as foreign

income. Therefore, it makes sense to adjust both numerator and denominator for the eliminations, and only calculate the ratio with allocated geographical information:

$$\frac{FI}{TI} = \frac{FI \text{ outside home country}}{\text{Total income excl. eliminations}} = \frac{30 + 30}{140 - 20} = 50\% \quad (3)$$

In other cases, banks reported combinations of regional/country information and business units:

Region	Income
Domestic	60
Region A	30
Region B	30
Investment banking	20
Total	140

Reported segments were in general named "investment banking", "international banking", "international corporate finance". As a rule of thumb, these activities have been classified as foreign activities based on the the description of activities in the annual reports and addition information from the case studies. In some cases, banks included business units which could not be classified as domestic or foreign, such as lease activities. In such cases, these business unit have remained unclassified, and have therefore been treated in the TNI calculation as "eliminations".

## B.2 Missing data

Although there have been a limited number of methods to deal with missing values, missing values have been treated on a case by case basis and not with available statistical estimation procedures. This assures that no averaging to the mean is introduced in the database. In general, the missing values which have been filled when the missing values caused large swings in TNI. On the other side, occasional data has been removed. For example, when only staff was reported for 1984, it might have caused a strong change for 1983-84, and 1984-85. Therefore, incidentally available data was left out. Filling missing values has been considered when they are part of a constant trend, either in absolute or relative terms. This implies that the change is continuous, mostly the case with autonomous growth. When large acquisitions or divestitures changed the trend, missing values have not been filled unless the change in assets, staff has been reported.

The records have been checked for outliers. In some cases they were related to the missing values, creating large swings in TNI. Major assumptions to deal with missing data are mentioned in appendix B, Data Sources.

# Appendix B. Data Sources

## B.1 Sources

"For obvious reasons, banks have to take greater care with the preservation of their records [...]. However, this does not mean that the historian has large numbers of bank archives at his disposal for his research" (Born, 1983, p. 323). Data has been collected from public sources, mainly:

- *Annual reports*. These have been consulted in Global Access (Thomson Research), mainly offering annual reports after 1990. For annual reports before 1990, two additional libraries were consulted: the annual reports library at the Erasmus University (Rotterdam), and the annual reports library of the Hamburg Welt Wirtschafts Archiv (Hamburg). For the annual reports not found through these sources, archives of the banks have been contacted directly.
- *SEC filings* for United States banks, or banks outside the United States but with an ADR status. The filings used were 10-K, 20-F and 6-F.
- *The listings of the Banker* "Global Top 50", published from 1992 have been consulted to verify where the aggregated regional data matches the percentages published by the Banker. In cases where no data could be found or collected data was not trustworthy, the Banker compilation has been used.

Other public sources provide internationalization data as well, for example the Worldscope database. These have not been used, due to reporting on a fragmentarily basis, and difficulties to match this data with the information published in annual reports. For specific countries secondary sources have been used:

- NIBE bankboekje, for Dutch banks, contains percentage staff of Dutch banks overseas
- Federal Reserve Structure Data Foreign Banks, lists reported assets of foreign banks in the United States.

Besides internationalization data, the key figures from the income statement and balance sheet have been collected as well. Although public sources exist for this type of data, especially from 1990 onwards, it was preferable to collect this data from the direct sources. First, coherent databases ranging before 1990 are scarce. Second, the income and balance sheet statement had to be reconciled with geographical information, warranting investigation into the annual reports anyhow. Third, checking the annual reports proved to

be the only way to check and control for the effects of mergers and acquisitions. Wherever possible, consolidated figures for income and balance sheet statements have been used. For Japanese banks between 1980 and 1985, in some cases only non-consolidated figures have been used. However, a comparison between consolidated and non-consolidated figures show that for Japanese banks, the difference is relatively small due to the centralized (international) organization structure of Japanese banks.

## B.2 Secondary sources for bank information.

This section describes secondary sources used for the case studies, and summarizes data remarks for calculation of the TNI. The Handbook on the History of European Bank (Pohl and Freitag, 1994) provides an exhaustive overview of the history of European banks. Augar (2000) is a useful source for foreign banks expanding their investment banking activities in London. Similarly, Roberts and Arnander (2001) provide a thorough review of consortium banks, with useful appendices to check linkages between banks. Rogers (1993) analyzed the largest American banks, and repeated this for British banks (Rogers, 1999). The case studies presented by Canals (1993, 1997) offers more insight into Spanish banks. In general, anniversary publications have been useful to check chronology of events. Deutsche Bank has published three studies, of which Gall et al. (1995) is by far the most comprehensive bank history in its field.

## B.3 Banks and their data sources

The following tables summarizes the major datasources used per bank, when primary sources (annual reports, SEC filings, Federal Reserve data) could not provide enough information. Major assumptions to deal with missing data are also mentioned, no claim is made to be exhaustive.

Bank	Adjustments , assumptions
ABN	<i>General:</i> in sample between 1980 and 1989. Succeeded by ABN Amro in 1990. <i>Secondary Sources:</i> de Vries et al (1998); De Leeuw, J. (1996, pp. 109-118), NIBE Bankenboekje (1990-)
ABN Amro	<i>General:</i> created in 1990, merger of ABN (1964) and Amro (1964). In sample between 1990 and 2000. <i>Secondary Sources:</i> de Vries et al (1998); De Leeuw, J. (1996, pp. 109-118), De Paula (2002). NIBE Bankenboekje (1990-) <i>Data:</i> Investment banking activities are considered foreign activities without regional classification, 1997-2000. ABN Amro Lease undefined (outside home/host calculations). Bouwfonds from 1999- classified as home.
Amro	<i>General:</i> in sample between 1980 and 1989. Succeeded by ABN Amro in 1990. <i>Secondary Sources:</i> de Vries et al (1998); De Leeuw, J. (1996, pp. 109-118), NIBE Bankenboekje (1990-). <i>Data:</i> assets reported from 1987 onwards. Before that, reported growth rates of

foreign loans in annual reported have been chainlinked to create proxy for foreign assets. Foreign income not available, foreign profitability available in 1987-89. Foreign staff from NIBE Bankenboekje.

- Argentaria *General:* created in 1991, merger of 7 state owned banks. In sample between 1991 and 1998. Acquired by BBV.  
*Secondary Sources:* Canals (1997, pp. 297-300).
- Banco Bilbao Vizcaya *General:* In sample between 1990 and 2000. After acquisition of Argentaria in 1999, name change to Banco Bilbao Vizcaya Argentaria (BBVA).  
*Secondary Sources:* De Paula (2002), Canals (1997, pp. 227-234), Pohl and Freitag (1994).  
*Data:* Assets in 1996 based on Banker Top 50 global banks, february 1998
- Banco Santander *General:* In sample between 1990 and 2000. Acquired Banco Central Hispano Americano, name change to BSCH. In 2000 name change to SCH.  
*Secondary Sources:* De Paula (2002), Pohl and Freitag (1994).  
*Data:* 20-F filing 1992, p12(assets). Assets 1990 Rest of World based on % average international assets
- Bank of America *General:* In sample between 1980 and 2000. Main mergers were Security Pacific (1992), and the acquisition by Nationsbank (1998).  
*Secondary Sources:* Hector, G. (1988); Johnston, M. (1990); Rogers, D. (1993), Canals (1997, pp. 88-89)  
*Data:* North America (international) 1980-1 classified as North America.
- Barclays *General:* In sample between 1980 and 2000.  
*Data:* Gross income 1980,81, 89, 90 based on regression estimates between percentage foreign assets and percentage foreign gross income 1980-2000. Stable relationship found. Due to several changes in organizational structure/reporting.  
*Secondary Sources:* Augar (2000), Rogers (1999, pp. 67-91), Vander Weyer (2000), Pohl and Freitag (1994).
- Bayerische Hypobank *General:* In sample between 1980 and 1997. Succeeded by HypoVereinsbank, as result of merger with Bayerische Vereinsbank.  
*Data:* TNI 1980-87: Based on average of assets 1980-87 reported in annual reports and staff figure in 1988 (1,11%), assumed stable before 1988..
- BNP *General:* In sample between 1980 and 2000. Acquired Paribas in 1999, Name change to BNP Paribas.  
*Data:* For 1980,81 assumptions made. Assets 1980,81 based on ratio assets United States/Assets Rest of World 1982-1986 (stable relationship). Staff 1980,81 estimated likewise.
- Chase Manhattan, JPMorgan Chase *General:* In sample between 1980 and 2000. Acquired by Chemical (1995), name Chemical dropped. After acquisition of J.P. Morgan in 2000 name change to J.P. MorganChase.  
*Secondary Sources:* Cattani and Tschoegl (2002); Rogers (1993, pp. 79-141); Wilson (1986), Canals (1997, pp. 85-88).  
*Data:* Staff 2000=estimate, based on correction for 1999 figures foreign staff Chase.
- Chemical Banking *General:* In sample between 1980 and 1995. Acquired Manufacturers Hanover (1991), acquired Chase Manhattan (1995), name change to Chase Manhattan.

	<p><i>Secondary Sources:</i> Rogers (1993).</p> <p><i>Data:</i> Data 1980-82: Foreign revenues as percentage of total revenues, taken from Dombrowski, 1996, p12. Foreign revenues taken as proxy for TNI (Assets and Income are closely aligned for American banks and Chemical after 1984. 1983: TNI, income average 1982, 1984. TNI 1994-95 lower due to availability staff figures.</p>
Citicorp	<p><i>General:</i> In sample between 1980 and 2000. In 1997 acquired by Travelers, bank name held, holding name changed to Citigroup.</p> <p><i>Secondary Sources:</i> Barnet and Cavanagh (1994). Rogers (1993, pp. 29-78); Van Cleveland and Huertas (1984); Zweig (1995), Canals (1997, pp. 92-95)</p>
Commerzbank	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Secondary Sources:</i> Krause, Schwerdtfeger and Gajo (1995) , Pohl and Freitag (1994).</p>
Crédit Agricole	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> TNI 1980-1992 based on assets. Assets 1980 based on assets United States + weighting other assets in 1993. TNI 1993 based on assets only, not staff due to staff series break 1994-95. Assets US extrapolated between 1992/95 using geometric average growth rate.</p>
Crédit Lyonnais	<p><i>General:</i> In sample between 1980 and 2000, during whole period state owned - no public listing.</p> <p><i>Secondary Sources:</i> Canals (1997, pp. 57-59) , Pohl and Freitag (1994).</p> <p><i>Data:</i> Break in staff figures between 1984 and 1985, significantly higher. No specific reason found, such as large foreign acquisition or change in reporting guideline.</p>
Dai Ichi Kangyo	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> TNI 1980,81 based on assets alone. Assets 1980,81 based on Assets United States (6,9%, 10,1%) and 22% other foreign assets, shown between 1983-86.</p>
Deutsche Bank	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> Break in TNI between 1990 and 1991 due to availability staff from 1990 onwards.</p> <p><i>Secondary Sources:</i> Augar (2000); Gall, Feldman, Holtfrerich and Büschgen (1995); Pohl (1999); Pohl and Freitag (1995).</p>
HSBC	<p><i>General:</i> In sample between 1991 and 2000, after acquiring Midland Bank.</p> <p><i>Data:</i> Data from 1990, from 1992 Midland Bank included, considered a UK bank.</p> <p><i>Secondary Sources:</i> Augar (2000); Jones (1993); Rogers (1999), De Paula (2002).</p>
Industrial Bank of Japan	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> Assets=differences loans and debentures issued in Japan compared to total loans (unconsolidated). Figures have been adjusted for a gap in 1995, adding 8%, and rescaled to total assets between 1980 and 1995.</p>
ING	<p><i>General:</i> In sample between 1991 and 2000. Successor of NMB.</p> <p><i>Secondary Sources:</i> De Leeuw (1996, pp. 126-132); Schreuder (1991).</p>
J.P. Morgan	<p><i>General:</i> In sample between 1980 and 2000. Acquired in 1999 by Chase Manhattan, name change to JPMorgan Chase.</p> <p><i>Secondary Sources:</i> Rogers (1993, pp. 193-239), Chernow (1990), Canals (1997, pp. 95-97).</p>

Lloyds	<p><i>General:</i> In sample between 1980 and 2000. After acquisition of TSB in 1995 name changed to Lloyds TSB.</p> <p><i>Secondary Sources:</i> Rogers (1999, pp. 42-66)</p>
Midland Bank	<p><i>General:</i> In sample between 1980 and 1991. Acquired by HSBC.</p> <p><i>Data:</i> Break in TNI between 1985 and 1986 due to availability staff from 1990 onwards</p> <p><i>Secondary Sources:</i> Augar (2000); Jones (1993), Rogers (1999, pp. 170-196) , Pohl and Freitag (1994).</p>
Mitsubishi	<p><i>General:</i> In sample between 1980 and 1995. Merged with Bank of Tokyo to form Bank of Tokyo-Mitsubishi.</p> <p><i>Data:</i> Assets 1980: % assets ROW in 1981 (20%) added to assets United States 1980 (11,38%). TNI 1980-1983: based on assets alone.</p>
National Westminster	<p><i>General:</i> In sample between 1980 and 2000. Acquired by Royal Bank of Scotland.</p> <p><i>Data:</i> % Foreign staff based on regression estimate between % foreign assets, % foreign staff 1980-2000. Figures for 2000 taken from 20-F filing, as a subsidiary from Royal Bank of Scotland.</p> <p><i>Secondary Sources:</i> Augar (2000); Jones (1993), Rogers (1999, pp. 120-146) , Pohl and Freitag (1994).</p>
NMB	<p><i>General:</i> In sample between 1980 and 1990. Succeeded by ING Bank</p> <p><i>Data:</i> %Foreign assets 1980-1987 based on %foreign/domestic loans. Foreign staff: NIBE Bankenboekje.</p>
Paribas	<p><i>General:</i> In sample between 1980 and 1998. Acquired by BNP.</p> <p><i>Secondary Sources:</i> Bussière (1992) , Pohl and Freitag (1994)</p> <p><i>Data:</i> 1980-87: TNI calculated as (Assets/3) + (Staff 1988+Income1988)/3, adjusting for the non availability of staff and income between 1980-87.</p>
Rabobank	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Secondary Sources:</i> De Boer and Graafsma (2002); De Leeuw (1996, pp. 132-144); Sluyterman Dankers, v.d. Linden and Luiten van Zanden (1998).</p> <p><i>Data:</i> Assets 1981-1983: Based on assets United States, adjusted for ratio United States / Rest of World for 1984-1986 (stable relationship assumed). Growth rates claims to foreign residents in NLG (OECD Bank statements) NLG used as proxy total foreign assets between 1984-1987 rebased at 1987, the first available proxy for foreign assets. Staff 1981 onwards available from NIBE Bankenboekje.</p>
Société Générale	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> Gross income estimate, extrapolation % gross income 1984-1987. Assets United States extrapolated between 1992/95 using geometric average growth rate. Assets 1980-1982: % Assets United States + Average % Assets Rest of World between 1983-86 (49%). Gross income 1980-81: Five year average 1982-1986.</p>
Standard Chartered	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Secondary Sources:</i> Jones, G. (1993)</p>
Sumitomo	<p><i>General:</i> In sample between 1980 and 2000.</p> <p><i>Data:</i> Staff based on extrapolation ratio % foreign assets / % foreign staff between 1990 and 1996. TNI based on assets and gross income, due to large leaps in staff availability. TNI 1980-1985 based on assets. Assets 1980: % Assets United States +</p>

Average assets Rest of World 1981-82 (30%).

Swiss Bank  
Corporation

*General:* In sample between 1980 and 1997. Merged with UBS.  
*Data:* Gross income based on average ratio % foreign assets / % foreign income between 1993 and 1996  
*Secondary Sources:* Augar (2000); Schütz (2000), Pohl and Freitag (1994).

Tokyo

*General:* In sample between 1980 and 1995. Merged with Mitsubishi Bank to form Bank of Tokyo-Mitsubishi.  
*Data:* TNI 1980-1992 based on Assets

UBS

*General:* In sample between 1980 and 2000. Merged with SBC.  
*Secondary Sources:* Schütz (2000).

Vereinsbank

*General:* In sample between 1980 and 1997. Succeeded by HypoVereinsbank, as result of merger with Bayerische Hypobank.  
*Secondary Sources:* Pohl and Freitag (1994)  
*Data:* TNI 1980-1993 based on Assets. Income for 1993 available, but unavailability Staff compared to 1994 causes leap in TNI.

WestDeutsche  
Landesbank

*General:* In sample between 1980 and 2000.  
*Secondary Sources:* Sinn (1999), Pohl and Freitag (1994).  
*Data:* TNI 1980-86 bases on average Assets and Staff in 1987.

## Appendix C. Selected activities between banks in sample

Year	Bank	Sell to/ purchase from	Bank	Description
1986	Deutsche Bank	Purchase	BankAmerica	The 99-branch Italian retail banking subsidiary, Banca d'America d'Italia (BAI).
1988	BNP	Purchase	Chemical Banking	The UK mortgage subsidiary of Chemical Bank.
1990	Barclays	Purchase	HSBC	The international private banking business of Marine Midland, the US subsidiary of HSBC.
1990	HSBC	Purchase	Lloyds	Loss making subsidiary of Lloyds Bank Canada.
1990	Rabobank	Sale	National Westminster	40% stake in F van Lanschot Bankiers, the Dutch merchant bank
1991	ABN Amro	Purchase	Chemical Banking	Seoul office of Chemical Bank.
1991	SBC	Purchase	Midland	Dominguez Barry Samuel Montagu, Australian merchant banking business
1991	UBS	Purchase	Chase Manhattan	Institutional asset management business, USD 30 bln under assets
1992	ABN Amro	Purchase	BankAmerica	Hoare Govett from America's Security Pacific Bank, put up for sale after merger with Bank of America
1993	Commerzbank	Purchase	Paribas	Caisse Centrale de Reescompte, a leading fund manager.
1993	Commerzbank	Purchase	Crédit Lyonnais	35% stake in Commerzbank-Credit-Bank, a joint venture founded in 1974.
1993	Crédit Lyonnais	Purchase	Chase Manhattan	Austrian unit of Chase Manhattan Bank.
1995	Crédit Lyonnais	Sale	Dresdner	Chilean subsidiary, Deutsche-Sudamerikanische Bank.
1995	National Westminster	Sale	Lloyds	Global custody business to Lloyds Bank. Some GBP 57 bln in assets will be transferred.
1995	Rabobank	Purchase	SBC	Dutch subsidiary, primarily active in sales and trading in Dutch securities.
1996	ABN Amro	Sale	Fortis	MeesPierson, Dutch merchant bank.
1996	Dresdner	Purchase	Crédit Lyonnais	BNP and Dresdner Bank buy Crédit Lyonnais' 55% stake in Chilean brokerage Crédit Lyonnais Valores.
1997	ABN Amro	Purchase	Citicorp	Citicorp's global futures trading business.

1997	ABN Amro	Purchase	Barclays	BZW Australian investment banking arm of Barclays.
1997	Barclays	Sale	Credit Suisse	The UK and continental European equities businesses of BZW.
1997	Credit Suisse	Purchase	Barclays	Parts of BZW Asia, the regional investment-banking arm of Barclays .
1997	Dresdner	Purchase	Vereinsbank	Direct banking activities, Advance Bank, as a result of Bayerische' planned merger with Hypo.
1997	Paribas	Sale	Société Générale	Retail banking network Credit du Nord
1997	UBS	Purchase	Lloyds TSB	German based Schroeder Muenchmeyer Hengst, asset management and private banking
1998	Deutsche Bank	Purchase	Crédit Lyonnais	Belgian subsidiary.
1998	Dresdner	Purchase	Crédit Lyonnais	Crédit Lyonnais's subsidiary in Stockholm.
1999	ABN Amro	Purchase	BankAmerica	Consumer banking business of BankAmerica in India, Singapore and Taiwan.
1999	ING	Purchase	UBS	Part of New York based activities, specialized in cash management and treasury activities.

## Appendix D. Key ratios bank sample

Ratio	Period	France		Germany		Spain		Switzer-land		United Kingdom		Nether-lands		United States		Japan	
		Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N
Net interest income, % total assets	1981-85	2.37	20	1.53	30	a.		0.87	15	3.05	24	2.17	20	2.53	29	1.22	19
	1986-90	1.99	24	1.48	30	a.		0.98	15	3.11	25	1.99	20	2.89	30	0.87	24
	1991-95	1.75	25	1.34	30	2.57	19	1.15	15	2.66	25	2.31	20	2.99	25	1.06	25
	1996-00	1.29	23	0.94	27	2.31	17	0.71	12	2.41	25	1.81	20	2.50	19	0.99	20
Non interest income, % total assets	1981-85	0.88	20	0.78	30	a.		1.53	15	1.44	24	0.70	20	1.11	29	0.36	18
	1986-90	0.90	23	0.81	30	a.		1.62	15	1.92	25	0.83	20	2.14	30	0.62	24
	1991-95	1.12	25	0.86	30	1.36	19	2.12	15	2.09	25	1.26	20	2.58	25	0.57	25
	1996-00	1.40	23	0.96	27	1.48	17	2.07	12	1.80	25	1.32	20	2.70	19	0.79	20
Gross income, % total assets	1981-85	3.25	22	2.31	30	a.		2.40	15	4.50	24	2.88	20	3.64	29	1.61	18
	1986-90	3.18	24	2.30	30	a.		2.61	15	5.03	25	2.91	20	5.04	30	1.50	24
	1991-95	2.87	25	2.21	30	3.92	19	3.27	15	4.75	25	3.68	20	5.58	25	1.64	25
	1996-00	2.72	23	1.91	27	3.79	17	3.02	12	4.25	25	3.12	20	5.20	19	1.78	20
Operating expenses, % total assets	1981-85	2.27	22	1.40	30	a.		1.34	15	3.08	24	1.84	20	2.42	29	0.80	18
	1986-90	2.15	24	1.45	30	a.		1.51	15	3.34	25	1.88	20	3.43	30	0.78	24
	1991-95	1.99	25	1.46	30	2.14	19	2.07	15	3.06	25	2.66	20	3.61	25	0.99	25
	1996-00	1.86	23	1.30	27	2.24	17	2.10	12	2.47	25	2.24	20	3.16	19	1.07	20
Net income, % total assets	1981-85	0.99	22	0.91	30	a.		1.06	15	1.42	24	1.04	20	1.22	29	0.81	18
	1986-90	1.03	24	0.85	30	a.		1.10	15	1.69	25	1.03	20	1.61	30	0.71	24
	1991-95	0.88	25	0.75	30	1.78	19	1.20	15	1.69	25	1.02	20	1.96	25	0.65	25
	1996-00	0.86	23	0.61	27	1.54	17	0.91	12	1.78	25	0.88	20	2.03	19	0.71	20
Total provisions, % total assets	1981-85	0.59	22	0.49	30	a.		0.42	15	0.52	24	0.60	20	0.44	29	0.32	18
	1986-90	0.55	24	0.34	30	a.		0.49	15	1.15	25	0.40	20	1.19	30	0.17	24
	1991-95	0.62	25	0.32	30	0.82	19	0.54	15	0.74	25	0.28	20	0.62	25	0.46	25
	1996-00	0.36	23	0.23	27	0.61	17	0.58	12	0.33	25	0.17	20	0.45	19	0.96	20
Profit before tax, % total assets	1981-85	0.40	23	0.42	30	a.		0.65	15	0.91	25	0.43	20	0.77	30	0.47	25
	1986-90	0.50	25	0.50	30	a.		0.60	15	0.53	28	0.63	20	0.42	30	0.53	25
	1991-95	0.26	25	0.42	30	0.98	20	0.66	15	0.93	26	0.74	20	1.35	25	0.18	25
	1996-00	0.50	23	0.38	27	0.93	17	0.33	12	1.45	25	0.71	20	1.58	19	(0.25)	20
Profit before tax, % capital and reserves	1981-85	18.96	23	15.67	30	a.		11.63	15	19.26	25	9.89	20	17.93	30	21.51	25
	1986-90	15.57	25	16.08	30	a.		9.96	15	9.39	27	10.41	20	7.06	30	21.33	25
	1991-95	5.79	25	13.28	30	17.33	20	11.27	15	19.17	26	12.13	20	19.58	25	5.05	25
	1996-00	12.22	23	13.59	27	16.46	17	7.75	12	25.50	25	13.33	20	23.59	19	(7.62)	20
Capital and reserves, % total assets	1981-85	2.56	25	2.69	30	a.		5.61	15	4.66	30	4.27	20	4.30	30	2.24	25
	1986-90	3.33	25	3.07	30	a.		6.03	15	4.94	29	5.83	20	4.87	30	2.57	25
	1991-95	4.30	25	3.21	30	5.59	20	6.02	15	4.76	26	6.09	20	6.70	25	3.66	25
	1996-00	4.13	23	2.81	27	5.67	17	3.95	12	5.96	25	5.64	20	6.62	19	3.60	20

Note a: Spanish banks between 1980 and 1989 not included in sample. Mean is calculated as unweighted average.

Ratio	Period	France		Germany		Spain		Switzer-land		United Kingdom		Nether-lands		United States		Japan	
		Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean	N
Non interest income, % gross income	1981-85	26.55	20	32.09	30	a.		63.58	15	31.99	24	24.94	20	30.29	29	23.66	18
	1986-90	28.93	23	33.26	30	a.		62.26	15	38.08	25	28.73	20	43.00	30	41.93	24
	1991-95	40.37	25	41.43	30	34.30	19	64.52	15	44.02	25	32.87	20	47.31	25	32.40	25
	1996-00	52.10	23	48.35	27	37.94	17	68.76	12	42.76	25	41.82	20	54.95	19	43.17	20
Operating expenses, % gross income	1981-85	69.57	22	60.00	30	a.		55.93	15	68.50	24	64.00	20	65.69	29	52.31	18
	1986-90	67.73	24	62.40	30	a.		57.93	15	66.33	25	65.04	20	67.71	30	52.27	24
	1991-95	70.02	25	66.72	30	54.74	19	63.94	15	64.33	25	71.04	20	64.75	25	60.65	25
	1996-00	68.17	23	67.28	27	59.63	17	69.91	12	59.10	25	71.62	20	61.66	19	60.50	20

Note a: Spanish banks between 1980 and 1989 not included in sample. Mean is calculated as unweighted average.

# Appendix E. Difference foreign and domestic profitability

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
France																					
Agricole	na	na	na	1.37	0.36	0.01	-0.31	-0.39	na	na	-0.59	-0.39									
BNP	na	na	-0.34	-0.39	-0.43	-0.47	-0.62	-0.51	-0.41	-0.31	-0.13	-0.16	-0.06	-0.04	0.06	0.15	-0.04	0.06	-0.02	-0.04	-0.93
Credit Lyonnais	na	na	na	0.21	0.02	-0.09	na	-0.37	-0.47	-0.23	-0.12	0.12	0.00	-0.22	-0.45	0.12	0.06	-0.03	0.02	0.13	0.17
Paribas	na	na	na	na	na	na	na	na	na	na	na	na									
Societe Generale	na	na	na	-0.30	-0.50	na	na	-0.86	-0.94	-0.68	-0.39	-0.47	-0.36	0.15	0.02	-0.32	-0.17	0.15	-0.48	-0.72	-1.02
Germany																					
Bay Hypobank	na	na	na	na	na	na	na	na	na	na	na	na									
Commerzbank	na	na	na	na	na	na	0.55	0.62	-0.51	0.17	0.27	-0.35									
Deutsche Bank	na	na	na	na	na	na	na	na	na	na	na	na									
Dresdner Bank	na	na	na	na	na	na	na	na	-0.45	-0.32	-0.53	-0.73									
HypoVereinsbank	na	na	na	na	na	na	na	na	na	-0.32	0.44	-0.07									
Vereinsbank	na	na	na	0.23	0.06	-0.05	-0.02	0.05	-0.13	na	na	na									
WestLB	na	na	na	na	na	na	na	na	na	na	na	na									
Spain																					
Argentaria	na	na	na	na	na	na	na	na	na	na	na	na									
BBV	na	na	na	na	na	na	na	na	na	na	na	na									
BCH	na	na	na	na	na	na	na	na	na	na	na	na									
Santander	na	na	na	na	na	na	na	na	na	na	na	na									
Switzerland																					
Credit Suisse	na	na	na	na	na	na	-0.73	0.50	-0.27	-1.66	-1.25	-1.59									
SBC	na	na	na	na	na	na	na	na	na	na	na	na									
UBS	na	na	na	na	na	na	na	na	na	na	na	na									
UK																					
Barclays	-1.45	-1.00	-1.41	-0.96	-1.70	-1.05	-0.92	-3.02	-1.18	-3.33	-0.59	-0.80	0.13	-2.28	-0.27	-0.49	-0.28	-0.07	-0.68	-0.22	-0.54
HSBC	na	na	na	0.95	0.66	0.70	0.46	0.75	0.04	-0.13	-0.28	0.38									
LloydsTSB	-1.00	-0.59	-0.31	-0.21	-0.67	-0.98	-1.23	-8.07	-1.79	-10.96	1.41	0.85	0.94	1.07	-0.05	-0.27	0.00	-0.06	-1.01	-0.53	0.04
Midland	0.40	-0.46	-0.96	-1.58	-1.79	-2.42	-1.28	-5.66	-1.03	0.59	2.10	0.89	na								
National Westminster	-0.50	-0.78	-0.58	-0.49	-1.08	-1.25	-1.46	-3.13	-1.44	-1.82	-0.56	0.00	0.46	0.20	-0.11	-0.46	-0.45	-0.96	-0.79	-0.22	-1.04
Standard Chartered	2.50	1.21	1.05	-0.18	0.31	-0.24	-0.01	0.66	0.42	-0.03	0.66	1.79	4.57	2.03	0.71	0.72	0.30	1.43	1.28	0.94	0.98
Netherlands																					
ABN	0.33	0.24	0.25	0.05	0.08	0.03	-0.10	0.73	0.01	0.15	na										
ABN/Amro	na	0.04	-0.24	-0.12	-0.06	0.09	-0.09	-0.19	-0.63	-0.60	-0.61	-0.07									
Amro	na	na	na	na	na	na	na	na	na	na	na	na									
Fortis	na	na	na	na	na	na	na	na	2.77	2.61	0.80	1.08									
ING (bank)	na	na	na	0.21	-0.21	-0.19	-0.10	-0.13	-0.44	-0.88	-0.27	-0.63									
NMB Bank	na	na	na	na	na	na	na	na	na	na	na	na									
Rabobank	na	na	na	na	na	na	na	na	na	na	na	na									
USA																					
Bank of America	0.43	0.80	0.65	0.32	0.21	-1.32	2.85	1.43	-3.38	-4.97	-2.48	1.79	1.64	0.92	-0.13	-0.91	-0.45	-2.07	na	na	na
Chase Manhattan	-0.04	0.33	0.46	-0.64	-0.81	-0.27	-0.77	-6.31	-0.93	-3.50	1.49	0.35	1.58	5.27	0.75	-0.06	0.09	-0.27	-0.36	-0.79	1.69
Chemical Banking	na	na	na	na	0.07	-0.11	-0.12	-6.23	3.40	-5.59	-0.59	0.58	0.44	1.60	0.30	-0.46	na	na	na	na	na
Citicorp	0.01	-0.08	0.74	0.33	0.40	0.36	0.34	-4.45	0.30	-0.92	0.50	-1.97	2.77	2.02	0.29	-0.20	-0.41	0.13	0.72	-0.08	0.91
JPMorgan	0.88	1.56	1.80	1.02	1.41	1.08	1.03	-2.01	1.37	-4.67	0.95	1.83	2.54	2.27	-0.09	0.50	0.45	0.09	0.22	0.95	na
Manufacturers Han.	0.06	0.24	0.30	0.41	-0.14	na	0.49	-6.53	1.22	-4.73	-0.16	na									
Japan																					
Dai Ichi Kangyo	na	na	na	na	na	0.22	0.45	1.71	0.90	1.97	0.39	0.62									
IBJ	na	na	na	na	na	0.07	0.56	0.11	0.25	0.21	-0.02	-0.04									
Mitsubishi Bank	na	-0.76	-1.00	-0.67	-0.65	-1.13	-0.47	0.00	0.29	0.27	na	na	na	na	na						
Sumitomo Bank	na	na	na	na	na	na	na	na	1.36	1.26	1.02	1.27									
Tokyo-Mitsubishi	na	na	na	na	na	na	na	0.37	1.98	2.38	1.31	2.05									
Tokyo	na	na	na	na	na	na	na	na	na	na	na	na									
Mean	0.15	0.13	0.14	-0.17	-0.31	-0.52	-0.14	-2.82	-0.36	-2.61	0.09	0.23	0.93	0.77	0.11	-0.03	0.24	0.13	0.08	0.02	0.08
Standard deviation	1.03	0.82	0.90	0.65	0.83	0.89	1.17	3.04	1.53	3.06	1.09	1.10	1.31	1.55	0.32	0.45	0.75	0.99	0.99	0.69	0.95
Minimum	-1.45	-1.00	-1.41	-1.58	-1.79	-2.42	-1.46	-8.07	-3.38	-10.96	-2.48	-1.97	-0.47	-2.28	-0.45	-0.91	-0.45	-2.07	-1.66	-1.25	-1.59
Maximum	2.50	1.56	1.80	1.02	1.41	1.08	2.85	1.43	3.40	0.59	2.10	1.83	4.57	5.27	0.75	0.72	2.77	2.61	2.38	1.31	2.05
N	11	11	12	14	15	13	13	16	16	16	16	15	18	18	20	22	22	23	22	23	22
N<0	4	5	5	8	8	10	9	13	10	14	9	6	4	6	8	13	9	12	12	14	12

Source: own calculations, based on annual reports and other sources. Na: not available

## Appendix F. Data variables and sources

Variable description	Used in chapter/analysis	Source
FDI outflow, million US dollar	Chapter 20, HYP20.1, client hypothesis	<i>Calculation:</i> FDI Outflow / GDP. <i>Source:</i> OECD, Foreign direct investment
Exports of goods, balance of payments basis, \$US	Chapter 20, HYP20.1, client hypothesis	<i>Calculation:</i> Exports / GDP. <i>Source:</i> Economic Outlook No 72: Annual and Semiannual data
Net interest margin	Chapter 20, HYP20.2, spreads	<i>Calculation:</i> Net interest income / total assets (EOY). <i>Source:</i> Annual reports. The OECD Bank profitability format and definitions for income statement and balance sheets have been applied.
GDP, Value, mln local currency.	Chapter 20, HYP20.3, economic structure Chapter 20, HYP20.4, Small home market	<i>Source:</i> Economic Outlook No 72: Annual and Semiannual data. Euro countries prior to 1999 recalculated to local currency
Total population, year end, million	Chapter 20, HYP20.3, economic structure	<i>Source:</i> Economic Outlook No 72: Annual and Semiannual data
Total banking assets, million US dollar		<i>Source:</i> OECD Bank profitability, "all banks" for Germany (1980-2000), Netherlands (1980-2000), Switzerland (1980-2000), Spain (1980-2000), Japan (1989-2000). For the United States, total assets are defined as large commercial banks + commercial banks + saving banks. United Kingdom: Bank of England, broadest measure of banking assets in the United Kingdom. <i>Missing data:</i> France (1980-1985), Japan (1980-1989), United States (1980-1984). As a proxy, the weighted asset growth of the banks in the country in the Banker Top 500 has been calculated. The growth rate has then been chainlinked to the first available banking assets figure to calculate banking assets. Bank profitability, all banks

Variable description	Used in chapter/analysis	Source
C3 ratio, total banking assets	Chapter 20, HYP20.4, Small home market	<i>Calculation:</i> Total assets of largest three banks, divided by total banking assets. Source three largest banks: The Banker Top 1000, with V11 (denominator). The C3 ratio used by Goldberg and Rai (1996); more common is the C5 ratio. However, 3 is the smallest amount of banks in a country throughout the period of analysis; therefore the C3 ratio is best interpretable for the sample.
Size of the stock market	Chapter 20, HYP20.5, Financial development	<i>Calculation:</i> 1- (domestic Market value of Stockmarket / World market value of Stockmarket). <i>Source:</i> Datastream
Non interest income	Chapter 20, HYP20.5, Financial development	<i>Calculation:</i> Non interest income / Gross income <i>Source:</i> annual reports
Banking assets	Chapter 20, HYP20.5, Financial development	<i>Calculation:</i> Total Banking assets / GDP <i>Source:</i> see sources for GDP, Total banking assets
Cost to income ratio	Chapter 20, HYP20.9, Efficiency	<i>Calculation:</i> operating expenses / gross income. <i>Source:</i> annual reports.
Profitability	Chapter 20, HYP20.10, Profitability	<i>Calculation:</i> profit before tax / capital and reserves. Profit before tax has been calculated based on the OECD framework; there are no extra ordinary charges or gains added or subtracted after profit before
Capitalization	Chapter 20, HYP20.11, Capitalization	<i>Calculation:</i> Capital and reserves / total assets.
Shareholder return	Chapter 22, relationship shareholder return and internationalization.	<i>Calculation:</i> All measures have been calculated geometrically: for example, TSR2 has been calculated as $((1+r) / (1+b)) - 1$ . For some banks the total return index could not be retrieved from Datastream. Citicorop (1980-1989), SBC (1985-1989) and Chemical Banking have been derived from Bloomberg financial systems. Fortis has had two major listings, in the Netherlands and in Belgium (1990-2000). The total return weighted by market value has been used as a proxy for a single Fortis share; market values of both countries have been combined.
PE ratio	Chapter 22, HYP22.1 and HYP22.2, relationship shareholder return and internationalization.	<i>Calculation:</i> Total market value / total profit before tax. Profit before tax instead of net income has been chosen, to alleviate taxation differences between countries.
Yield curve differential	Chapter 22, HYP22.1 and HYP22.2, relationship shareholder return and internationalization.	<i>Calculation:</i> Long term interest rate -/- short term interest rate.

Variable description	Used in chapter/analysis	Source
Provisions	Chapter 22, HYP22.1 and HYP22.2, relationship shareholder return and internationalization.	<i>Calculation:</i> Total provisions / Total assets. Total provisions=loan provisions + extraordinary charges and gains.
Change in asset position	Chapter 22, HYP22.1 and HYP22.2, relationship shareholder return and internationalization.	<i>Source:</i> Bank profitability, commercial banks
Foreign exchange rate major currencies	Chapter 8, general developments.	<i>Source:</i> Datastream
Total financial assets institutional investors, million US dollar		<p><i>Calculation:</i> Financial assets of institutional investors. Vol 2002 release 01. Data 2000 preliminary. Table S.1. Financial Assets of Institutional Investors in billion US Dollars. Total financial assets = Assets Insurance companies + Assets Pension funds + Assets Investment companies + Assets Other forms of institutional investment.</p> <p><i>Missing data.</i> For Switzerland, pension assets were reported for every other year. For the missing years in between, the average of the year before and the year after was calculated.</p>

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# Summary

This study examines the internationalization strategies of the world's largest banks originating in eight countries between 1980 and 2000. These banks have dominated the internationalization of banking to a large extent. Three issues are addressed: what incentives did banks have to internationalize, what patterns did internationalizing banks show, and has internationalization been effective in terms of bank performance and shareholder return.

Internationalization strategies of banks have drawn attention from several authors; the added value of this study lies in its scope and breadth. The length of the period researched provides more, deeper and dynamic insights in the internationalization patterns. By choosing the 44 largest banks of 8 countries, the study encompasses all major bank developments. Finally, a database for the degree of internationalization was constructed to systematically investigate claims to internationalize as well as its resulting performance.

The study is organized in three parts: (I) concepts, (II) patterns and (III) effectiveness. In Part I a literature review is presented, discussing the theoretical framework for internationalization activities of banks and the incentives to internationalize. Literature has produced a number of incentives; international financial intermediation theories apply especially to banks, while international business theories have been mainly developed and extended to banks. The incentives were clustered in three groups: *Extrinsic* (institutional), *Bank intrinsic* (company internal), and *Sector intrinsic* (mixed) incentives.

## **Patterns of internationalization**

In Part II the development of internationalization activities is analyzed. For 44 banks, case studies of their actual internationalization strategies are presented. These banks have been (and still are) among the 100 largest banks in the world, covering for example more than 48% of total assets for the Top 100 banks between 1980 and 2000. Banks from other countries, for example emerging countries, have been left out but this has hardly any effect on the representativeness of the sample. Size and internationalization have been mainly reserved to OECD countries.

The internationalization patterns of the bank's case studies are assessed by calculating the TNI (Trans Nationality Index) as the measure of the degree of internationalization of banks. The index is calculated as an unweighted average of foreign assets to total assets ratio, foreign gross income to total gross income ratio and foreign employment to total employment ratio. For the sample as a whole, the average TNI in the 1980s remained between 28 and 30%. There were distinctive underlying dynamics during this period; Japanese and European banks increased their TNI while American and British banks decreased theirs. From 1990, the overall TNI of the largest banks increased to almost 40% in 2000, mainly the result of accelerated internationalization activities of European banks. Five different realized internationalization strategies could be identified each represented by sufficient cases: banks who maintained a high degree of internationalization (*established*); banks who retreated from internationalization (*retreating*); *moderately* internationalizing banks increased their internationalization activities steadily; *accelerating* banks increased their internationalization with large acquisitions; banks with an *imploding* internationalization cycle showed fast international expansion as well as retreat periods.

### **Effectiveness of internationalization**

In Part III the questions are addressed what the incentives are for internationalization, and whether internationalization of banks has been effective in terms of performance for the bank and for its shareholders. The study established a relationship between the degree of internationalization of banks and particular incentives to internationalize, such as exports, profitability, market power and capitalization. Extrinsic incentives showed mixed results. Export as a client incentive to internationalize had explanatory power in the 1990s but not in the 1980s. No relationship with foreign direct investments was found. Net interest margins were a determining factor to internationalize in the 1980s, shifting towards fee income in the 1990s.

Financial development was found to be positively related to the degree of internationalization for continental European banks, but negatively related for banks of the United States, Japan, and the United Kingdom, the countries with the world's largest financial centers and securities markets. Market power and herding, sector intrinsic incentives, also had the explanatory power and expected signs. A higher degree of market concentration was positively related to the degree of internationalization and; furthermore individual banks tended to be sensitive to the overall degree of internationalization, an indication of herding. Bank intrinsic incentives to internationalize - profitability, capitalization and efficiency - also explained the degree of internationalization.

Next, relationships between the degree of internationalization, domestic and foreign performance indicators, shareholder return and realized internationalization strategies were investigated. The banks in the sample showed lower profitability on foreign banking activities than on domestic banking activities. They also reported a decrease in total profitability when their degree of internationalization was higher, as well as a higher variability of profitability. If banks had intended to increase their profitability by serving

new foreign banking markets and clients, or profit from geographical diversification, then on average they seem not to have succeeded.

The degree of internationalization or changes in the degree of internationalization has had no influence on shareholder return, in contrast to performance. However, shareholders valued *large* foreign acquisitions and foreign divestitures differently. Large changes in the degree of internationalization led to additional shareholder return. While with a decrease in TNI additional shareholder return increased over time, with an increase in TNI additional shareholder return decreased over time. The return-risk ratio improved most with large decreases in the degree of internationalization. Shareholders also attached different valuations for changes in the banks' realized internationalization strategies. *Retreating* and *established* banks generated the highest total shareholder return, whether this is measured in absolute returns or adjusted for country averages. These groups include relatively many American and British banks. *Moderate* and *accelerating* banks would have generated the least returns, in spite of *accelerating* banks having attracted relatively large amounts of capital to fund their activities.

Finally, the existence of a home bias was found in the study. Domestic financial ratios were more stable than foreign ratios, an indication of more stable domestic than foreign banking activities. Major changes in internationalization activities were examined, the number of major changes increased in the 1990s. Five years accounted for half the major changes in internationalization activities between 1980 and 2000, indicating that major changes are concentrated in time and interrelated over borders. This is to some extent supportive of herding among the banks. Finally, international banking activities were broken down into different geographic regions. European banks expanded in the European region and the United States, especially between 1996 and 2000. American and Japanese banks were less active in their geographic home region, indicating that regionalization is a specific phenomenon for European banks.

### **Implications and further research**

An implication of this study is that it is not likely that all banks that substantially expanded their foreign bank activities (*Accelerating*) in the 1980s and 1990s, will maintain their high degree of internationalization in the near future. Future domestic deregulation and absence of stable sources of foreign income will probably prompt a reorientation of foreign bank activities for at least half of the number of *Accelerating* banks.

Possible avenues for further research might be to see whether the observed relationships in this study can be replicated in a broader setting and whether more in depth knowledge can be acquired on the relationship between the internationalization of firms, banks and their regulators.



# Dutch Summary/Samenvatting

Deze studie analyseert internationalisatie strategieën van de grootste banken ter wereld tussen 1980 en 2000. De meeste van deze banken behoren tot de 100 grootste banken ter wereld, en hebben de internationalisatie activiteiten wereldwijd gedomineerd. In totaal worden 44 banken uit 8 landen onderzocht. Drie vragen worden gesteld: wat zijn de motieven geweest voor de banken om naar het buitenland te gaan, hoe zijn de banken geïnternationaliseerd, en is de internationalisatie effectief geweest voor het rendement van de bank maar ook voor haar aandeelhouders.

Internationalisatie strategieën van banken zijn door meerdere auteurs onderzocht. De toegevoegde waarde van deze studie is dat internationalisatie over een lange periode wordt geanalyseerd waardoor nieuwe inzichten in de internationalisatie patronen worden verkregen. Door banken uit verschillende landen te onderzoeken, omvat deze studie ook de belangrijkste internationalisatie ontwikkelingen van de afgelopen twee decennia. Tenslotte, de analyses in deze studie zijn ontwikkeld met een zelf ontwikkelde internationalisatie database voor banken, waardoor systematisch onderzoek naar zowel motieven als effectiviteit voor internationalisatie mogelijk is.

Het proefschrift bestaat uit drie delen: (I) Raamwerk (*Concepts*), (II) Patronen (*Patterns*) en (III) Effectiviteit (*Effectiveness*). In deel I wordt een literatuur overzicht en theoretisch raamwerk gepresenteerd voor motieven van banken om te internationaliseren. Dit is een combinatie van theorieën over internationale financiële intermediatie, en algemene internationalisatie strategie literatuur. Drie groepen van motieven om te internationaliseren werden geïdentificeerd: extrinsieke motieven (institutioneel, van buiten af bepaald), bank intrinsiek (van binnen uit) en sector intrinsieke motieven (gecombineerd).

Deel II analyseert vervolgens de internationalisatie patronen: hoe hebben banken hun internationalisatie strategie ontwikkeld? Voor 44 banken worden case studies ontwikkeld. De internationalisatie patronen van deze banken worden ondermeer geanalyseerd door het berekenen van de TNI (Trans Nationality Index) als indicator voor de mate van internationalisatie. Deze index is een gemiddelde van het percentage buitenlands balanstotaal, inkomsten uit het buitenland en het percentage medewerkers actief in het buitenland. Voor de groep als geheel bleef de gemiddelde TNI tussen de 28 en

30% in de jaren 80, maar steeg naar 40% eind jaren 90. Tussen banken onderling zijn er echter grote verschillen geweest. Vijf verschillende typen konden worden geïdentificeerd: banken met een lange historie in het buitenland (*established*), banken die zich juist terugtrokken uit het buitenland (*retreating*), banken die in beperkte mate internationaliseren (*moderate*), banken die daarentegen in versnelde mate internationaliseren (*accelerating*), en tenslotte een kleine groep banken met snelle buitenlands groei maar ook met daaropvolgend snelle terugtrekking (*imploding*).

Deel III richt zich op de belangrijkste onderzoeksvraag, de effectiviteit van deze internationalisatie strategieën. Allereerst worden motieven om te internationaliseren onderzocht. Er worden positieve verbanden gevonden tussen de mate van internationalisatie en export van een land, de mate van concentratie tussen banken in een land, en winstgevendheid en kapitalisatie van een bank. Het cliënt motief om te internationaliseren wordt ondersteund voor de jaren 90 maar niet voor de jaren 80, terwijl er geen verband gevonden is tussen buitenlandse investeringen en de mate van internationalisatie. Tenslotte lijken rente inkomsten een belangrijk motief in de jaren 80 voor banken om te internationaliseren; in de jaren 90 is dit geleidelijk verschoven naar provisie inkomsten.

Met behulp van een internationalisatie database worden vervolgens verschillen in binnenlands en buitenlands rendement berekend, en effecten van internationalisatie op aandeelhoudersrendement. Over het algemeen heeft een toename van internationalisatie een negatief effect gehad op het rendement van de bank. Op eenzelfde manier hebben aandeelhouders niet geprofiteerd van meer internationalisatie. Daarnaast bleek dat de winstontwikkeling van banken met meer buitenlandse activiteiten niet stabiel geworden is, wat suggereert dat er niet veel geografische diversificatievoordelen te behalen zijn. Banken die hun internationalisatie beperkten (*retreating*) genereerden het meeste aandeelhoudersrendement, net als banken met een langdurige aanwezigheid in het buitenland (*established*). Banken die daarentegen hun buitenlandse activiteiten over een langere periode sterk uitbreidden (*accelerating*) hebben het minste rendement voor aandeelhouders gegenereerd.

De studie richt zich ook op toekomstige ontwikkelingen in het internationaal bankieren - welke strategieën zullen de banken hanteren? Mogelijkheden voor verdere binnenlandse financiële deregulering, en de gekozen business mix van banken spelen een belangrijke rol in de richting van toekomstige internationalisatie strategieën en de mogelijkheden voor extra rendement.

# Curriculum Vitae

Alfred Slager was born on September 1, 1967 in Haarlem, The Netherlands. From 1987 until 1993 he studied economics at the Erasmus University, Rotterdam. After serving military service, he worked for KBW Wesselius Effectenbank, part of the Fortis group, where he held different positions in private banking and asset management between 1995 and 2000. Between 1998 and 2000 he was head of research. His primary focus was to set up an investment process and create modelportfolios, as well as develop a system to implement this for the private banking clients.

From 2000 onwards Alfred Slager joined PGGM Investments, the Dutch pensionfund for the healthcare, for investment strategy and advised among others portfolio managers on European sector strategies. From there he moved on to managing projects, implementing performance measurement and streamlining day-to-day operations. He has taught courses for investment advisors on a wide range of subjects.

The Ph.D. research project started end 1998 at the Erasmus University/Rotterdam School of Management, where he contributed to the SCOPE project of the Department of Business-Society Management, by setting up an internationalisation database for banks. His research interests focus on international business and financial markets in general, and in particular (international) banking strategies and asset management. His background in financial services has culminated in this study on "Banking on Borders".



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## Banking Across Borders

Since the 1980s, many of the largest banks in the world have increased their foreign activities dramatically. Currently, international capital and banking markets are more intertwined than ever, making a correct assessment of the costs and benefits of internationalization a serious matter for bank management, regulators as well as shareholders. This study contributes to a better understanding of the internationalization of banks. The study appraises to what extent banks internationalized because of internal, institutional or sectoral incentives. The internationalization strategies of the world's largest banks in eight countries between 1980 and 2000 are described and analyzed. These banks have dominated the internationalization of banking. Strategic commonalities and differences are identified on the basis of a strategic typology developed for this study.

The central research question deals with the effectiveness of internationalization. Using a self constructed internationalization database, differences are estimated between foreign and domestic performance, and the effects on shareholder return. A higher degree of internationalization has on average not contributed to bank performance. Similarly, most shareholders have not gained by more internationalization.

The study also tries to address the future outlook for international banking - how will the internationalization of banks proceed? The potential for further financial deregulation in the home country, uncertainty on the international regulatory regime, and the business mix of the bank are likely drivers for the bank's future internationalization strategy and profitability enhancement.

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