Theoretical and Applied Economics
Volume XVIII (2011), No. 7(560), pp. 43-52

Forms and Strategies of the Banks to Enter on a Foreign Market

Nicoleta HURDUC
Bucharest Academy of Economic Studies
hurduc.nicoleta@gmail.com
Alin NIȚU
Bucharest Academy of Economic Studies
eduardnitu2000@yahoo.com

Abstract. *Main forms of entry on a foreign market are greenfield investiments and achisition of a control position from a local institution. Both forms, Greenfield and acquisition entry strategies, are specific to CEE. In selecting the entry mode, one bank's objective is to maximize its risk-adjusted rate of return.*

Searh for new markets strategy means that by some reasons banks are always looking for new international market.

Keywords: international banks; cross-border lending; banking services; Greenfield investiments; achisitions; expansion of banks.

JEL Codes: E51, E52, G21.
REL Code: 11C.

1. Entry strategies

One of the ways to enter a new market is to make foreign direct investments. In fact, banks may prefer to engage in cross-border lending without being physically present abroad. The only way this can be done is through a correspondent bank. This may be appropriate for services/ transactions already consumed, but not for expanding the business opportunities. It is also not suitable for serving existing clients, even if they have a strong and long-term relationship.

The relationship built through a correspondent bank is therefore just the first step to internationalize operations (Khoury, 1998, pp. 154-155). It is true that there are numerous correspondent banking relationships. However, these relationships are focused on relatively standardized products, in particular on the collection or payment of foreign funds, usually within trade finance arrangements. It can be argued that correspondent banking relationship is not so much an entry strategy as an alternative to genuine competition in foreign markets, particularly in areas which do not warrant full scale entry. The "sales approach" proposed by Franklin Root (see Table 1) is not as relevant to an international bank as it would be to another trader. Banking services are not easily provided without having a trader in the target market. So making a direct investment in a branch is a viable alternative. Entering a new market by using the traditional foreign direct investments approach might mean ignoring the fact that the foreign direct investments decisions are irreversible and they are made in uncertain circumstances.

In banking, the issue of irreversibility of investments arises because access to a branch network is crucial for the attraction of deposits and for establishing long-term customer relationships, thus for starting building the lending business. When deciding whether to enter a new market, banks have to take into account three cost components: fixed costs to enter the new market (which increase depending on the importance of legal entry barriers), fixed costs to leave the new market, and operating costs.

The optimal investment policy of a bank must thus consider the value of the real investment option: as information about the economic environment improves over time, it pays to wait and to postpone investment. Entry and exit costs create a state of inaction: revenues have to increase sufficiently before the bank enters the non-traditional market, but once having entered the new market, the bank can't leave unless revenues decrease substantially.

Table1

Short-term vs. long-term internationalisation approach

	External sales approach	Entry strategy approach
Time horizons	**Short term**	**Long term (min. 3-5 years)**
Target markets	No systematic selection	Selection based on the potential of the market
Dominant objective	Immediate sale	Buil permanent bank-client relations
Resources used	Resources needed for immediate sales	Resources needed for positioning on the market
Entry mode	No systematic choice	Systematic choice
New product development	Exclusive sale on the domestic market	For both domestic and foreign markets
Product adjustments	Mandatory adjustments to meet legal/technical requirements	Adjusting products to the local preferences of the clients, to the income level and to the demographics
Sales channel	No control	Full control given by marketing strategies
Price	Depending on the domestic market with some adjustments to specific sale situations	Depending on the demand and supply existing in the host country and on the marketing policy of the bank
Promotion	Sales made by subcontractors	Direct promotion

Source: Khoury, 1998, p. 155.

It is impossible to discuss about the organizational structure or about the activity level of the foreign bank without referring to the banking legislation. Dale (1986) points out that in almost all banking systems regulation starts from the early stage of market penetration. Some countries limit the entry of foreign banks to branches, while others prefer subsidiaries. The issue is with the compromise that has to be done between the local regulation and that from the country of origin and the support of the local central bank.

Banking rules can discriminate between countries of origin, based on bilateral treaties, reciprocity reasons or industry structure. Alternatively, a country may restrict the expansion of its banks abroad.

There are two forms of entry on a foreign market:

1) greenfield investment, which involves setting up an institution from scratch. The newly established institution may require a capital infusion from the beginning, but in some cases (a representative office or a branch) the transfer is very limited or replaced only by the transfer of human capital;

2) acquisition of a control position from a local institution. Acquisition size can range from a 100% purchase of the social capital of a given institution to a minority stake.

Entering a market via greenfield investment allows the foreign bank to take advantage of its international reputation, especially in less developed countries or less stable economies, where the depositors are looking for secure placements. It also gives foreign banks the opportunity to address those market segments that would not be reachable via a simple acquisition of a local entity.

By acquiring a control position from a local institution, foreign banks get access to the profiles of the old local banking clients that might be incompatible or at least inconsistent with the market positioning of the mother-bank, thus requiring adjustments that might be expensive. However, inflows through mergers and acquisitions have their advantages. For example, this type of foreign bank entry provides access to local knowledge. Moreover, if the mother-bank's strategy calls for a global retail network, acquisition may be the most feasible alternative, especially if a rapid growth is desired. In addition, the acquisition also provides immediate access to deposits, which allows an immediate signing up for local currency lending. Finally, acquisitions may be advantageous for multinational banks where little is known about host markets.

Foreign banks are better positioned to offer products and services that require a global platform, a considerable amount of capital that have a strong technological content, as well as the experience and skills needed to provide sophisticated products. Domestic banks are good in providing products and services that require local abilities and knowledge, access to local currency, possession of a branch network. The acquired banks are more able to capture these capabilities than their greenfield counterparts.

As a result, foreign banks tend to focus on corporate banking, while the local banks concentrate on operating in retail banking and SME-s. Foreign banks offer a wide variety of products: trade finance, project finance, syndicated loans, foreign exchange services, risk management products, cash management services, financial advisory services, while the presence of the banks on the local market can be used for working capital accreditation and long-term investment loans granting (Pomerleano, Vojta, 2001).

Both greenfield and acquisition entry strategies are specific to CEE and have different characteristics. First of all, changing the mono-banking system into a two-tier banking system led to the first wave of greenfield entries. Later, the beginning of the privatization process created opportunities for the foreign banks to acquire local banks, thus leading to the second wave of market penetrations and economic concentrations resulted from acquisitions.

The most attractive way of entering a new market is either by setting up a new branch or by acquiring an existent bank. However, in the specific case of Czech Republic, the up-most entry strategy is by establishing a branch. This reflects the permissive legislation from Czech Republic. In fact, since 1992 the Law of Banks has opened the door to foreign branches, thus allowing the release of operating licenses under less restrictive conditions. Expectation approach was pursued by a number of investment banks and some specialized banks have preferred to open a bank's representative office.

From the institutional point of view, the foreign investment is associated with establishing or acquiring one of the following organizational structures: a local representative office, a branch office or a subsidiary. These "institutional" vehicles for entry have different attractiveness for various types of banks. Specialized banks, such as investment banks, will tend to operate through a number of representative offices or may even set-up a non-banking company. The reason for this is that they usually do not perform typical banking activities (at least in the host country) that require a banking license. Regulators tend to treat banks as special entities when they conduct typical activities i.e. collection of bank deposits, money transmission etc.

When operations are limited to certain consulting services, the risk is lower and thus the host market regulation is becoming less important. Representative offices of foreign banks do not perform self-independent activities, they rather attract and set up businesses abroad for the mother company.

Often, the representative offices of foreign banks also negotiate correspondent relationships with domestic banks. It offers the banks a low cost entry mode, allowing them to establish their brands without having any capital costs related to setting up a branch or subsidiary. This activity provides a particular advantage when the entry value on the local market has yet to be proven or the regulatory frameworks have a degree of uncertainty. Should market development exceed expectations or certain profitable deals be granted only to those banks present on the market, opening a representative office is definitely an entry strategy.

For a wide range of industries, the lowest cost option to enter a foreign market is to have a low level of ownership. In selecting the entry mode, one bank's objective is to maximize its risk-adjusted rate of return. The degree of transaction control is seen as the single most important determining factor both for risk and return. Cost is just one of the several elements determining the most efficient level of the

Investment, the others might include financial infrastructure, foreign exchange risk, competition and market size. A small market can lead to a less optimal investment and to the impossibility of reaching an appropriate return on capital employed.

A foreign bank representative office is the most limited form of organization and the less expensive one. Still it can not perform any kind of activity. That is why it is mainly used for exploring business opportunities from a foreign country.

A branch is not an independent legal entity, but an integral part of the mother company. It can offer a complete range of banking services. The decision making process is not fully delegated to the foreign branch and the activities of the branches are based on the social capital of the mother company. Foreign banks' branches are subject to banking supervision both at home and in the host country.

Subsidiaries of foreign banks are legally independent from their mother company and use their own capital for performing their activities. Hence, foreign banks need to invest more capital abroad if they want to facilitate the same level of lending activity through a subsidiary rather than through a branch. Branches are an integral part of the mother company. A branch cannot fail unless the mother-company fails. Subsidiaries and branches are separate entities. A subsidiary may fail even if the mother company is solvable and vice versa, a subsidiary can be solvable even if its mother company is not. Under the Basle agreements, the supervisory authorities from the host country are responsible for prudential supervision of subsidiaries and the authorities from the country of origin are responsible for the branches of the mother company. If a foreign affiliate bank doesn't have control over its subsidiary, it has a clear exploring role and doesn't express a long-term commitment.

Table 2

Forms of external presence

	Representative office	**Branch**	**Subsidiary**	**Minority stake**
Legal status	Dependent	Dependent	Independent	Independent
Investment costs	Not necessary	Necessary	Necessary	Necessary
Control capacity	Direct	Direct	Direct and substantial	Low control
Business intermediation	Promoting	Promoting	Promoting	Low
Flexibility	Low	High	High	Low
Number of employees	Low	Depending on the level of activity	High	N/A

Source: Bosch 2000, p. 38.

Foreign banks usually follow two different positioning strategies for clients in emerging countries:

a. Making the most of the foreign banks status, mainly devoted to their international clients and to the top segment of the local market, like the large local companies that need corporate banking, bonds issues or share listing. Most are not active in retail banking outside their home market. Competition can sometimes be very tough, because most foreign banks prefer to remain in this foreign bank position and the niche market becomes overcrowded.

b. Making the most of the local banks status, especially in countries that allow foreign banks to get a license providing the same treatment as to domestic banks. There are only a few international banks active in retail banking sector, due to high barriers to entry in this segment, compared to, for example, corporate banking. The distribution network is very different when a bank serves a hundred of clients (one branch), or tens of thousands of clients in retail banking or millions of customers (the need for infrastructure is huge).

2. Strategies used for banking expansion overseas

Depending on the strategy used for entering new markets, we can distinguish the following strategies used for banking expansion overseas:

1) follow the client strategy,
2) lead your client overseas strategy,
3) look for a new market strategy,
4) follow your leader strategy.

We have already discussed about the first strategy in the chapter about ways of entering new markets. This is a reactive strategy. If banks do not follow their customers abroad, the clients might establish new banking relationships in order to replace the already existing relationships with the domestic bank. A banking relationship consists of a flow of information. This flow of information enables the bank to assess any new loan proposal at a low marginal cost, as most of the assessment work has been done previously. The lower marginal cost gives a bank's offshore subsidiary a competitive advantage over its traditional competitors.

Following the client behavior leads to new business opportunities (take as example the expansion of banks from Austria, Germany and Netherlans). Austrian and German banks were among the first to enter the CEE countries and now they have a predominant number of representatives. In Hungary, Austrian banks tend to buy low-risk customers with a high volume of transactions, such as state-owned banks, former monopolies (Majnoni et al., 2003). Citibank, ING and ABN AMRO follow their customers in these countries, and then, after start-up phase, they tend to develop a portfolio of services using local customer base, engaging in competition with local banks.

Another reason for following customers was to simply make sure that the bank had an initial position on the foreign market and then look for extension in the near future. This expectation approach is pursued, for example, by Deutsche Bank in Hungary (Majnoni et al., 2003.). There are also specific factors that led to the entry of foreign banks through mergers and acquisitions. For example, in

Poland, a number of foreign banks have agreed to take over certain Polish banks with problems, simply to "buy" a license to operate in this market.

These actors were not interested in these banks and therefore they will not engage effectively in restructuring and managing the problems of the banks. For example, in December 1994, Westdeutsche Landesbank agreed to buy 29% of the new issue of shares of Morski Bank in exchange for a license given by the National Bank of Poland in February 1995. A similar procedure was later applied by other German banks. In order for them to get an operating license, they had to either support banks facing difficulties or to take over bankrupt banks (Konopielko, 1999).

While banks may merely follow their customers into foreign countries, they may, as well, be present in foreign markets prior to their corporate clients, pursuing the so called “leading the customer” strategy (Buch, 1997, p. 344). Often a bank can act as an external agent for its domestic clients through the newly developed contacts abroad. Especially small- and medium-sized enterprises, which are the clients of large international banks, are being helped by their bank’s expansion abroad, as they have access to information about the external markets and are also provided with proper advisory services.

This fact gives the possibility for internationally operating banks not only to improve and enlarge their range of products and services, but also to expand their portfolio of clients. Small and medium enterprises are often able to obtain adequate detailed information on their own. Clients of banks operating abroad, SMEs can take over trade relationships with foreign companies through information obtained from the bank. Through these services the credit institution helps the medium clients to enter new and unknown markets, and the small clients and companies with no prior foreign experience to expand abroad. Such information and consultation services are known as "banking consultancy”. They help building customers’ loyalty for their banks.

Search for new markets strategy means that by some reasons banks are always looking for new international markets. According to this strategy, the bank is trying to find a new niche on the international market. The strategy presumes to search for better returns adjusted to some greater risks than those present on the home market, even in uncertain circumstances. Mainly experienced and strong international banks follow this strategy because they can bear greater risks. Such banks aim to achieve a global service network that should be multicultural and in order to achieve cost and sales synergies.

“Follow your leader” strategy explains why banks chose to open branches in other countries, even though they do not have clients there. On an international scale, oligopolistic rivalry leads to some typical patterns of conflict, be it between banks originating from the same country or from different countries. The scheme most often referred to in literature is undoubtedly "follow your leader". When a bank has an interest in a foreign country, all its competitors tend to move in that country too, as they are all concerned that the advantages gained by the first arrived will change the configuration of the competitive home market (Bouteiller, Marois, 1999, p. 6). Competition in the banking sector is usually very intense, and only due to a steady development it is possible for a bank to remain competitive. This strategy is associated with lower risks than the previously mentioned strategy. The market which was already penetrated by a competitor has an acceptable risk level and a thorough market analysis is no longer needed.

As in the general case of emerging countries, the most important fields of activities of the foreign banks in CEE countries are corporate banking, trade finance and foreign exchange transactions. Retail activities are perceived as the least important. The main reasons are low income levels of the population and the high costs of setting up branch networks. However, in the second half of the 1990s, some foreign banks began to realize the potential of the retail market and began to actively operate in this market. Other corporate services that complement the existing corporate products are non-financial services (such as consultancy), market trading services and leasing services. These services enable banks to use their know-how and liquidity resources to generate some extra income.

In the Czech Republic, as far as the assets structure is concerned, the weight of credits and debt securities in the balance of foreign banks is smaller than in the balance of large local banks. On the liabilities side, foreign banks depend heavily on inter-bank markets, with a much lower level of customer deposits in their portfolios. This emphasizes the corporate-oriented approach of the foreign banks. In Poland, foreign banks employ around 40% of their assets in inter-bank operations and trade finance. Another important differentiation of foreign banks is their reduced weight of fixed assets in the total assets. This is caused by the reduced number of branches of these banks. In most cases, the headquarters of the banks are rented and therefore they make a contribution to the operating costs. In some banks (UniCredit, ING and Société Generale) recently involved in the development of their own office buildings, there might be registered an increase of the weight of fixed assets in the total assets and a decrease of operating costs.

References

Aliber, R.Z., „Towards a Theory of International Banking”, *Economic Review*, Federal Reserve Bank of San Francisco”, 1976, pp. 5-8

Bonin, J. P., Mizsei, K., Szekely, I. P., Wachtel, P. (1998). *Banking in Transition Economies: The Role of Foreign Banks in Economies in Transition*, Bodmin, Cornwall, MPG Books Ltd

Grubel, H., „A Theory of Multinational Banking”, *Banca Nazionale del Lavoro Quarterly Review*, No. 29, 1997, pp. 349-363

Khoury, S.J., „Foreign Banks in the United States: Entry Strategies and Operations”, *Advances in International Banking and Finance*, Vol. 3, 1998, pp. 152-175

Williams, B., „Positive Theories of Multinational Banking: Eclectic Theory versus Internalisation Theory”, *Journal of Economic Surveys*, Vol. 11, No. 1, 1997, pp. 71-100

Williams, J., Liao, A., „The Search for Value: Cross-border Bank M&A in Emerging Markets”. *Comparative Economic Studies*, 50, 2008, pp. 274-296

Rugman, A.M., Kamath, S.J., „International Diversification and Multinational Banking”, in *Recent Developments in International Banking and Finance*, 1987, Lexington Books

Majnoni, G., Shankar, R., Varhegyi, E., „The Dynamics of Foreign Bank Ownership - Evidence from Hungary”, *The World Bank Policy Research Working Paper Series*, 3114, 2003

Mohanty, S., Nolle, D., Seth, R., „Do Banks Follow Their Customers Abroad?”, *Financial Markets, Institutions & Instruments*, Vol. 7, No. 4, 1998, pp. 1-25

Bouteiller, E., Marois, B. (1999). *Strategies of European Banks in Emerging Countries: A Comparative Approach*, HEC Foundation

Gray, J.M., Gray, H.P., „The Multinational Bank: A Financial MNC?”, *Journal of Banking and Finance*, No. 5, 1981, pp. 33-69

Konopielko, L., „Foreign Banks’ Entry into Central and East European Markets: Motives and Activities”, *Post-Communist Economies*, Vol. 11, No. 4, 1999

Dunning, J.H. (1975). *The Economic Theory of Multinational Enterprise*, London, Macmilan

Pomerleano, M., Vojta, G., „What Do Foreign Financial Institutions Do in Emerging Markets?”, *Open Doors: Foreign Participation in Financial Systems in Developing Countries*, 2001, Washington DC, Brookings Institution Press

Tschoegl, A.E., „International Banking Centers, Geography, and Foreign Banks”, *Financial Markets, Institutions & Instruments*, Vol. 9, No. 1, 2000, pp. 7-31

Tschoegl, A.E., „Financial Crises and the Presence of Foreign Banks”, *Wharton Financial Institutions Center Working Paper*, 35, 2003

Curry, E., Fung, J., Harper, I., „Multinational Banking: Historical, Empirical, and Case Perspectives”, in Mullineux, A.W., Murinde, V. (ed.) *Handbook of International Banking, UK and USA*, 2003, Edward Elgar

Yildirim, H.S., Philippatos, G.C., „Efficiency of Banks: Recent Evidence from the Transition Economies of Europe, 1993-2000”, *The European Journal of Finance*, 13, 2007, pp. 123-143

Root, F. (1982). *Foreign market entry strategies*, AMACOM, New York