Multinational Banking in China

Theory and Practice

Chen Meng

NEW HORIZONS IN INTERNATIONAL BUSINESS

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For my family

Contents

Figures

Tables

Abbreviations

CAR	Capital adequacy ratio
CBRC	China Banking Regulatory Commission
FDI	Foreign direct investment
FIE	Foreign invested enterprise
FIFI	Foreign invested financial institution
GATS	General Agreement on Trade in Services
IJV	International joint venture
JV	Joint venture
M&As	Mergers and acquisitions
MNB	Multinational bank
MNE	Multinational enterprise
NPL	Non-performing loan
NUD*IST	Non-numerical unstructured data indexing searching and theory-building
PBOC	People's Bank of China
PRC	People's Republic of China
QFII	Qualified Foreign Institutional Investor
R&D	Research and development
RMB	Renminbi (Chinese local currency)
SAFE	State Administration of Foreign Exchanges
SEZ	Special economic zone
SOE	State owned enterprise
WTO	World Trade Organization

Foreword

The middle of a global financial crisis is perhaps not the best time to be studying multinational banking in China. However, Chen Meng's thoughtful survey of the theory and practice of foreign entry into the Chinese banking market is both relevant and useful. The study examines the difficulties facing regulatory authorities trying to balance prudence and control with market freedoms. The Chinese banking system, as described here, is clearly in need of reform and of refreshing in terms of the introduction of innovative foreign practices. However, the regulatory authorities also need to be mindful of maintaining the stability of the system. Modernizing the system must not mean abandonment of control. From the point of view of the foreign entrants, China's banking market clearly represents a great opportunity. They have clearly been pressing for the removal of restrictions on entry into the potentially lucrative Chinese market. Chen Meng's study traces these developments with great care and with attention to the practical details.

I am delighted to be able to commend this book as it began as a doctoral thesis in the Centre for International Business, University of Leeds. I am sure that it represents a valuable contribution to the literature on multinational banking and to the increasingly valuable studies of the emergence of China as a global superpower.

Peter J. Buckley
Director, Centre for International Business,
University of Leeds
October 2008

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1. Introduction

GLOBAL TRENDS FOR SERVICE FDI

Following the enforcement of the World Trade Organization (WTO) agreement, particularly the General Agreement on Trade in Services (GATS), the continuous process of liberalization of foreign direct investment (FDI) policies and deregulation of key service industries has led to large inflows of FDI into industries that were previously dominated by the State or domestic private sector firms. As the transnationalization of the services sector in home and host countries lags behind that of manufacturing (Dunning, 1993b), there is scope for a further shift of FDI towards services.

The past three decades have witnessed the shift of FDI flows from manufacturing towards services. There has been a decline in the manufacturing sector in total FDI flows and stock in recent years. This is the same scenario for both inward and outward FDI, and in all groups of economies. The services sector continues to capture an increasing share of FDI. Services gain the most from the surge of FDI, particularly finance, telecommunications and real estate (UNCTAD, 2007). By 2002 services accounted for about 60 per cent of the world FDI stock, compared to less than half in 1990 and only one quarter in the early 1970s. The world's inward stock of services FDI reached an estimated 4 trillion USD. During 2001–02 FDI inflows in services were valued at approximately 500 billion[1] USD (UNCTAD, 2004). As an emerging trend of world FDI, investment firms, collective investment institutions and schemes including private equity firms and various financial investment funds (for example, mutual funds and hedge funds) have recently become growing sources of FDI. Private equity firms successfully raised a record 432 billion USD in 2006, about half of which were used for FDI. In addition, private equity funds and other collective investment funds accounted for 18 per cent of worldwide mergers and acquisitions (M&As) in 2006 (UNCTAD, 2007).

Services are usually perceived as intangible, invisible, perishable and requiring simultaneous production and consumption (Erramilli and Rao, 1990; Erramilli, 1991; Buckley *et al.*, 1992; Casson, 1990; Clegg, 1993; Enderwick, 1989). However a conceptual distinction between goods and services is not straightforward. Some services have elements of tangibility (for example, a consultant's printed report), visibility (hotels) and storability (emails). Most goods and services are jointly and simultaneously supplied because nearly all goods require non-factor services for their production and most services require physical assets and intermediate goods. There is a lack of uniform classification of service industries between countries. The most widely accepted measures of classification are the International Standard Industrial Classification and the Central Product Classification, both developed by the United Nations. The heterogeneity of service industries creates difficulties in conceptualization as well as empirical examination of service multinational enterprises (MNEs) (Dunning, 1993b; Boddewyn *et al.*, 1986). Boddewyn *et al.* (1986) and Berry *et al.* (1985) suggest that specific analysis of sub-sectors of services is more fruitful than the creation of a general category of service MNEs.

A large proportion of outward FDI in services is controlled by goods rather than service MNEs (UNCTAD, 2004). This reflects the globalization of corporate service functions by MNEs in the manufacturing and the primary sectors rather than the global expansion of service MNEs. This study only considers service MNEs rather than service FDI controlled by goods MNEs and it focuses on the theoretical development and empirical examination of one sub-sector of services – banking. The financial services industry has traditionally accounted for the largest share of services FDI in all regions. Existing empirical studies on multinational banking focus on developed country markets such as the USA, UK and Japan. In developing countries, the stock of FDI in financial services grew 1.5 times between 1990 and 2002, to 250 billion USD (UNCTAD, 2004). However little light has been shed on developing and emerging markets. As the world's largest FDI recipient in 2003 and the fourth largest country in inward FDI stocks in services in 2001 (UNCTAD, 2004), China is particularly important for research on multinational banking.

INTERNATIONAL BANKING AND MULTINATIONAL BANKING

If a bank offers its intermediary or payments services across national boundaries, it is engaging in international trade activities and is like any other global firm that seeks to boost its profitability through international trade. A multinational enterprise is normally defined as any firm with plants extending across national boundaries. Similarly a bank with cross-border branches or subsidiaries is a multinational bank (MNB) (Heffernan, 1996, pp. 74–6).

In explaining multinationality of firms, Heffernan (1996) emphasizes three key factors. They are locational efficiency, barrier to free trade and imperfections in the market place. Locational efficiency refers to the choice of a plant location. It is an advantage in being the lowest cost producer of a good or service. Barrier to free trade derives from government policy or monopoly power in supply markets. Imperfections in the market place are often in the form of a knowledge advantage possessed by a certain type of firm which cannot be easily traded. This explanation is in line with the definitions derived from internalization theory (Buckley and Casson, 1976). The same framework can be applied to explain the presence of multinational banks. Banks may choose to set up branches or subsidiaries overseas because of barriers to free trade and/or market imperfections. In addition, the nature of banking means banks possess a number of intangible assets that cannot be traded in the market place. Such intangible assets can refer to experience gained in other markets or reputation. Provided that the locational efficiency conditions are met, reputation may be a profitable reason for a bank expanding across national borders.

Many researchers argue that multinational banks exist because banks need to follow their corporate customers overseas to protect their own assets. If the bank is going to lend funds to a multinational firm, it will require information on the foreign operations to correctly assess the creditworthiness of the client. The optimal method of gathering information may be the establishment of a branch or subsidiary in the foreign country. The bank effectively internalizes the implicit market for this information. However in the days of colonial trade when banking systems were underdeveloped, this factor was more important than today when firms are expanding into countries which, in most cases, already have well developed banking systems. Even if a MNE has operations in a developed economy with an extensive banking system, it may wish to employ the services of a home country bank. This is because the cost of local bank credit is likely to be higher if local banks do not have knowledge of the firm.

Therefore the term international banking should be defined to include two different activities: trade in international banking services, consistent with the traditional theory of competitive advantage for why firms trade, and MNBs, consistent with the economic determinants of the multinational enterprises. Having understood international banking in this way, we now pay more attention to the multinationality of banks and developments in international banking services.

WHY RESEARCH THE CHINESE BANKING MARKET?

The banking industry has grown explosively over the last 25 years. America's financial services industry accounted for 40 per cent of the country's corporate profits last year, up from a mere 10 per cent in the early 1980s. According to Morgan Stanley, an investment bank, financial leverage is thought to have driven almost half of the growth in their return on equity between 2003 and 2007. In particular, revenues from emerging markets delivered a healthy boost to even the most anemic global banks. Demand from developing countries is the most obvious source of growth for the industry as a whole in the coming years.

Empirical studies of banking internationalization have concentrated on a few developed countries such as the USA, UK and Japan.[2] Transitional countries and emerging markets have not been given sufficient attention (Sabi, 1988; Goldberg *et al.*, 2000; Scott-Green, 2002). Bol *et al.* (2002) argue that the existing evidence of banking internationalization so far is confusing and cannot be generalized since the existing empirical literature covers only a few transitional countries. This makes it difficult to develop relevant hypotheses associated with the Chinese banking market or to test readily available hypotheses in the context of the Chinese market. Research concerning inward FDI in China's banking sector is still rare (for example, Chan and Wong, 1999; Leung and Young, 2002; Leung and Rigby, 2003; Leung *et al.*, 2003). Most of it consists of descriptive studies (for example, Chen and Thomas, 1999; Balfour and Clifford, 2002; Ross, 2002; Tsang and Wong, 2002; Howson and Ross 2003; Guerrera, 2004). The existing empirical studies on foreign banking activities in China appear to be incomplete and cannot be generalized to explain inward FDI in China's banking sector.

By the end of 2005 there were over 178 foreign banks authorized to establish 163 branches, 223 representative offices, eight wholly owned subsidiaries and five joint ventures (JVs) in China. The total assets of foreign banks in China experienced a steady growth over the last two decades and reached over 170 billion USD at the end of 2007. Foreign banks and financial institutions invested about 12 billion USD in China's banking industry in 2005, compared to 3 billion USD in 2004. According to the China Banking Regulatory Commission (CBRC), 154 foreign banks have been allowed to conduct Renminbi (RMB, China's local currency) business in 25 Chinese cities by the end of 2005. Foreign investors rapidly entered the market by acquiring stakes in Chinese banks in the past two years rather than establishing their own branches. Twenty foreign financial institutions have acquired minority equity control of 20 domestic Chinese banks (*People's Bank of China Quarterly Statistical Bulletin*, 2007). However China's 'big four' state owned commercial banks still dominate the local banking market. They accounted for over 50 per cent of the local banking assets, loans and deposits. In contrast, foreign banks only accounted for about 2.4 per cent of China's banking assets. The People's Bank of China (PBOC), the central bank of China, still tightly controls the business scope, type and currency of products and services, operational volume, customer base, number of branches as well as location of foreign bank operations. The People's Republic of China (PRC) joined the WTO in 2001, thereby agreeing to conform to full market liberalization and the creation of an environment in which foreign banks are able to compete on equal terms with domestic banks. Little research has been conducted on a nationwide basis to investigate the market entry of foreign banks in China. It is important, at the current stage of deregulation of the local banking market, to examine and identify characteristics relating to the market entry and post-entry development of foreign banks in China.

CONCEPTUAL INNOVATIONS IN ANALYSING MNBs IN CHINA

Do we need a new theory for service MNEs? The debate focuses on the differences between services and goods manufacturing MNEs. The banking sector as an important sub-sector of the services industry is often examined to test various theories of MNEs. Most of the prior research concentrates on aggregate level data to investigate the reason and pattern for banks to become multinational. These studies mostly follow the stream of transactions cost theory of the firms. Some other strategy research on banking has put more weight on firm level data to examine the behavior of several individual banks. There obviously exists a gap between the static model of multinational banking and dynamic elements of banking strategy. We should beware and pay more attention to the interplay between theory and practices and introduce a new research approach to study banking internationalization. The theoretical innovation of this study does not lead to the creation of new theory for multinational banking or service MNEs but rather the introduction of an eclectic theoretical framework that incorporates broader insights in the research of multinational banks.

One further issue arises which leads us into the realm of research method. This is the question of whether an 'objective' or 'subjective' explanation is required for banking internationalization. Is it sufficient to examine motives, structure, management and strategy of multinational banks using secondary data alone? Or is there something more important to the growth of the bank that requires knowledge, perception and skills of the individual manager? The research agenda arising from this goes on to identify the types of conditions that lead to the foreign market expansion of banks. Key variables are not purely economic but include environmental factors and cultural elements. Key determinants include barriers to trade and licensing (lack of patent rights, inseparability of producer-buyer interaction and non-tradable nature of client information), barriers to joint venture (cultural distance, complementarities of resources and capabilities, and compatibility of management strategy) and barriers to market development (policy restrictions, technological advancement, client resources, economy in scale and scope, and competition). Most of these are precisely the areas where managerial judgment or perception of the relevant comparative costs is likely to be at their most crucial.

KEY ISSUES IN MARKET ENTRY AND DEVELOPMENT

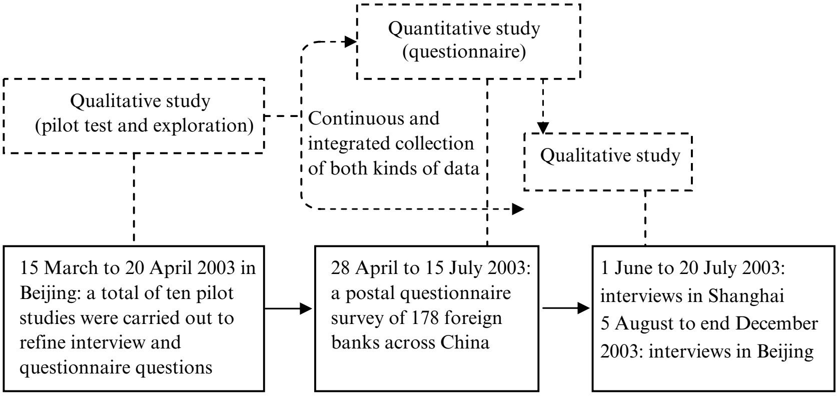
We can identify two major *motives* for banking internationalization based on existing research. They are market seeking and following the client. It is controversial in the literature which motive actually dominates the foreign market expansion and the interrelations between these two motives. Evidence shows that for trade-driven multinational banking activities there can be both market seeking and following the client motives involved. Market seeking is a broadly defined notion and can incorporate various strategic orientations such as geographical diversification and competition-driven. In addition, location factors (such as regulatory restrictions or preferential treatment) and cultural elements may also significantly influence foreign market entry versus non-market entry decisions.

Foreign market entry involves two interdependent decisions on *mode of control* and *location*. Exporting is domestically located and administratively controlled. Foreign licensing is foreign located and contractually controlled. FDI is foreign located and administratively controlled. The nature of banking services determines that banks favor direct investment to exporting or licensing. In examining mergers and acquisitions, special attention has been paid to the costs of adaptation and cultural integration that are encountered in the case of mergers. Buckley and Casson (1988, 1996) summarize the conditions conducive to international joint ventures (IJVs) as: the possession of complementary assets, opportunities for collusion and barriers to full integration such as economic, financial, political, legal or cultural. The IJV literature has focused on partner selection, management strategy and the measurement of performance. Decisions on location are largely influenced by host country policy and regulations and are related to the banking service segments. Some banking services are less location-bounded such as investment banking. Some are primarily determined by the distribution of target clients, for instance, corporate and retail banking.

Buckley (1983) argues that MNE theories should explain not only the initial FDI but also switches of mode of foreign market servicing and the direction of growth of the firm. The dynamic analysis of the growth of the firm is to be able to specify the timing of strategic outcomes as well as the evolutionary development of firms in host markets. *Adaptation* lies in the center of examining post entry development of foreign banks in China. Successful adaptation in distant markets relies on the interplay of both internal and external *determinants*. These determinants consist of environmental factors (for example, policy and regulation, and cultural elements) and *competitive advantages* of banks. Location costs, internalization factors, financial variables, cultural factors (such as trust and psychic distance), market structure and competitive strategy, adaptation costs to the local environment and the cost of doing business abroad are all identified in the literature as playing a role in determining firms' foreign market entry decisions. *Managers* are increasingly important in international business theory (Buckley, 1996; Casson, 1986, 1998, 2003). They make judgments in the face of uncertainty and therefore they make mistakes sometimes. Superior judgment stems from either privileged information or from a superior mental model of the environment applied to publicly available information or from a combination of both. Managers' perceptions of risk are important to the bank and the attitudes of individual managers will greatly influence the environment in which they operate.

METHODOLOGY AND INTERRELATIONSHIPS

Our theoretical framework determines that the analysis of internationalization of multinational banking requires a sophisticated design of research methodology and strategy (Figure 1.1). Interviews and questionnaires are both constructed in order to minimize the cultural distance between academic perception and participant understanding. Research strategy also needs to comprehend the interrelations between different variables, in particular how different variables interact with each other given different research methods in order to tackle the research questions. Our findings explain the structure, motives, control and management, and adaptation not only at the macro level but also at firm level. This can add further insights and dynamics into the understanding of foreign banking strategy in China. A detailed introduction to the research methods can be found in the Appendix.



Source: Author's elaboration on Miles and Huberman (1994), p. 41.

Figure 1.1 Data collection process and research design

CONCLUSIONS

Multinational banking is not a unique phenomenon in today's business activities. However there is no straightforward theoretical perspective designed for and exclusively dealing with multinational banking. Some of the previous research has been empiricism without a fully thought out theoretical structure in many cases. Multinational banking can be examined by conventional theories of international business. Attention is paid to certain interrelated variables such as motives, entry mode, determinants and competitive advantages. However we need to know far more about how business practitioners perceive the interactions and dynamics of these variables and how business strategies are constructed accordingly.

DOMAIN OF THE STUDY

This study focuses on the examination of internationalization of a subset of service FDI activities – that of multinational banks. The main objective of the study is to examine the evolutionary process of market entry and development of foreign banks in the Mainland after China's WTO accession. As already noted, the research needs to concentrate on motives, mode of control, determinants for development, management and adaptation, and competitive advantages. The analysis on post entry development and adaptation reveals the dynamics of the market entry of foreign banks.

The background literature, definition and operationalization of variables, and research questions of the study are detailed in each of the respective chapters that follow. Essentially this study is of an empirical nature and consists of an analysis of primary data obtained from senior managers at mainly subsidiary operations by means of personal interviews and self-administered questionnaire surveys. Our data set is believed to be the first collected nationwide to study foreign banking activities in China. The research methods of the study are set out in the Appendix.

Chapter 2 builds on prior research and develops a general theoretical framework for multinational banking. The framework is based on internalization theory as a synthesizing notion integrating alternative strategy literature such as resource based view. Multinational banks do not implicitly differ from manufacturing MNEs. The nature of multinational banking changes the conditions for internalization but the principle of the theory is still the same. The bank-client relationship is an important firm specific asset that cannot be traded in the open market. The banking service shares most of the general characteristics of the service industry, namely being intangible, non-tradable and the inseparability of producer-consumer interaction. This implies that banks may prefer to grow via direct investment rather than trade or licensing. The resource based view and knowledge based approach shed more light at the firm level by investigating capabilities and privileged relationships with outside actors. The evolutionary view of the MNBs adds a learning perspective to the understanding of bank internationalization.

Chapter 3 provides a background introduction to China's banking industry and the market entry of foreign banks in China. The introduction pays special attention to China's accession to the WTO and its impact upon the market entry of foreign banks. The WTO entry allows foreign banks to enter China with a five-year transitional period. Policy and regulations appear to be fundamental barriers to market entry and development.

Chapter 4 investigates strategic motives of market entry and entry methods. Both questionnaire and interview data suggest that foreign banks enter China with multiple motives and the dominance of strategic motives switches over time with the accumulation of local client resources, market knowledge and experience. Market seeking and following the clients are dominant motives. Following the clients is particularly important at initial entry stage. Market seeking banks demonstrate a more aggressive local market expansion style. Wholly owned entry, that is, branch and subsidiary, is still the dominant entry method. Alternative entry methods, for example, minority equity acquisition and joint venture, are also evident in our sample and M&As activities have taken shape in recent years. Empirical findings suggest that the success of a JV bank depends heavily on shared vision and value, a compatible management strategy and complementarities in capabilities.

Chapter 5 replicates and extends a number of findings regarding market development of foreign banks and determinants dictating the post-entry development. The findings show that market expansion of foreign banks takes place incrementally. Foreign banks combine multiple strategic orientations at the same time and motives switch over time given the change of local market conditions. Firm specific attributes are identified as key determinants in local market development. These attributes include product innovation, local client resources, technological adaptation, quality of local human capital stock, the persistence of China-market-related corporate strategy and cultural proximity. Well resourced banks demonstrate a higher degree of local market commitment and a speedier pace of local expansion.

Chapter 6 identifies the key strategic options adopted by foreign banks and develops an evolutionary framework of development strategies. Three strategic options are analysed. They are client-driven, product-driven and multi-objective driven strategies. The chapter presents a framework to examine the three strategic options in the context in which they are interrelated and evolve over time. Client-driven strategy focuses on managing important existing clients and developing the local client base. The strategy is implemented based on a careful management of the client portfolio and an in-depth understanding of local demands. Product-driven strategy concentrates on product innovation and expansion of the local distribution network. Multi-objective strategy seeks synthesized advantages by simultaneously integrating both client-driven and product-driven strategies. Client- and product-driven strategies are interrelated. Our findings also suggest that strategic options switch over time.

Chapter 7 examines environment, adaptation and competitive advantages. Findings support that location and bank specific factors influence the post-entry adaptation. Policy constraints appear to be the vital external barrier to successful local market development and adaptation. This chapter also examines the extent to which differences in culture pose a problem to the management of a JV. The findings show that differences in national culture and corporate culture do exist and can greatly affect the performance and operation of the JV. How foreign banks cope with external knowledge and respond to local market conditions lies at the center of local market adaptation. Growing evidence suggests that a well designed organizational structure and effective internal coordination are crucial elements in banking strategy. Organizational learning constitutes the core competitive advantage of MNBs. Cultural proximity, high quality of managerial resources, innovation in product and marketing, and special client segments are all essential in differentiating development strategies of foreign banks.

A summary and conclusions from the whole study are presented in Chapter 8. It concludes lessons to be learned from the past experience and seeks to set out key implications both for business practitioners and industry regulators.

NOTES

1. In this volume, one billion will mean a thousand million.
2. For example, Fuentelsaz *et al.* (2002), Mutinelli and Piscitello (2001), Miller and Parkhe (1998), De Young and Nolle (1996), Ursacki and Vertinsky (1992), Grosse and Goldberg (1991), De La Baume and Gupta (1991), Cho (1986), Nigh *et al.* (1986), Gray and Gray (1981), Goldberg and Saunders (1980), Goldberg and Johnson (1990), Khoury (1979), Khoury and Pal (2001), Hellman (1994), Tschoegl (1982) and Yamori (1998).

2. General theory of banking internationalization

INTRODUCTION

The expansion of services FDI in recent years has stimulated the search for theoretical development of service multinational enterprises. However do we really need a 'new' theory for service MNEs? The answer very much depends on the distinctions between services and goods MNEs. Many researchers believe that service firms do not differ fundamentally from the manufacturing firms (Gray and Gray, 1981; Casson, 1990; Buckley *et al.*, 1992; Williams, 1997). Therefore theories derived from manufacturing MNEs can be applied to explain service internationalization. As more service functions become directly tradable, international production systems involving services are being established. Advances in information and communications technologies facilitate trade in services as they make it unnecessary for providers and users to be close to one another. Information can nowadays be easily digitized and sent across the world at negligible cost. These new technologies also allow services to be split into components, each of which can be located in countries that can provide them most efficiently. As a result, IT-enabled services or service functions are now increasingly globalizing in the same way as manufactures have been for several decades. For instance, HSBC established its global call center in India and global data processing center in Shanghai and Guangzhou, China. Although most services FDI, such as finance, retailing and telecommunications, have been driven by host country market-seeking motives, the situation is changing.

This chapter provides a theoretical examination of service internationalization, which therefore provides a theoretical foundation for researching multinational banking in China. The following section briefly reviews the economic theories relating to the internationalization of manufacturing MNEs. Section 3 introduces supporting theories to analyse the internationalization of firms. Section 4 explains why traditional theories deriving from manufacturing MNEs can apply to explain multinational banking. Theoretical framework and research themes are presented in Section 5. We end with conclusions in Section 6.

THEORY OF MULTINATIONAL ENTERPRISE

Buckley (1983, 1990) argues that an established theory of the multinational enterprise exists. The synthesis and unification are based on internalization theory and its incorporation with location theory and competitive dynamics. The synthesis largely depends on the fundamental concepts derived from Coase's (1937) transaction cost theory and Hymer's (1972, 1976) monopolistic competition.

Historical Development of the Theory

In the 1960s the main focus of the Hymer-Kindleberger theory (Hymer, 1972, 1976; Kindleberger, 1969) and the product cycle theory (Vernon, 1966) was exporting versus FDI. Hymer and Rowthorn (1971) and Kindleberger (1969) argued that MNEs must possess some monopolistic advantages which allowed them to compete with indigenous firms in foreign markets. There were two barriers to market entry and servicing: barriers to trade which prevented MNEs from optimizing the benefit and scale by exporting, and barriers which kept indigenous firms from producing or acquiring the monopolistic advantages. Although Rugman (1981) further widened the theory by addressing that the key characteristic of a monopolist was its possession of a firm specific advantage in knowledge, it was still a confusion of how and where a differential advantage might have been built up and transferred within the firm to bridge the internal market and the final market (Buckley, 1983). The Hymer-Kindleberger theory did not explain why direct investment is the preferred means of exploiting the competitive advantages rather than exporting and licensing (Buckley, 1983, 1985a, 1990; Buckley and Casson, 2002). In fact, experience, skilled management and 'learning by doing' effects were all likely to make a well-established MNE a formidable competitor even in the absence of certain monopolistic advantages.

Vernon's product cycle theory assumed that changes in production and marketing could be forecasted. Restricted information on technology was an oligopolistic advantage (Vernon, 1979) that created industry barrier to entry. However the theory was weak in explaining how MNEs pursued investment policies in each product stage. Well-resourced MNEs were capable of developing, maturing and standardizing products almost simultaneously.

Knickerbocker's (1973) theory asserted that knowledge as an intermediate product was unequally distributed between firms. The oligopolistic advantage was the result of superior market intelligence systems that firms possessed.

Aliber's (1971) theory successfully predicted the direction of the post-war expansion of MNEs, particularly the American takeover of Europe in the 1950s and 1960s and the Japanese takeover of Southeast Asia in the late 1960s and early 1970s. The ability to finance at a cheaper cost was a kind of advantage that the firm possessed over its competitors. Such a kind of firm specific 'monopolistic' advantage deriving from imperfect capital markets could best be exploited via FDI rather than exporting or licensing.

Kojima's 'model of trade-orientated (Japanese) FDI' (see Kojima (1978) and Kojima and Ozawa (1985) for details) argued that because of the industry specific nature of the productivity-improving resources, it was easier for firms that possessed such attributes to relocate abroad, mainly in less developed countries, rather than to seek diversification among other domestic sectors. The differentiation between Japanese FDI and the US FDI described by product cycle hypothesis (Vernon, 1966) left Kojima the attempt to develop a distinct approach on the theory of MNEs. However the misuse of plant level economies of scale left Kojima's approach as a special case of a special case (Buckley, 1985b, 1991). Some of the major gains from multinational operations arose in the area of firm level economies of scale. These economies through the operation of internal markets allowed the more efficient coordination of functions within the firm (Buckley and Casson, 1976).

The empirical work conducted by Horst (1972a, b) and Wolf (1977) on the US export and investment to other countries focused on identifying the industry specific and firm specific factors that dictated the diversification process. Technical know-how and large firm size were identified as the key attributes that stimulated the US manufacturing firm to operate on a multinational and multi-industrial basis. Both industrial diversification and various forms of internationalization had a common foundation as part of a firm's complex innovating, producing and marketing strategy.

Williamson (1975, 1981) recognized that firms and markets were alternative modes of organizing economic activities. The theory of 'markets and hierarchies' created a useful insight to examine the interaction between firm structure and market structure, however it failed to produce theoretical propositions under which market or hierarchy would be replaced by the other (Buckley, 1983, 1985a).

The development of mergers and acquisitions in the 1980s (often regarded as a short cut to globalization) emphasized the choice between greenfield ventures and acquisitions. Meanwhile, the increasing involvement of US corporations in IJVs drew attention to the role of cooperative arrangements.

In the 1970s the internalization approach identified licensing, franchising and subcontracting as other strategic options. Internalization theory presented a much clearer model to explain the internationalization of MNEs based on well defined notions on market imperfections (barriers to entry) and firm specific advantages (see Buckley and Casson, (1976) for details). Internalization theory integrated important inputs from several different strands of literature in the 1970s, such as the theory of oligopolistic reaction, currency zone approach, Kojima's theory of Japanese FDI, industrial diversification theory and markets and hierarchies hypothesis.

In the 1990s the development of FDI in emerging and transitional countries such as China and Central Europe brought back the focus on some of the classic issues in the 1960s: the cost of doing business abroad and the importance of psychic distance. It renewed interest in the general questions as to why some modes of entry offered lower costs than others and why certain circumstances seemed to favor certain modes over others.

Although the eclectic theory has been regularly revised and updated to accommodate the dynamic empirical research, it is too much of a paradigm or framework and too little of a model to provide detailed advice on research design and hypothesis testing (Dunning, 1980; Buckley and Casson, 1998a). Dunning's eclectic theory (Dunning, 1977) relied on the OLI paradigm: ownership specific advantages, location endowments and internalization advantages. The inclusion of a third factor, 'ownership advantage', was a double counting if internalization was interpreted dynamically (Buckley, 1988). Multinational firms' dominance was no longer through ownership of production but through a network of contracts appropriate to the strategy of the firms and entailing tight control only of key core functions. Even Dunning himself (Dunning, 1988) admitted that because of the generality of the eclectic theory, it had only limited power to explain or predict particular kinds of international production.

However the contribution of Dunning's eclectic theory was its explicit emphasis on and incorporation of location theory and the explanation of the interaction between market entry motives and international production. Market failure might occur at structural level, such as price distortion deriving from government intervention, or at transactional level, such as a firm's ability to enhance arbitrage and leverage opportunities. Either kind of market imperfection, structural or transactional, created locational inequality that stimulated MNEs to internalize to seek the least cost location.

Dunning (1988, 1993a) identified four main types of motives for FDI: market seeking, efficiency seeking, strategic asset seeking and natural resource seeking. Young *et al.* (1989) suggested other strategic motivations that reflected a much wider context of business activities such as coalitions, collaborations and co-partnerships, and so on. These objectives included access to the expertise or attributes possessed by partner enterprises, achievement of economies of scale or learning through clusters of research and development (R&D), risk reduction, shaping competition, diversification and bypassing policy restrictions of host markets. Young *et al.* (1989) also implied that the short to medium-term objectives of a firm might differ from its long-run motive in order to enjoy certain immediate benefits or tackle external entry barriers in host markets.

Internalization Theory and its Extensions

Attempts to integrate various strands of theory of the multinational enterprise have focused on the concept of internalization which is described as 'a concept in search of a theory' (Buckley, 1983, 1985a). The internalization approach considered the firm as an internalized bundle of resources that could be allocated between product groups and between national markets. Firms grew by internalizing the imperfect markets up to the point where the benefits of further internalization were outweighed by the costs. The internalization decision should be based on a careful examination of the overall costs and benefits in relation to particular markets at specific points of time and across limited economic space (Buckley, 1988). Such an examination dictated which entry mode, namely exporting, licensing, franchising and FDI, MNEs should choose and the timing of market entry. The concept of internalization theory can be traced back to transactions based theory. Coase (1937, p. 9) explicitly asserted that forming an organization and allowing some authority (an entrepreneur) to direct the resource allocation could save some cost of operating via open market transactions. Market uncertainty was a principal barrier to the efficient establishment of the external market, which in turn incurred the cost of using the price mechanism. As a result, a firm should consider bringing some business relationships within the internal market structure of the firm rather than using external markets.

Although Buckley and Casson remained close to orthodox economic theory by taking profit maximization as the only objective of the firm (Scott-Green, 2002), their approach differed greatly from the orthodox theory by relaxing the traditional assumption of perfect competition. Buckley and Casson's approaches (see Buckley and Casson (1976) and Casson (1985), for example) allowed the existence of monopoly or oligopoly power, emphasized very general forms of imperfect competition[1] deriving from the costs of organizing markets and focused on imperfections in intermediate product markets.

By internalizing the imperfect external markets, the firm could also impose severe barriers on new entry (Buckley, 1985a). Internalization theory clarified four main groups of factors that could create barriers to the efficient use of external markets to the internationalization of the firm.

Industry specific factors (similar to Kojima (1978)) related to the nature of the product and the structure of the external markets. Region specific factors concerned the geographical and social attributes of the regions linked by the markets. Nation specific factors referred to the political and fiscal relations between the national markets (similar to Aliber (1971, 1984)). Firm specific factors related to the degree of professionalization of management. Since organizing internal markets would incur further costs, such as communication and administrative costs to ensure efficient internal coordination, the incentive to internalize the external markets thus depended on the interplay of the above four factors.

The main emphasis of the internalization approach was the imperfection in intermediate product markets rather than the final product markets. This was highlighted by Buckley and Casson (1976) as the imperfections in the markets of proprietary knowledge and information particularly in the post-war period. The critical role of information as an intermediate product was not only an important synthesizing element (Buckley, 1985a, p. 11) but also provided internalization theory with a more powerful explanatory ability. Rugman (1981) asserted that the nature of the MNE was its possession of a firm specific advantage in knowledge. The concept of firm specific advantage enabled the internalization approach to embrace other theories such as the 'monopolistic or oligopolistic advantages' (Hymer, 1976; Kindleberger, 1969; Vernon, 1979), ownership advantages (Dunning, 1977, 1980), internal resources (Penrose, 1956) and competitive advantages (Porter, 1980, 1990, 1998).

It was often in debate whether firm specific advantage was a necessary condition for multinationality. The Hymer-Kindleberger theory asserted that multinational firms must have monopolistic advantage to overcome the incumbents' natural advantage. The ownership advantage (Dunning, 1977) was developed domestically by the MNE and then applied overseas. Internalization theory considered the cost of overcoming the domestic firms' incumbency to be one component of the costs of global operations. The decision to invest was not made on the basis of the incumbency costs versus ownership benefits but rather on the basis of total costs versus total benefits. Penrose (1956) also argued that with certain advantages in internal resources, such as management, technology or capital, firms might grow somewhat faster than domestic firms even in the absence of any exorbitant degree of monopoly power. Casson (1987) considered the advantage that the multinational possesses relative to its competitor firms. This advantage might well be a non-monopolistic advantage relative to other MNEs. Thus the concept of ownership advantage was one more correctly applied to the analysis of performance post entry rather than to the analysis of choice pre entry.

The attention drawn on the knowledge as a firm specific advantage led to a further analysis of the diffusion of technical and marketing knowledge within the internal market of the firm. It thus added more dynamic elements to the internalization approach. Both multinationality and growth of the firm were linked to R&D through the internalization of knowledge. Buckley and Casson (1976) provided a detailed description of the interdependency of firm's activities through the integration of production, marketing and R&D. They highlighted the role of R&D in creating and acquiring the knowledge and the diffusion of the know-how through efficient coordination within the firm. Unlike Hymer-Kindleberger's monopolistic advantages as 'manna from Heaven' (Buckley and Casson, 2002, p. 69), the internalization approach cast a special light on how to create and maintain such a 'monopolistic' advantage over time through a well managed internal market structure (Buckley, 1983). The theory also implied a stepwise entry into markets and a rational international diversification strategy.

Rugman (1981) further developed the internalization theory by including 'spatial cost saving' as an internalized firm specific advantage. In fact the least cost location approach and more generally related location theory were implicitly argued in the 1976 version of the internalization theory. The choice of least cost location was a result of the costs of internalization. Locational advantages were incorporated within the internalization decisions and were balanced between the internal and external market structures. Moreover the flow of FDI reflected the pattern of world social, geographical and political relations. The source countries tended to invest in a host country whose structure was the closest, in a broad sense, to that of the source country. It explained why the initial trend of the flow of FDI in the post-war period was among developed countries, mainly between the USA and European countries. A more explicit redefinition of the location factor as an internalized firm specific advantage by Rugman (1981, 1982) and Buckley (1988) allowed internalization theory to further integrate the location theory (for example, Vernon, 1966; Dunning, 1977, 1988) which was seemingly segmented from the previous general approach of internalization.

SUPPORTING THEORETICAL CONCEPTS

Internalization theory allowed a maximum dynamism in the theoretical explanation. However the theory was difficult to operationalize (Scott-Green, 2002) and could not be examined directly at its most general level. Therefore supporting theories needed to be integrated for testing the segmented framework and more dynamic elements needed to be introduced to the theory. The core theory of international business should expand beyond the narrow economic approach to encompass social and political effects in order to produce a complete and dynamic theory that explained the development of the firm and industry.

The main contribution of the resource based view (RBV)[2] of strategic management to economic theory of MNEs was its ability to bring together several strands of research in economics, industrial organization, organization science and strategy itself (Rugman and Verbeke, 2002). From the perspective of the RBV, the business was defined in terms of its resources and capabilities instead of served markets (Andersen and Kheam, 1998). It was the concentration of the business strategy to develop and exploit the internal resources and capabilities to create sustainable competitive advantages. An optimal pattern of firm expansion existed which involved a balance between exploitation of existing resources and development of new ones (Penrose, 1959; Wernerfelt, 1984). Since resources were involved in integrated activities, they yielded more rents to the firm than to the market and other firms (Kogut and Zander, 1993). Most attention had been paid to internally accumulated resources such as routines and capabilities rather than to those that could be purchased on factor markets (Foss and Foss, 2000). Barney (1986) asserted that only heterogeneous, rare and hard to imitate resources acquired in imperfect factor markets could be rent-yielding strategic assets to firms.

Resource based theory provided value added theoretical explanations about the direction of a firm's diversification strategy (Andersen and Kheam, 1998; Foss and Eriksen, 1995). Firms tended to develop new products and enter new markets where the resource requirements matched their resource capabilities. Diversification was seen as the result of excess capacity in resources that had multiple uses and for which there was market failure (Peteraf, 1993; Teece, 1982). Firms with generalizable or flexible resources were able to diversify quite widely while firms with specialized or inflexible resources, mainly physical resources and intangible resources, would follow a rather narrow diversification strategy (Chatterjee and Wernerfelt, 1991).

The resource based view yielded more insights at the firm level rather than on the external environment. The growth of the firm was largely determined by the internal resources of the firm such as experience, innovations, managerial ability and technological know-how rather than by external conditions (Penrose, 1956, 1959; Wernerfelt, 1984). Penrose argued that it was the resources of the firm that limited the growth and choice of markets it might enter. Key resource constraints included shortage of labor or physical inputs, shortage of finance, lack of suitable investment opportunities and lack of sufficient managerial capacity. Andersen and Kheam (1998) identified two different traditions of using the resource based theory to predict the growth strategy of the firms. One focused on the role of corporate resources in determining the boundaries of the firm's activities (see, for example, Peteraf, 1993). The other tradition focused on the business strategy level that relied on the management's perceptions of the firm's competitive advantages.

Resource based research clarified how resources and capabilities at the firm level might contribute to firm level competitive success. A firm's capacity to deploy resources was based on the firm's ability to develop, carry and exchange information through its human capital (Amit and Schoemaker, 1993; Andersen and Kheam, 1998; Foss and Eriksen, 1995).

Casson (1986) argued that any satisfactory explanation of the dynamics of firm specific advantage must rest on the reinstatement of the role of the entrepreneur to a central position in the theory of the firm. Many previous theories only partially explained different aspects of the firm behavior and these theories were difficult to synthesize into a comprehensive theory due to their lack of attention to integrate entrepreneurship literature (see, for example, Alchian and Demsetz, 1972; Foss and Mahnke, 2000; Foss and Klein, 2002; Casson, 1986, 1998, 2000, 2003) with the economic theory.

With the scarce knowledge and information, entrepreneurs could influence the expectations of others, used this influence to align people's expectations, and thereby facilitated cooperative activities (Casson, 2003). Specialization in judgmental decision making defined the core characteristic of the entrepreneur. Superior judgment stemmed from either privileged information or from a superior mental model of the environment applied to publicly available information, or from a combination of both. Entrepreneurs usually had the reputation for knowing more than others because of their superior access to information.

Information was unevenly distributed among firms and the market environment was extremely volatile, a constant concentration on preserving entrepreneurs was essential to internalize external information and knowledge. The identification of entrepreneurship offered more insight into the implementation procedures of the decision making such as explaining the administrative procedure and the implementation of new corporate concepts. With such an inside approach of the firm, one should be granted a greater flexibility to explain the behavior of the firms, in particular the service firms such as banks since banking products were heavily information and human embodied (Casson, 1990; Buckley *et al.*, 1992; Dunning, 1993b).

Firms existed because they produced, stored, transferred and utilized knowledge, particularly tacit knowledge, more efficiently than markets (Foss and Foss, 2000). The boundary of the firm should be explained in terms of the specificity and non-tradability of knowledge assets such as routines and capabilities. The multinational corporation arose out of its superior efficiency as an organizational vehicle by which to transfer the knowledge across borders (Kogut and Zander, 1993). Such a knowledge based approach of MNEs treated the firm as a social community whose productive knowledge defines a comparative advantage.

Knowledge was considered as a tacit good rather than a public good by developing continuous scales of the underlying dimensions of codifiability, complexity and teachability. The more tacit the technology the more likely technology would be transferred within the firm. The costs of technology transfer were viewed as stemming from the degree of tacitness of the knowledge. The knowledge based approach was quite useful in explaining the internationalization of services such as banking where competitive advantages were mainly characterized as tacit knowledge about clients, products and markets. The knowledge based approach offered more dynamic insights into the examination of how firm specific advantage was created and transferred. This was done by introducing more testable variables and proxy measures of how tacit the underlying knowledge was and what the costs of transfer were. Contractor (1981) and Davidson and McFetridge (1984) suggested that the costs of transfer were related to the accumulation of experience and learning associated with previous transfers.

In stages or incrementalism approach (Johanson and Vahlne, 1977; Calof and Beamish, 1995; Petersen and Petersen, 1998), lack of knowledge was an important obstacle to the development of international operations and knowledge determined the pattern and pace of internationalization of the firm. Knowledge was so often experiential in nature. Market experience would lead to a step-wise increase in the scale of the operations and of the integration with the market environment where steps would be taken to correct imbalance with respect to the risk situation on the market. Human resources played an important role in gaining experiences and diffusing marketing and managerial knowledge across different working units in the firm.

The supporting theoretical concepts add explanatory power to explain the activities that firms will undertake and the means that managers use to apply their firm specific advantages. By focusing on the banks' internal resources, including managerial capabilities, financial strength, knowledge of client and market, and product expertise, these theories enable the operationalization of internalization theory. They emphasize managerial resources as the main driver (or constraint) to facilitate effective knowledge transfer and thus to maintain a competitive edge in international expansion. The accumulation of knowledge and experience is an incremental process during which corporate learning is essential for the acquisition and exploitation of market related knowledge. Banking expansion is carried out in distinct steps from representative offices to branches or subsidiaries together with an accumulation of knowledge. During this incremental progress, managerial expertise is gained to facilitate new operations. Meanwhile, a bank engages in a process of organizational learning that adds further resources which can be transferred within the bank to create more value. The balance between the pursuit of diversification and the focus on core resources is determined by the strategy of each individual bank and the external markets surrounding the banks.

MULTINATIONAL BANKS AS SERVICE MNEs

The nature of the service industry changes the conditions for internalization but the principle of the theory is still the same (Casson, 1990). Internalization theory expects the banking industry to be multinational in scope (Buckley, 1988) as it is highly human, skill, knowledge and communication intensive (Jones, 1993). Information and knowledge as an intermediate product plays an essential role in the growth of service firms. Services being intangible, non-storable and untransportable cannot be traded without requiring the providers or receivers to physically relocate. This increases the likelihood of service MNEs such as banks pursuing FDI strategies as opposed to licensing contracts and exporting (Dunning, 1989). Service multinationals do not implicitly differ from the manufacturing firms, therefore theories derived from manufacturing MNEs are likely to be applied to explain service internationalization (Gray and Gray, 1981; Casson, 1990; Buckley *et al.*, 1992; Williams, 1997). However foreign expansion strategies of service MNEs may differ from those traditionally associated with product manufacturing.

Service firms have unique market entry and delivery technique possibilities. One of the unique characteristics of service firms that affects their choice of entry mode is the inseparability of producer-consumer interaction (also see, for example, Berry *et al.*, 1985; Boddewyn *et al.*, 1986; Cho, 1986; Enderwick, 1989; Nicoulaud, 1989; Casson, 1990; Buckley *et al.*, 1992; Clegg, 1993). Due to product intangibility and inseparability, most of the service products are experienced rather than inspected and buyer uncertainty tends to be greater (Casson, 1982; Clegg, 1993). It also indicates that the provider of services must ensure adequate service through the control of quality. It is recognized that the internationalization process of many services moves rather more swiftly through the exporting phase to the foreign production phase, compared with typical manufacturing industry (Clegg, 1993). The degree of internationalization of services is generally less than that of goods. A sizeable proportion of FDI in services follows rather than leads investment in goods (Dunning, 1993b).

Banking as an important sub-sector of services shares most of the service features in general. Banking industry is a heavily knowledge and human skills intensive sector. The non-tradability of banking products determines the location and mode of service delivery. The importance of knowledge within the banking industry dictates that the organizational form of banking growth is largely internalized because of market imperfections in information markets. Soft technologies such as information, expertise, organizational skills, management, marketing and technical know-how are the main means of knowledge and skills transfer in multinational banking. Information about firms and markets such as commercial knowledge, experience and reputation in a particular product or regional area, the possession of superior and unique banking techniques and organizational skills are more relevant for MNBs (Dunning, 1988). Knowledge deriving from experience in products, markets, clients, routines and culture (Kogut and Singh, 1988; Jones, 1997) has the ability to serve as a source of sustainable differentiation and hence leads to competitive advantage (Gupta and Govindarajan, 2000) in multinational banking.

Previous studies (Gray and Gray, 1981; Casson, 1990; Cole, 1998) suggest that personal contact or the bank-client relationship constitutes the main competitive advantage for multinational banking. The bank-client relationship[3] consists of a set of information flows. The bank cannot sell its knowledge about the client and receive a fair price. Banks cannot elect to service their existing clients overseas by exporting information to banks in the host nations (Williams, 2002). Delegated monitoring and the need to protect the knowledge of the client and product lead banks to high levels of internalization with a preference for wholly owned operational modes over exporting and licensing. Both banks and multinational companies use their long-term relationship as a means to reduce uncertainty (Engwall and Johanson, 1990), minimize transaction cost (Grubel, 1989) and expand globally (Scott-Green, 2002). This can be observed from the most typical entry method of establishing branches and subsidiaries abroad and the wave of cross-border mergers and acquisitions of international banks in the 1980s and early 1990s. MNBs choose internalization for a number of reasons, especially when it is important to safeguard proprietary knowledge, minimize transaction costs associated with opportunism, avoid search and negotiation costs, tap synergies from geographical diversification or develop new markets (Dunning, 1993b, pp. 52–4).

THEORETICAL FRAMEWORK AND RESEARCH THEMES

The analysis of existing theories suggests that the explanation for the internationalization of banks should be based on the internalization theory and its integration of alternative literature. Figure 2.1 presents the general framework to study banking internationalization and the associated research approaches.

Central to the theory of MNEs is the nature of firm specific advantages (Buckley and Casson, 1976; Casson, 1987; Kogut and Zander, 1993), which explains the reasons for the existence of MNEs and why a firm internalizes operations across national boundaries. Internalization theory provides a fundamental theoretical argument to explain the existence of banks and the reason for multinationality and to predict and explain the process of internationalization of banks. Based on this fundamental argument, alternative theories are incorporated to offer a more insightful and dynamic explanation, mostly at the bank level, on how banks develop in foreign markets. Other theoretical concepts offer more insights into how management uses firm specific factors to affect its competitive position and the types of activities that a bank will undertake. The synthesis or the concentration of various arguments once again draws upon the management of knowledge and information in international operations. Key determinants such as managerial capability and corporate learning are identified.

Internalization theory together with strategy literature set out a fundamental framework to examine the market entry and development of foreign banks. This study seeks to investigate the following research issues and to deliver practical insights into the evolution of strategic patterns of foreign banks in China.

Discussion of the effect of internalization factors on the market entry:

1. Issues of motivating why banks enter (or decide not to enter) the Chinese banking market.
2. Issues of mode of control and location choice.

Discussion of the effect of strategy literature, mainly resource based factors, on the market entry:

1. What are the capabilities and resources of being successful in a distant and emerging market?
2. To what extent do entry patterns differ according to products segments (for example, wholesale and investment banking, asset management, trade finance and credit)?

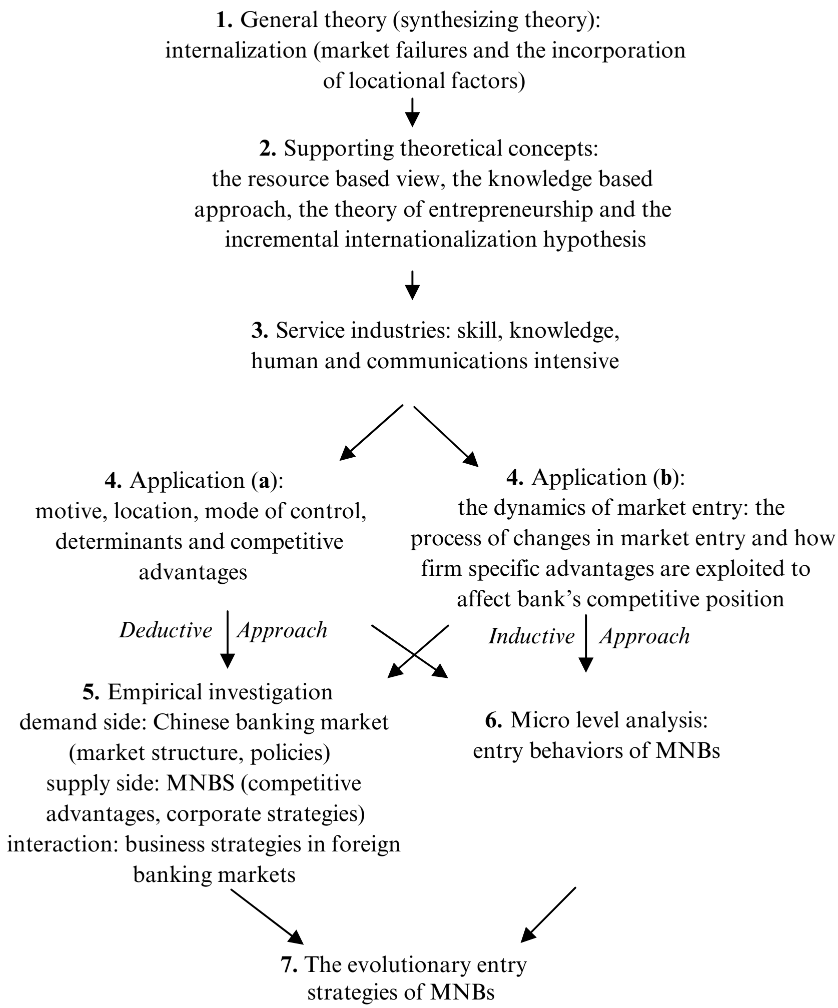


Figure 2.1 General framework of banking internationalization

3. Managerial issues that significantly affect the market development of foreign banks:
   a) How do banks successfully relate to the Chinese government?
   b) How important are location decisions?
   c) How do banks cooperate with a Chinese bank without full control through equity where the bank risks losing bargaining power and diluting competitive advantage by having transferred its IT system and other critical capabilities?

d) How can banks manage localization and innovation of their services?
e) How can banks adapt into the local market by minimizing their risk exposure without losing opportunities for growth?

CONCLUSIONS

This chapter develops a general theoretical framework based on the analysis of existing theories on MNEs. The center of the framework focuses on the analysis of internalization theory and its integration of strategy literature. The conceptual innovation of this study does not lead to the creation of new theory for banking internationalization but rather the introduction of an eclectic theoretical framework with associated research approaches that sheds light on both economic and strategic analysis of multinational banking.

NOTES

1. Internalization theory identified five main types of market imperfection which generate significant benefits to internalization. See Buckley and Casson (1976) for details.
2. See Penrose's (1959) initial notion of internal resources of the firm and Pfeffer and Salancik's (1978) resource dependence theory for details.
3. See Williams (2002) for a complete discussion on defensive expansion hypothesis of MNBs.

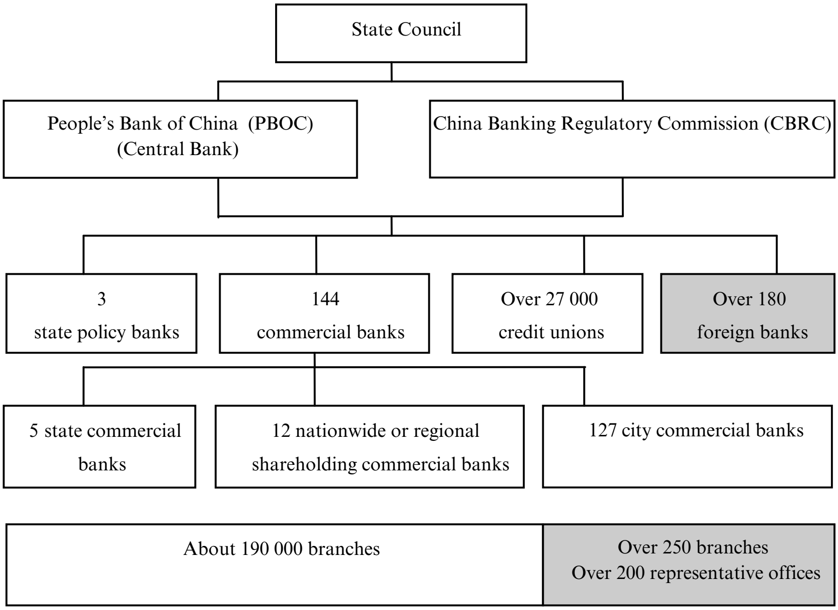
3. China's banking industry

INTRODUCTION

Given the great market size and potential, MNBs have been constantly seeking market entry and development opportunities in the Chinese banking market. The purpose of this chapter is to give a background introduction to China's banking industry, in particular the dynamics involved before and after China's WTO accession. It aims to achieve a better understanding of the behaviors of foreign banks in the market entry. This chapter is set out as follows: the next section discusses the structure of China's banking industry; Section 3 outlines the liberalization process of the Chinese banking market; Section 4 discusses the market entry of foreign banks before and after China's accession into the WTO; the chapter ends with conclusions in Section 5.

THE STRUCTURE OF CHINA'S BANKING INDUSTRY

China's banking sector is dominated by its domestic banking network which is made up of three state policy banks, five state owned commercial banks, 12 shareholding commercial banks, 127 city commercial banks, 599 city credit cooperatives, 27 036 rural credit cooperatives, 60 rural cooperative banks and 12 rural commercial banks with an aggregate branch network exceeding 190 000 locations throughout the country (China Financial Stability Report, PBOC, 2006) (Figure 3.1). All banks are governed by the PBOC, the central bank, which is responsible for setting China's monetary policies. CBRC established in 2003 is responsible for the supervision of banking operation and services. The local currency is not freely exchangeable. The interest rates are tightly monitored and controlled by the PBOC. Since 1986 the PBOC has been explicitly made responsible for monetary policy and the supervision of the financial system including the money and capital markets. With the objective of containing inflation, the PBOC takes the responsibility for formulating a credit plan that sets an aggregate credit ceiling on each PBOC branch according to the national economic plans and authorizes each branch



Source: Author's elaboration on *People's Bank of China Quarterly Statistical Bulletin*, various issues and *China Statistics Yearbook of Finance*, various issues.

Figure 3.1 Structure of the Chinese banking industry

to allocate credit under the ceiling. The PBOC is not an independent regulatory body. It functions as a line ministry under the State Council and its monetary policy decisions are subject to the approval of the State Council.

The big four state owned commercial banks ('big four'), namely the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the Agricultural Bank of China (ABC) and the China Construction Bank (CCB), are transformed from the four major business divisions of the former PBOC specializing in industrial and commercial business, foreign currency business, agricultural business and infrastructure development business respectively. They dominate the banking sector in terms of branches and employment. Now three of the big four commercial banks have been listed on the stock market after overhauling reforms. Prior to their commercialization their lending was largely restricted to designated sectors based on the government's industrial policy. Since then the four state owned banks have been allowed to lend to any sectors freely, although their business has in practice remained concentrated in the traditionally prescribed areas. China Post Savings Bank was only recently approved on 31 December 2006 by the CBRC to become the fifth state owned commercial bank. Three policy lending banks (the Agricultural Development Bank of China, China Development Bank and Export-Import Bank of China) were established in 1994 to take over long-term development finance and policy lending business previously performed by the specialized 'big four' banks.

The 127 city commercial banks resulted from the restructuring of the former 90 city credit cooperatives. The 12 nationwide or regional shareholding commercial banks are commercial banks established in the late 1980s or early 1990s. Although the rest of the commercial banks have all adopted a shareholding ownership structure, the State still has a controlling stake in most of them. The 12 nationwide or regional shareholding commercial banks have the central government or the respective provincial or municipal governments holding a control stake, while the 127 city commercial banks have the respective city governments as the largest shareholders.

Over 180 foreign banks were authorized to establish 163 branches, 223 representative offices, eight wholly owned subsidiaries and five joint ventures in China by the end of 2005. The number of branches and subsidiaries of foreign banks increased to 254 by the end of 2006 (China Financial Stability Report, PBOC, 2006). The total assets of foreign banks in China experienced a steady growth over the last two decades and reached 171 463 billion USD at the end of 2007. One hundred and fifty four foreign banks have received licenses to conduct RMB business across 25 Chinese cities. Twenty five foreign financial institutions have each acquired minority equity control of 20 domestic Chinese banks (China Financial Stability Report, PBOC, 2006) by the end of 2005. China's 'big four' state owned commercial banks still dominate the local banking market. They accounted for over 51.3 per cent of the local banking assets, loans and deposits at the end of 2006. In contrast foreign banks only accounted for about 2.4 per cent of China's banking assets. Before full market accession status was granted in 2007 the PBOC tightly controlled the business scope, type and currency of products and services, operational volume, customer base, number of branches and location of foreign bank operations. This is a key factor contributing to the imbalance of foreign banks' presence compared to domestic counterparts. For example, the ICBC, the largest domestic bank in China, has some 37 000 branch and sub-branch locations while HSBC, the foreign bank with the biggest presence in China, had just about 30 in 2007.

THE LIBERALIZATION PROCESS OF CHINA'S BANKING INDUSTRY

Prior to 1979 China's banking system was not modern and played only a limited role in promoting economic growth. This reflected the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from state owned enterprises (SOEs) and allocating investment through budgetary grants (Ma, 2001; Mo, 1999). Under these circumstance banks simply provided credit needed by the SOEs for their production plans and monitored cash used principally to cover labor costs and purchases of agricultural products.

The government has embarked on a series of banking sector reforms since 1979. A central task was to establish a two-tier banking system comprised primarily of a central bank and four specialized banks that were wholly owned by the central government. In the process of establishing the new banking system, the government first removed the monopolistic position of the PBOC in 1979 by establishing four specialized banks: the ABC, BOC, CCB and ICBC.

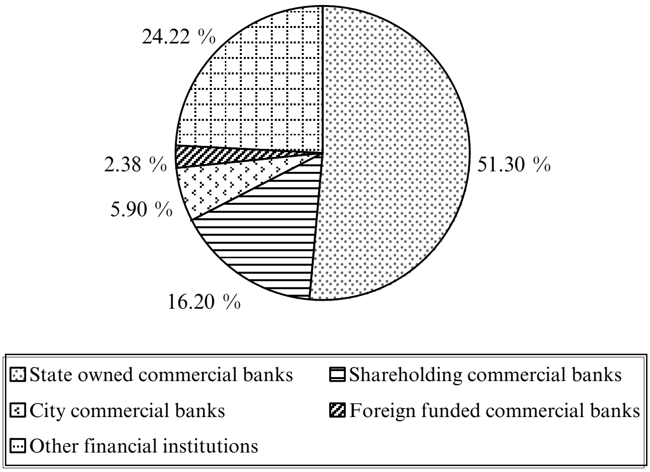
The liberalization of China's banking industry has exhibited five main stages. In the first stage (1979–82), 31 representative offices of foreign financial service companies were allowed to establish in open cities or Special Economic Zones (SEZs) such as Beijing, Shanghai, Guangzhou, Tianjin, Dalian and Qingdao. In the second stage (1983–91), the Chinese government authorized the first foreign bank – Nanyang Commercial Bank Ltd, Hong Kong – to open branches in the Mainland in 1982. This signaled a new period of opening up reform in the local banking industry. Since then foreign banks have been allowed to have wholly owned or joint venture branches in SEZs and open cities. However the business scope of these foreign subsidiaries was rather narrow. Most of them could only conduct part of the foreign currency business. Deng Xiaoping's southern tour pushed the liberalization of China's banking market into the third period (1992–2001). Foreign investors expanded their business into banking, security and insurance sectors. The number of cities with foreign financial subsidiaries increased to 23. Until the end of 2001 foreign banks had opened 193 subsidiaries that were approved to do business in China. The rapid market entry and development of foreign banks took place between 1994 and 1997. Within these four years the total number of foreign banks increased by 90 and total assets of foreign banks in China increased by nearly four times. The Asia financial crisis slowed down the pace of banking market liberalization. China's entry into the WTO at the end of 2001 represented the beginning of a new era towards the full liberalization of the local banking market. The newly approved Regulations on the Administration of Foreign Invested Financial Institutions and the Implementation Rules set a much clearer opening timetable for foreign banks. Chinese banks enjoyed a final five-year transitional period until the local banking market was fully opened to foreign investors in 2007. Since 2002 market expansion of foreign banks in China has speeded up. The recovery of investor confidence in Asian markets and a series of policies adopted by the Chinese government to deepen the banking reform since WTO accession have greatly contributed to the market entry and development of foreign banks. Since 2001 China has taken a series of measures to gradually open its financial market including the introduction of the QFII (qualified foreign institutional investors) scheme in 2003 to allow foreign institutional investors, such as UBS, Deutsche Bank and Citigroup Global Markets Limited, to engage in the securities business. By the end of 2006 the total assets of foreign banks in China had exceeded 171 billion USD, that is, four times the figures compared to the financial crisis period. According to WTO rules, full market entry was granted in January 2007, symbolizing a new boom for foreign banking activities in China. RMB business with retail customers such as credit cards, private finance and mortgages becomes a new battlefield. Foreign banks will pursue more in-depth local market penetration in terms of geographical diversification and client diversification.

THE MARKET ENTRY OF FOREIGN BANKS

An Overview of the Market Entry of Foreign Banks

Since the Chinese banking market was reopened in the 1980s, there have been over 180 foreign funded banks operating in China with over 200 representative offices and over 250 branches and subsidiaries. By the end of 2007 the total assets of foreign banks in China reached 171.463 billion USD, up by 47 per cent compared with the beginning of 2007. The total assets of foreign banks accounted for 2.38 per cent of total assets of financial organizations nationwide (Figure 3.2). The balance of loans, liabilities and outstanding deposits amounted to 95.156 billion USD, 155.423 billion USD and 60.663 billion USD by the end of 2007 respectively, and accounted for 2.5 per cent, 2.3 per cent and 1 per cent of that of the financial organizations nationwide respectively (*People's Bank of China Quarterly Statistical Bulletin*, 2008).

The banking industry remains critical to China's economic development and restructuring. Due to years of centralized management style and the separation between banking and other financial services, such as insurance



Notes:

1. The state owned commercial banks include the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the China Construction Bank and Bank of Communications. As the number of state owned commercial banks has increased in 2007, this figure is incomparable with that of 2007.
2. The shareholding commercial banks include CITIC Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co., Evergrowing Bank, China Zheshang Bank and China Bohai Bank.
3. The other financial institutions consists of policy banks, rural commercial banks, rural cooperative banks, urban credit cooperatives, rural credit cooperatives, finance companies affiliated to enterprise groups, trust and investment companies, financial leasing companies, auto financing companies, money brokers and postal savings.

Source: Author's calculation based on CBRC news release in 2007.

Figure 3.2 Asset distribution of financial institutions by the end of 2006

and securities, the big four state owned commercial banks are heavily under-capitalized and suffer from large amounts of non-performing loans (NPLs) deriving from the policy lending directed by the provincial governments. The Chinese banking market is not mature and domestic banks are not competitive enough. Under these circumstances the central government will monitor closely the entry of foreign banks to ensure that home grown players remain on top of things. Therefore the operations of foreign banks are tightly controlled by the PBOC. Although the total assets of foreign banks increase over time, foreign funded commercial banks only account for an insignificant proportion of the total assets of the Chinese banking industry.

Table 3.1 Distribution of foreign banks (branches) by country of origin in 2002

	2002
Total number of banks (branches)	178 (160)
Japan	31 (20)
Hong Kong, China	14 (36)
USA	17 (14)
EU	64 (46)
Germany *Mainly*	12 (7)
France	6 (17)
Netherlands	5 (9)
UK	5 (8)
Other Asia	34 (36)
Singapore *Mainly*	3 (12)
South Korea	9 (9)
Thailand	3 (5)
Other	18 (8)

Notes: Number of branches is shown in parentheses. The figure includes seven joint venture banks and six locally incorporated banks. Foreign funded finance companies and insurance companies are excluded.

Source: Author's calculation based on the *People's Bank of China Quarterly Statistical Bulletin* (2002, Q3).

Foreign banks registered in China are diversified by nationality. Table 3.1 shows the distribution of foreign banks (branches) by source country in 2002. It illustrates the dominance of Asian banks, mostly from Japan, Hong Kong, Singapore and South Korea, in the development of foreign banks in China. Hong Kong banks take the lead in terms of branch building. Banks from Germany, France, Netherlands and the UK account for the majority of the branches established by European banks. French banks set up the broadest local networks compared with other European banks.

FDI in China's banking industry is unevenly distributed by region. Foreign bank branching activities cluster in SEZs, open cities in coastal areas and several authorized cities. Beijing and Shanghai are two most preferred locations given their political importance, healthy business environment and efficient government services. Shanghai attracts foreign banks from 23 different countries of origin and appears to be the prior choice for the establishment of locally incorporated bank subsidiaries. By the end of 2007 Shanghai had approved 17 locally incorporated foreign banks. The figure accounts for 58.6 per cent of the total number of foreign bank subsidiaries that are locally incorporated. The total assets of these locally incorporated subsidiaries reached over 105 billion USD in 2007 that accounted for 58.84 per cent of the total assets held by foreign banks in China (*People's Bank of China Quarterly Statistical Bulletin*, 2008).

Foreign banks also target the inner regions as the second step long-term business expansion once they establish their footholds in SEZs and financial centers. For instance, Standard Chartered Bank initiated a project to provide loans of small amounts to cotton peasants from Xinjiang Autonomous Region. HSBC opened in rural areas of Hubei province and Chongqing municipality city to provide unsecured loans for peasants and secured loans for township enterprises.

Historical, geographical and cultural links may also influence the location choice of foreign banks. For example, banks from Thailand mainly locate in south western China which is geographically close to Thailand. Japan established most of their operations in north eastern cities of China, such as Dalian and Shenyang, which used to be Japan's occupations during the Second World War. Hong Kong banks locate most of their affiliates in the southern part of China where they share a similar culture and language and enjoy the benefit of being geographically close to the targeted regional markets. Furthermore Hong Kong has the highest number of branches in China and the broadest regional coverage (*People's Bank of China Quarterly Statistical Bulletin*, 2003).

Due to the less developed financial market, the operation of foreign banks is highly restricted by local regulations. The business scope of foreign banks is very narrow. During the initial five years of China's WTO accession, most foreign banks can only conduct business in foreign currencies with foreign firms, individuals and a limited number of Chinese companies. Foreign banks are quite competitive in foreign currency business. Take Shanghai as an example, foreign banks have accounted for over 50 per cent of the total local foreign currency business by the end of 2007. The development of the local banking market is largely subject to the policy changes. Full market liberalization after 2007 will certainly bring far-reaching implications to foreign banks. A number of banks such as HSBC, Standard Chartered, Citibank and Bank of East Asia have been fully prepared to engage in consumer RMB banking services.

The Impact of the WTO Membership on Market entry of MNBs

Following China's WTO entry on 11 December 2001, full market access was granted in stages to foreign banks over a five-year period. On 29 December

2001 the State Council approved the landmark Regulations of the PRC on the Administration of Foreign-Invested Financial Institutions (the 'Regulations'). Following this, the PBOC amended the Implementation Rules for the Regulations of the PRC on the Administration of Foreign Invested Financial Institutions ('the Implementation Rules') on 29 January 2002. Both took effect from 1 February 2002. The Regulations apply to foreign bank branches in China, wholly foreign-invested banks and finance companies with their head offices in China, Sino-foreign joint venture banks and finance companies operating in China. The Regulations are also applicable to financial institutions that are set up by financial institutions from Hong Kong, Macau and Taiwan.

According to the 'Regulations' and the 'Implementation Rules', all the restrictions on customer types for foreign banks' foreign currency business were removed upon accession. The Chinese government would broaden the scope of foreign banks' RMB business, gradually eliminate the geographic restrictions on RMB business within five years of accession and gradually eliminate the restrictions on customer types for RMB business. Table 3.2 outlines the major regulation changes before and after China's accession to the WTO. The liberalization timetable of China's banking sector is presented in Table 3.3. After China's entry into the WTO, there have been plenty of regulation changes for foreign banks. China allowed foreign banks to conduct RMB corporate banking business with Chinese companies within two years after its WTO entry and retail banking with Chinese individuals five years after its WTO accession. Both geographic and customer restrictions on foreign bank operations were lifted five years after accession. Foreign banks had the same rights (national treatment) as Chinese banks within designated geographic areas. The Chinese government would not interpose foreign banks' further expansion.

For the formation of a joint venture bank or finance company, the Chinese party does not need to be a financial institution as previously required. However the Implementation Rules do insist that the sole or largest foreign party of a wholly foreign owned or joint venture bank must be a commercial bank with a capital adequacy ratio (CAR) of no less than 8 per cent. Similarly the sole or largest foreign party of a wholly foreign owned or joint venture finance company should be either a commercial bank (with CAR $\geq$ 8 per cent) or a finance company. The foreign party of a foreign invested financial institution (FIFI) must also meet certain requirements for total assets. The Regulations do not specify the minimum foreign ownership in a joint venture bank or a finance company. However as long as foreign capital within an alliance exceeds 25 per cent limit the bank is regarded as a foreign invested bank.

Table 3.2 The impact of the WTO on China's banking industry

		Before WTO	After WTO
Local currency business	Geographical opening	Allowed on an experimental basis, but highly restricted as to two cities: Shanghai and Shenzhen	• Permitted immediately after accession in four cities: Shanghai, Shenzhen, Tianjin, Dalian • 1 year after accession: Guangzhou, Qingdao, Nanjing, Wuhan • 2 years after accession: Jinan, Fuzhou, Chengdu, Chongqing • 3 years after accession: Beijing, Zhuhai, Xiamen, Kunming • 4 years after accession: Xi'an, Shenyang, Ningbo, Shantou • 5 years after accession: full lifting of geographical restrictions
	Customer access	No domestic business or individuals allowed	• Access to Chinese domestic enterprises within 2 years after accession • Access to Chinese consumers 5 years after accession
Foreign currency business	Geographical opening	Restricted geographically	No geographical restrictions
	Customer access	Foreign customers only	No customer restrictions
Licensing requirements		Non-prudential criteria existed	Elimination of any non-prudential measures within 5 years after accession
Products and services		Restrictive list as set out in business license	Gradual liberalization of products and services (for instance, credit cards and mortgage) is expected

Source: Author's elaboration on Implementation Rules.

According to the Implementation Rules, foreign banks must meet three criteria if they want to establish branch operations in China. First, a foreign bank must establish a representative office at least two years prior to application; second, the parent company of the FIFI must have total assets of at least 20 billion USD; third, the parent company or headquarters must

Table 3.3 The liberalization timetable of China's banking sector

	2002	2003	2004	2005	2006	2007
Corporate banking	Local currency business with foreign enterprises in four cities: Shanghai, Shenzhen, Tianjin, Dalian	Four additional cities: Guangzhou, Qingdao, Nanjing, Wuhan	Local currency business with foreign and Chinese enterprises Four additional cities: Fuzhou, Chengdu, Jinan, Chongqing	Four additional cities: Zhuhai, Beijing, Xiamen, Kunming	Four additional cities: Ningbo, Shenyang, Shantou, Xi'an	Geographic and customer restrictions will be removed
Retail banking	Foreign currency business with Chinese clients (license is required)					Local currency business with foreign and Chinese clients
Investment banking	Establish securities operations as a joint venture with a minority (up to or equal to 33.33%) equity share for foreign investors		Increase to 49% equity share			

Table 3.3 (continued)

	2002	2003	2004	2005	2006	2007
	to underwrite A and B shares					
Asset management	Manage assets through a joint venture with foreign minority equity share (up to or equal to 33.33%)		Increase to 49% equity share			

Source: Author's elaboration on Implementation Rules.

Table 3.4 The quantitative criteria for the formation of a FIFI

Criteria for forming a FIFI	Minimum period of operation of a foreign party as a representative office in China	Minimum total assets of a foreign party
Foreign bank branch	2 years	20 billion USD
Wholly foreign owned bank or finance company	2 years	10 billion USD
Joint venture bank or finance company	Not specified but required	10 billion USD

Source: Author's elaboration on Implementation Rules (2002).

be located in a country with sound financial supervisory and administrative systems. The market entry criteria for the formation of a foreign funded institution remain unchanged after China's accession to the WTO. Table 3.4 summarizes the quantitative criteria required to establish a FIFI for different ownership types.

The whole application process could take up to 18 to 27 months to complete if the PBOC receives all the required documents on time. If an application fails at any stage during the process, the applicant has to wait for 12 months before reapplying in the same city. In addition, a foreign bank cannot apply to establish an additional branch until 12 months after the previous approval. The Regulations require a FIFI to seek the PBOC's approval prior to undertaking any significant changes in areas such as capital, significant shareholders (≥ 10 per cent), senior management or the scope of business. The rules are designed to enhance the PBOC's prudential supervision of FIFIs.

What is inconsistent with international practice is that the introduction of new products[1] within a foreign bank's authorized scope of business requires the PBOC's prior approval. Certain restrictive ratios have been relaxed, however, additional capital funds are required for foreign banks that intend to expand their business scope to take advantage of the changes introduced by the WTO. Depending on the intended scope of RMB or foreign currency business and customer types, the Implementation Rules impose various requirements of minimum registered capital and operating funds on foreign banks. Table 3.5 exhibits the working capital required for the expansion of business scope by foreign funded branches, subsidiaries and joint ventures. In order to obtain a full business license to conduct

Table 3.5 Working capital required for the expansion of business scope by foreign funded branch, subsidiary and joint venture

Business Scope	Requirements on working capital	
	Wholly owned foreign bank branches	Wholly owned foreign bank and joint venture bank as an independent legal person in China
• Foreign currency business to foreign institutions, foreign funded companies and foreign individuals including Hong Kong and Taiwan • Part of the foreign currency business to non-foreign funded companies	Total working capital: equivalent free convertible foreign currency ≥ 100 million RMB	Total working capital: equivalent free convertible foreign currency ≥ 300 million RMB
• Foreign currency business to foreign institutions • Foreign currency and RMB business to foreign funded companies and foreign individuals • Part of the foreign currency and RMB business to non-foreign funded companies	Total working capital: ≥ 200 million RMB (RMB ≥ 100 million or equivalent foreign currency ≥ 100 million)	Total working capital: ≥ 400 million RMB (RMB ≥ 100 million or equivalent foreign currency ≥ 300 million)
• Full foreign currency business without customer limitations • RMB business to foreign funded companies and foreign individuals • Part of the RMB business to non-foreign funded companies	Total ≥ 300 million RMB (RMB ≥ 100 million or equivalent foreign currency ≥ 200 million)	Total ≥ 500 million RMB (RMB ≥ 100 million or equivalent foreign currency ≥ 400 million)

• Full foreign currency business without customer limitations	Total ≥ 400 million RMB (RMB ≥ 200 million or equivalent foreign currency ≥ 200 million)	Total ≥ 600 million RMB (RMB ≥ 200 million or equivalent foreign currency ≥ 400 million)
• Full RMB business to foreign funded companies and foreign individuals and non-foreign funded companies		
• Full foreign currency and RMB business with no customer limitations	Total ≥ 600 million RMB (RMB ≥ 400 million or equivalent foreign currency ≥ 200 million)	Total ≥ 1000 million RMB (RMB ≥ 600 million, equivalent foreign currency ≥ 400 million)

Source: Author's elaboration on Implementation Rules.

both foreign and local currency business without restrictions on the type of customers, a foreign bank will have to invest at least 600 million RMB in a single branch.

In addition, in order to obtain a RMB business license a foreign bank must have three years of business operation with two consecutive years of profitability prior to the application. A minimum of 8 per cent CAR requirement has been set for the local currency business of each foreign bank branch. The Chinese government also imposes a 50 per cent limit on the RMB borrowing rate. The latest regulation released by the end of 2006 states that foreign banks must receive independent Chinese legal person status in order to conduct RMB business to Chinese individual customers. This means that the State will lift restrictions on RMB and foreign currency transactions by solely foreign funded banks and Sino-overseas joint venture banks. Chinese branches of foreign banks are banned from engaging in RMB services with Chinese citizens unless an individual, having obtained the approval of the banking regulatory body, makes a fixed deposit of no less than 1 million RMB. The minimum required registered capital for a locally incorporated bank is 1 billion RMB.

The Regulations present a great opportunity for the foreign invested banks to expand. The geographical restriction on RMB business may not be as onerous as it appears because customers from other opened areas can access RMB services provided by foreign banks across provinces. The main barriers are likely to be the minimum two-year operation in China (three years for conducting RMB business) prior to formation and the one-year mandatory waiting period for establishing additional branches. The granting of licenses for additional foreign banks' branches remains tightly controlled by the Chinese regulators. It will take many years for foreign banks to build a relatively large presence in a country the size of China. Alliances and joint ventures will therefore be a likely route for many foreign banks but these will need to be carefully chosen and may require significant levels of investment. There are severe restrictions on the acquisition of domestic banks, which are certain to be in force for a lot longer than five years. The Chinese government and the regulators are selling minority stakes in the domestic sector to foreign banks in order to speed up the local bank reform process. However despite the possible advantages of such alliances, for example, the possible collusion of local networks, concerns over the high entry price and the unknown extent of structural problems such as overstaffing and high NPLs may cause many foreign banks to adopt a wait and see approach. These banks will either hope to get better deals in the future or will set up their own operations.

CONCLUSIONS

Foreign banks have been present in China over the last two decades. China's accession to the WTO is regarded as a milestone leading to the full liberalization of the local banking and financial market. However it is suggested that the progress of the market liberalization will take real effects in a longer time than the five-year 'window' period. Until foreign banks are allowed to fully participate in the local currency markets and access retail customers, China's WTO agreement to progressively open up its banking sector is unlikely to lead to explosive growth by foreign banks. The high capital requirements and tough prudential controls over opening new branches would also limit foreign banks' expansion. Changes in regulations or local business environment can materially impact upon the formation and implementation of local business strategy. Foreign banks need to be flexible and employ different entry strategies that best incorporate firm specific attributes and external environmental factors. They also need to think about how to respond to the dynamics of the local institutional context and adapt to the local market rather than taking a static approach towards business growth.

NOTE

1. A new product is defined as one not yet offered by banks or financial institutions in China and normally such a product contains high operational risk due to the lack of historical data.

4. Strategic motives and market entry

INTRODUCTION

Casson (1990) argues that economic theory of the MNB is a special case of a general approach to economic theory in which the emphasis is on the selection, through competition and rational evaluation of alternatives, of the most efficient organizational form for coordinating a division of labor between related activities. This approach helps to identify a small number of possible motivations for multinational banking which are analogous to similar motivations operating in manufacturing but which manifest themselves differently due to the different nature of the banking industry.

This chapter examines strategic motivations of foreign banks as well as their entry mode choice, and how motives and entry mode evolve over time given the change of the Chinese banking market conditions. The rest of the chapter is set out in the following way: literature relating to market entry of MNBs and research questions are discussed in the following section. Section 3 discusses the research methods. Section 4 presents a discussion of the findings. Conclusions are in the final section.

LITERATURE REVIEW AND DEVELOPMENT OF RESEARCH QUESTIONS

Strategic Motives

Drawn from manufacturing MNEs, existing research has identified many strategic motives for FDI (see, for example, Dunning, 1988, 1993a; Young *et al.*, 1989). These motives include:

1. Market seeking
2. Efficiency seeking
3. Strategic asset seeking
4. Natural resource seeking
5. Risk diversification
6. Coalitions

7. Collaborations
8. Co-partnerships.

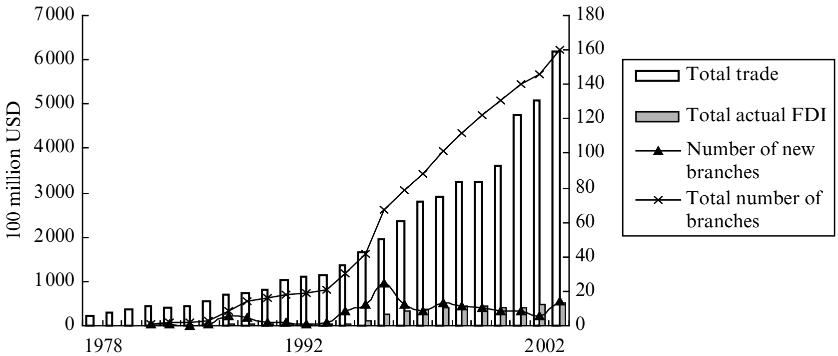
The nature of banking products determines that strategic motives pursued by a bank may differ from those in manufacturing industry. Market seeking is a particularly important motive in banking. The growth of banks is mainly achieved by internalizing economic rents deriving from the market imperfections in different countries. FDI in banking is rarely motivated by efficiency seeking (Scott-Green, 2002) unless international banking activities are carried out for the purpose of risk diversification (Canals, 1997). Competition for resources (Barney, 1986; Weston, 2002) and competition for strategic asset accumulation (Dierickx and Cool, 1989) are also rare motives in banking. The only relevant evidence is that banks attempt to acquire a local bank in a new market with particular product expertise (Scott-Green, 2002) or client resources or have direct access to indigenous supplies of key currencies. However both attempts should be regarded as means of market seeking. Erramilli (1992) identifies two general types of foreign market entry situations among service firms including banks. They are following the client entry and market seeking entry. Following the client entry stands for the case where a bank follows and continues to serve its home market clients abroad. The market seeking entry refers to the case where a bank enters foreign markets primarily to serve foreign customers or to exploit host market business opportunities.

The bank-client relationship is of central importance in banking strategy. The existence of market imperfections in banking and the nature of banking products suggest that it is the fear of losing existing bank-client relationships to a competitor bank that results in banks accompanying their clients abroad (Williams, 2002). Such a defensive expansion approach (Brimmer and Dahl, 1975; Williams, 2002) is not necessarily aimed at generating profits in the new region but is instead aimed at preventing losses at a pre-existing location (Kindleberger, 1983). A large volume of empirical research has been conducted to find the supporting evidence for the defensive expansion hypothesis (for example, Grubel, 1977, 1989; Glodberg and Saunders, 1980; Nigh *et al.*, 1986; Engwall and Johanson, 1990; Brealey and Kaplanis, 1996; Mutinelli and Piscitello, 2001). MNBs grow internationally in order to internalize their pre-existing bank-client relationships and following the client approach is more likely to be associated with wholly owned equity ownership than joint ventures (Casson, 1990; Dunning, 1993b). The most complete review of the defensive expansion theory can be found in Williams (2002).

Market seeking motive is a very general term to describe international banking activities. Market seeking entry contains much broader and more specific motives than serving foreign market clients defined by Erramilli (1992). Economic historians, such as Jones (1993), observed that British MNBs were formed exclusively to provide banking services outside Britain in the nineteenth century, with no equity links to domestic British banks and no domestic banking business. The initial motive for multinational banking was to seek geographical diversification. Tripe (2002) argues that the essential reason that banks choose to expand internationally is profitability. In other words, revenues generated as a result of the international expansion will exceed the costs of expanding. Williams (1997) argues that the increase in profitability sought may be for the banking group as a whole on a global basis rather than just in a new foreign market. There are a variety of ways in which international expansion can be argued as enhancing banking profitability, including regulations, competition and customer behavior. For example Bol *et al.* (2002) conclude several forms: following the clients (defensive expansion), attractiveness of the host market, imitation of competitors, reduction of capital cost and risk diversification.

Sabi (1988) suggests that following the client and market seeking entries are essentially the same in nature and can be integrated. The client is the market in banking and all other service industries (Moubray, 1991). It is difficult to clearly distinguish between a group of variables that primarily deals with 'following the client' and 'attractiveness of the market' reasons (Bol *et al.*, 2002). International expansion occurs in order to take advantage of externalities in the host market or to minimize the impact of externalities at home. Such external factors as suggested by Cho (1986) include the tax system, interest rate differentials across countries, governmental regulation and entry barriers, imperfections of host country financial market, size and structure of host economy and its level of economic development, home country economic presence in host country markets and the availability of local skilled personnel. The decision to go abroad should relate to the context of the individual bank and the specific host country market.

Figure 4.1 compares the trade flows, the actual inward FDI and the entry of foreign banks in China in terms of the number of branches since 1978. The paralleled pattern between the establishment of branches and the flows of trade and FDI suggests that the total number of branches increases with the growth of trade flows and actual inward FDI. The establishment of new branches has speeded up since 1992, which parallels the rapid growth of China's inward FDI since Deng Xiaoping's southern tour. The branch building activities reached another rising momentum after China's WTO accession in 2001 and full market liberalization in 2007. According to our calculations based on various news releases from the CBRC, the total number of foreign bank branches and subsidiaries reached nearly 280 by the end of 2007. In the year 2007 alone between 30 and 40 branches



Source: Author's calculation based on MOFCOM database (2003) and the *People's Bank of China Quarterly Statistical Bulletin* (2002, Q3).

Figure 4.1 Foreign bank entry, trade flows and actual inward FDI (1978–2002)

and subsidiaries were approved to establish, an increase of above 15 per cent. The pattern also parallels with the steady increase of China's trade volume and FDI inflows after 2001. Although not accurately reflected by the current aggregate level data, the evidence implies a possible correlation between foreign banks' entry decisions and the flows of trade and China's inward FDI. Lifting of policy restrictions and foreign banks' expectations of local market liberalization may greatly influence the market entry and expansion decisions.

Entry Mode Choice

FDI in banking is assumed to be a market oriented process (Casson, 1990). What factors determine MNBs' entry choice and how MNBs cope with fast growing competitive markets are often at the center of discussion. The key issues relating to the market entry are the degree of control and choice of location. The imperfections in the production of banking services deriving from information systems and communications costs explain the choice of locations of banking services and give the reason why banks prefer to internalize their services across national boundaries. Banks prefer direct investment to exporting or licensing. It is largely determined by the nature of the banking products and the competitive advantage of banks.

Cho (1986) argues that FDI by MNBs implies the transfer of capital, managerial and technological assets of a bank from one country to another by the same bank. The lesser use of licensing or other contractual involvement in foreign markets is due to certain unique characteristics of the banking industry such as the absence of an extensive patent system, ease of product imitation and limited product differentiability. Ursacki and Vertinsky (1992) argue that if banks attempt to maintain accurate and up-to-date information on their overseas borrowers, having a direct overseas presence may prove crucial to overcome asymmetric information problems. In addition, the lack of patent or copyright protection on most banking innovations means that banks are often constrained from exploiting them abroad through licensing.

Casson (1990) argues that the growth of the FDI in manufacturing by high-technology mass market oriented firms created a new demand for corporate banking services overseas. Corporate clients wished to deal with bankers familiar with home country language and culture as well as with indigenous banking methods. These requirements could have been met in several ways:

a. by the export of banking services from the home country
b. by correspondent relations between home and host country banks
c. by the establishment of home country bank subsidiaries overseas.

The objection to *a* is that many banking services require regular face to face contact, cash deposits and withdrawals cannot easily be handled at a distance. The objection to *b* is that the correspondent bank may be inexperienced in meeting clients' needs and the quality of services the correspondent provides cannot be easily controlled. Furthermore the home country bank may benefit very little from the goodwill enjoyed by the correspondent bank. Finally there is a risk that the home country bank may build up the correspondent bank into a competitor. *c* is the obvious strategy. Home country banks capitalize on their goodwill by following their customers overseas. The multinationalization of manufacturing firms creates a derived demand for the multinationalization of banks as well. The most effective use of the client based information and knowledge know-how is to keep the clients in-house (Casson, 1989). Williams (1997) identifies multinational retail banking as a clear consequence of internalization with key factors including knowledge and economies of scale. Moreover, as noted by Tschoegl (1987), successful international expansion by a retail bank is likely to require the acquisition of market share in significant chunks and organic growth will not suffice.

Banks conduct their FDI through one or more of four common organizational forms: representative office, agency, branch and subsidiary. Gray and Gray (1981) argue that these operational forms represent an increasing qualitative integration with the local market. In the first three, the organizations are legally part of their parents. By contrast, a subsidiary is incorporated in the host country and is a separate legal entity. A representative office may perform liaison, customer solicitation and information gathering activities but is not permitted to book assets and liabilities. Representative office is typically the first step toward overseas expansion with the most limited organizational form. It is used primarily for exploratory purposes to forwarding information to the parent bank. Agency may make loans and take foreign deposits. Branch and subsidiary may accept domestic deposits. Subsidiaries typically also engage in retail activities. Miller and Parkhe (1998) argue that overseas branches are supported by the resources and lending capabilities of the entire organization and they are mandated by the parent bank. The advantages of establishing a branch office include securing the full credit backing of the parent bank, attracting clients by exploiting the parents' reputation and using the managerial and technical support of the parent bank. Kitching (1982), Grabowski *et al.* (1993) and Ball and Tschoegl (1982) also argue that branch banking is a more efficient organizational form than the bank holding company. Branching increases the availability and convenience of services to customers, enables banks to achieve economies of large scale operation and can lower the risk of failure through diversification. Overseas subsidiaries maintain separate legal entities and are subject to the laws and regulations of the host country. They adopt a local management to obtain access to the local business market. They require higher capitalization than branches of the same size. Anderson and Gatignon (1986) expect customized business such as banking to be dominated by high control entry modes because high control entry modes are more efficient for products customized to the user.

Boddewyn *et al.* (1986) and Dunning and Norman (1983) once argued that banking is a non-location bound activity. However various researches have shown that traditional location theory is still applicable to the location choice of multinational banking. Casson (1989) argues that advances in transport and communications have significantly influenced patterns of bank location. In addition, the distribution of clients and the location of financial centers are found closely related to a bank's location choice in foreign markets (Chan and Wong, 1999; Leung, 2000). Unlike the manufacturing sector, where location of production is largely dependent on transport costs and tariff barriers, location of service firms is more concerned with the closeness to customers and adaptation to customers' requirements. Brealey and Kaplanis (1996) find that trade and FDI have a significant impact on MNBs' location choice abroad. Yamori (1998) also suggests that FDI in manufacturing industry is an important determinant of the location choice of Japanese financial institutions.

Research Questions

Drawn from empirical studies, we are now able to develop the following research questions. First, why would foreign banks enter China? Second, if market entry is driven by multiple motives, how would each specific motivation relate to market entry decisions (mode of control and choice of location) and would market entry strategies be differentiated given the difference in strategic motives? Third, more importantly, we need to examine evolutionarily each motive in the process of the market entry, for instance, does each specific motive sustain over time? If motive switches, what factors stimulate the change and dictate the timing of change? Our research questions focus not only on the clarification of entry motives and mode choice relating to the Chinese market but also the interrelationships between motives and entry decisions and how such interrelationships affect entry strategies.

RESEARCH METHODS

We adopt a multi-method approach (both qualitative and quantitative) using data collected from 37 interviews and a postal questionnaire survey of 178 foreign banks in China in 2003.[1] The data collection method follows Miles and Huberman's (1994) research design using mixed data collection methods.

The nature of the research objectives determines that the use of qualitative research interviews as a method of data collection for the current research is advantageous. Foreign banks in China are diversified by country of origin and business scale and scope. In order to allow in-depth analysis of complex issues constituting foreign banking strategy in China and a rich depiction and strategic comparison across cases (Firestone, 1987), this research carried out a total of 37 in-depth interviews in Beijing, Shanghai and Shenzhen where foreign banks cluster. Following the process of qualitative interview (Crotty, 1998; Easterby-Smith *et al.*, 2002), pilot studies were first conducted in Beijing to clarify interview questions and to identify major themes. A total of 33 banks, accounting for 18.5 per cent of the total number of foreign banks in China in 2003, were interviewed based on the criteria of location, business scope, nationality and Chinese market commitment. To ensure representativeness, banks of different sizes and source countries, different levels of local market commitment including wholly owned representative offices, branches, subsidiaries and joint banks were interviewed. Interviews were undertaken between February to December 2003 and involved general managers of foreign banks' subsidiaries in

Mainland China. All interviews were recorded in writing in detail according to Yin's (1994) proposed guidelines and were analysed using NUD*IST 4 software (Barry, 1998; Lewis, 1998; MacMillan and McLachlan, 1999). Table 4.1 shows the representativeness of the interviewed sample.

The postal questionnaire was finalized based on six identified strategic orientations and 15 refined competitive methods. The aim was to establish the ex ante entry mode choices of banks and the products that foreign banks offered. All the questions were answered on a five point scale (1 = least important; 5 = most important). The particulars of foreign banks were obtained from China's central bank database and *China Statistical Yearbook of Finance* (2002). To enhance the quality of the data, telephone contact was made with each foreign bank to ascertain the name and position of the most appropriate senior manager to whom the questionnaire was personally addressed. The finalized questionnaires were posted to the general managers of 350 bank offices of all 178 foreign banks across Mainland China. In order to ensure a high response rate, telephone follow-ups were made at the end of the second and fifth week after the questionnaire had been posted (Zikmund, 1995). A total of 62 questionnaires were returned, a response rate of 17.7 per cent. Two responses were later excluded from the statistical analysis due to the existence of a large number of missing values. Eventually 60 useful responses were analysed. Compared with the population, the sample exhibited good representativeness. The 60 questionnaires include two wholly owned subsidiaries, 33 wholly owned branches, 23 wholly owned representative offices and two joint banks, and comprise 23 EU banks (38 per cent), 10 Hong Kong banks (17 per cent), three Japanese banks (5 per cent), four American banks (7 per cent) and 20 Asian banks (33 per cent).

FINDINGS AND DISCUSSION

Interview Data

Entry motives

The interview data suggests that multiple motives are evident in the market entry decisions and many foreign banks combine several motives at the same time. The dominance of each strategic motivation switches over time with the accumulation of local market knowledge and local client resources.

Market seeking is still the dominant motive because of China's rapid economic growth and huge domestic market potential, for instance, some bank managers commented:

Table 4.1 Composition of the interviewed banks compared with the population

Major source countries	Population (%)	Interviewed banks (%)	World ranking of bank size in terms of total assets at the end of 2002*	Population (%)	Interviewed banks (%)
USA	17 (9.6)	4 (12.1)	Top 100	100 (60.6)	18 (56.3)
Hong Kong	14 (7.9)	3 (9.1)	101–200	30 (18.2)	6 (18.8)
UK	5 (2.8)	2 (6.1)	201–300	21(12.7)	4 (12.5)
Germany	12 (6.7)	3 (9.1)	301–500	9 (5.5)	2 (6.2)
France	6 (3.3)	3 (9.1)	501–	5 (3)	2 (6.2)
Japan	31 (17.4)	1 (3.0)			
Joint Ventures	7 (3.9)	1 (3.0)			
Other EU	35 (19.7)	6 (18.2)			
Other Asia	33 (18.5)	6 (18.2)			
Other	18 (10.1)	4 (12.1)			
Total	**178**	**33**		**165***	**32***

Notes: * Excluding the seven joint venture banks and six wholly owned foreign banks registered in China. All interviewed banks were anonymized in our analysis and discussions.

Source: Author's calculation based on the *Banker* (2002, July).

> We are mainly market seeking type. The first thing that top managers observe is probably China's untapped financial market with a population of over 1 billion.
>
> The major motivation to enter China is the attraction of China's huge market potential. I do not totally agree with the following the client idea because some of our important clients and revenue providers are developed after the entry. Following the client approach probably only affects the initial feasibility study and lasts for a very short period.

The evidence is particularly strong for investment and wholesale banks focusing on the capital market services, syndication lending and project finance. Asian banks, particularly those from Hong Kong, demonstrate a faster pace of local market penetration than Western banks due to their geographical and cultural proximity to the Mainland. There is a fairly strong intra-regional nature of Asian banks, many of which treat China as the future primary market equivalent of their home markets.

Following clients is an important strategic motive particularly for those banks having a large amount of source country FDI in China. These banks establish their physical presence in China in order to preserve their existing bank-client relationships. Maintaining the existing bank-client relationships lies at the center of their current operations. Personal contacts and banking relationships are the most valuable assets of a bank. Such a relationship offers the bank an easy access to the foreign markets. Following the client is particularly useful and important during the initial entry stage and forms an emergent strategy when entering emerging markets. Banks that are not familiar with the local market context may find following the client as the safest way of doing business. Being the follower of the clients is perhaps the best option for banks with conservative and risk-averse corporate cultures and those that do not have the competitive strength to overcome the local barriers and market uncertainties.

Our interview analysis also suggests that foreign banks combine following the client with the market seeking motive rather than taking client retention as the single factor in market entry decisions. On the one hand, banks are keen to expand their business in the world's largest emerging market. On the other hand, banks operate to serve their existing global clients that are currently investing in China. Given the heterogeneity in internal resources owned by individual banks and in the business segment (corporate, retail and universal banking), foreign banks may concentrate on different strategic objectives at different stages. Many foreign banks simultaneously combine both market seeking and following clients motives at initial entry, for instance, some bank managers remarked:

> We had both market seeking and following the client intentions when we entered China. We noticed the remarkable progress of China's economic reform and the

> huge banking market potential particularly the local consumer banking market. We realized that China would be our most important overseas market in the next couple of decades. Meanwhile, we had many clients here. At the very early stage, our clients first entered China then we followed them.
>
> The single most important factor that led us to enter China is its market potential. Banks are profit-driven and market-driven companies. What really attracts us is China's huge market size and great market potential. In my opinion, following the clients and market seeking are not conflicting. As a matter of fact, they cannot be separated. The reason why our clients enter China is also because of the great opportunities of this emerging market. Banks are the same as any other multinational companies, driven by profit maximization. As long as there are opportunities to make more money, they will go for it. Based on my knowledge, market seeking is still the major motivation to enter a new market, and it should be integrated with the following the clients strategy.

The above evidence implies that many foreign banks consider the growth in the local market as a long-term objective and serving existing corporate clients as a short-term emergent strategy. In order to further explore the local market growth, banks employ more deliberate strategies rather than simply following their clients:

> Of course, clients are important for us. But as far as I am concerned, following the client orientation is meaningless for practicing managers. Clients indeed influence and shape our allocation of resources in the local market. But we must also have our own development strategy to achieve profitability. We enter China not simply because our clients are here, but more importantly, we think that the Chinese market has reached a certain stage that is ready for us to explore. We always have a deliberate strategy. Since our entry into China, our client base has become diversified.

By sticking to their existing clients, MNBs can accumulate local market knowledge including local polices and regulations, consumer culture and local competitive conditions. Such knowledge is obtained through practicing in the local market and learning from competitors and manufacturing clients. MNBs increase incrementally their market commitment and become more local market orientated by serving the Chinese clients as they become more experienced. Following the client expansion may increase multinational size, but has little impact upon MNB profits and does not sustain long-term foreign banking investment.

Other strategic motives are also evident such as geographical diversification, being the first mover and following competitors. Some big MNBs particularly highlight the importance of a worldwide network. 'As a global bank, it is necessary to have a presence in the world's largest emerging market.' A similar approach is also evident for some Asian banks that intend to grow globally.

Being the first mover is evident when analysing large-sized MNBs, overseas Chinese banks and Hong Kong based banks. Image and reputation of the bank are important to the clients. The bank can develop an enhanced reputation by being a pioneer. Overseas Chinese banks and Hong Kong based banks share a similar culture and language with the Mainland. The familiarity with the local market offers them easier access. Early entry works in their favor and quickly being the first is translated into their corporate policies. A crucial strategic choice for competing in emerging industries is the appropriate timing of entry. Early entry involves high risk but may involve otherwise low entry barriers and can offer a large return. An early mover can develop a resource that is rare, valuable, difficult to imitate and non-substitutable. Such a resource can be experience and trust gained through early working with the local government and domestic financial institutions. Early entry can initiate the learning process in banking business in which the learning curve is important and experience is difficult to imitate and will not be nullified by later entrants. A sound relationship with local authorities and a good reputation in the local market are critical for long-term development.

However seeking first mover advantages needs to be based on an accurate and in-depth understanding of the local market conditions, otherwise the decision may be 'bold' rather than pioneering. Mistakes would occur because banks may overestimate the speed of openness of the local market. Some of them have paid the price for being the 'early bird':

> At the initial entry stage, the intention to serve local demands proved to be impractical. We became the first few banks that started operation in northern China. However this proved to be an unsuccessful decision after years of operation. We found that China's regulatory system was far from mature and China lacked history of creditability. Plus a less developed accounting and legal system, our business ethic and operating system could hardly match local practice.

In the context of a dynamic and emerging market environment like China, some learning stages can hardly be skipped. China's economy is unevenly developed by region. Lessons learned or experience gained in one region may not be generalized to other regions. This is because China lacks a uniform and consistent regulatory environment. Each province may enforce different rules and regulations given their own local conditions and business environment varies across regions. Foreign banks should be patient and cautious on every major investment decision unless one has rich experience and knowledge about the local market or a certain competitive strength to overcome the disadvantage of foreignness. Market expansion tends to be incremental. Service adaptation and corporate learning are stressed by many banks as crucial in local business operation.

Cultural link is another important factor that attracts foreign banks, Asian banks in particular, to invest in China. Banks from Hong Kong and Southeast Asia share a strong Chinese background and are keen to enter China as early as possible. For some overseas Chinese banks, investing in the Mainland is probably more than just for business. Their intention is to 'return to the motherland and do something for the home town'.

Interviews indicate that maturity and intensified competition in the home market plays a role in pushing some banks to seek new markets overseas. The evidence is mainly from French and Australian commercial banks. Competition-driven banks are more passively seeking local market development. As a result, they appear to rely more on following the client strategy.

Certain banks operating as representative offices hold a rather opportunistic approach due to the limited number of home market clients in China. Their priority is to maintain a good relationship with Chinese correspondent banks and the Chinese government and to strengthen delegated monitoring because of the relative immaturity of information dissemination in China.

Market entry is a dynamic process. Interview evidence shows that the dominance of motivations switches over time due to a change of the local market context and accumulation of local market knowledge and client resources. It can be observed that the direction for the switch of motivations between market seeking and following the client is a two-way phenomenon. Many foreign banks constantly adjust their strategic orientations with respect to the change of local market context. Market seeking and following the client motives often replace each other over time.

> During the initial entry stage in early 1980s, foreign banks held very high expectations on China's market potential. Foreign banks especially Japanese banks were actively engaged in financing local projects. The 'June 4th' event threw a bomb to foreign investors. Many of them became skeptical about the political stability of China. However their confidence was rebuilt later by the speech of Deng Xiaoping in his southern tour . . . Asia financial crisis revealed more serious problems of China's financial system. The bankruptcy of Guangdong International Trust and Investment Corporation (GITIC) became a wake-up call to foreign banks. They began to realize that projects with governmental background would also be risky. Many banks encountered great loss due to the bond default of GITIC. Since then, foreign banks become more and more realistic when doing business in China.

In the past two decades foreign banks experienced a 'cooling down' process from the passion of 'China is big; I have to be there' to the more rationalized perception of 'China is big, why am I here?' Although the Chinese market is huge and full of potential, it does not match everyone's strategic goals. After years of local operation, some foreign banks have successfully clarified and adjusted their objectives and strategies. They have developed aggressively in the local market whereas others have decided to exit the local market or maintain their representative offices. Many managers argue that when dealing with trade services at representative office level, banks may not have an explicit perception of the local market. It is often the case that many banks do not have a clear objective of their future development in China. Some banks take representative office as an experimental stage for corporate learning. With the accumulation of corporate clients and a much clearer vision of the local market, banks will pursue more deliberate objectives. The timing and scale of local penetration appear to diverge among the different banks.

Entry methods

Findings on entry mode choice of foreign banks in China are in line with the literature that banks prefer complete or majority control over their operations in China. Greenfield investment (wholly owned representative offices, branches and subsidiaries) is still the dominant entry method. In transition economies like China, transaction costs are particularly high because of the less developed infrastructure for communication and uncertain regulatory framework. It is essential for foreign banks to internalize client information, marketing skills and managerial knowledge in order to exploit most efficiently their firm specific attributes in China. Internalization of intermediate products such as client information is a natural outcome of transaction cost reduction. It is critical to have complete control over overseas operations because it is the best way to transfer banking assets and information within the bank. Wholly owned operational mode favors the bank to have effective monitoring of their overseas operations. The majority of foreign banks start as wholly owned representative offices and establish wholly owned branches in the consequent stages:

> We always prefer 100 per cent control over our overseas operations because only in that case we can most efficiently run our business.
>
> Wholly owned mode is more preferable if the parent bank wants to transfer its know-how to the overseas offices safely and at a lower cost.

For wholly owned operation, the choice between branch and subsidiary turns out to be an area for only limited discussion. A branch requires lower capital input and is considered as an integral part of the parent bank, whereas a subsidiary needs more investment and managerial duties and is a stand-alone entity in the foreign market. Being a complete local entity can result in some extra tax preferential and more flexibility in managerial decision making. The disadvantage is the high entry cost compared to a branch. Extra registered capital required by subsidiary level has often outweighed the benefits of being an independent local entity, especially in the initial entry stage where clients resources are rare or unstable. Most of the foreign banks still prefer to set up branches rather than subsidiaries. As an integral part of the parent bank, a wholly owned branch can benefit a lot from strong financial support of the parent bank. According to the PBOC regulations, foreign banks' lending quota in China is calculated on the basis of their parent banks. For subsidiaries and JVs, this is measured by the registered capital in China. However in RMB retail business, foreign banks turn out to have no choice but to establish locally incorporated subsidiaries. If foreign banks have already had their branches operating in the Mainland and their branches meet the quantitative and qualitative criteria of the PBOC, they can apply to upgrade the branch to subsidiary by injecting extra registered capital. For many banks, this appears to be a costly decision. However for dedicated banks specializing in retailing business, such as HSBC, Citi Bank, Standard Chartered and Bank of East Asia, they are planning their local expansion regardless of the cost. By the end of 2007 the above mentioned four banks had established over 100 retail outlets across China including subsidiaries, branches and sub-branches. 'This number is likely to double in the next two years', say their general managers.

Table 4.2 presents a comparison of different entry routes. Several alternative strategies are viable in an institutional context that does not allow for more than 20 per cent of foreign ownership of single foreign banks in local banks. The first option is to speed up organic growth. The second option is to look for alternative non-organic expansion and a number of alternative strategies are possible:

1. Acquire a (small) bank that is 100 per cent foreign owned (the limitations only account for acquiring stakes in local Chinese banks).
2. Buy a commercial team in order to get access to their customer base that can be served from the existing organizational infrastructure (local presence is required).
3. Acquire a related business to improve local coverage and/or marketing potential; examples include post offices and insurance networks.

A JV with a local financial institution is only useful as an investment to profit from local growth because full decision power will not be obtained with only 20 per cent ownership. It is difficult to cooperate with a Chinese bank without full control through equity because there is a risk of losing bargaining power and diluting competitive advantages after the transfer of IT systems and other critical capabilities. Foreign banks normally appoint

Table 4.2 Comparison of entry routes

Item	Branch	Bank WFOE	Bank EJV	Domestic banking institutions with foreign minority investment
Control	Absolute control over branch or WFOE		Potential majority control over EJV	Only minority shareholder rights
Price of investment	Capital contribution usually at par value			Negotiable
Limitation of foreign equity interest	NA	NA	None	Individual 15% (exceptions may exist), total 24.9%
Assets	\$2 billion	\$10 billion		NA
Representative office in China	2 years	2 years	No time minimum	NA
Minimum registered capital (for foreign exchange transactions with foreign customers)	¥100 million	¥300 million	¥300 million	¥1 billion (for commercial banks)
Prudential requirements	30% of working capital in PBOC-designated interest-bearing assets, foreign exchange and RMB assets deposited separately (from each	Minimum 8% capital adequacy ratio, unutilized credit line not to exceed 25% of capital unless approved by PBOC, ratio of balance of liquid assets to balance of liquid debts at least 25%, fixed assets not to exceed 40% of equity, total absorbed foreign exchange deposits not to		Minimum 8% capital adequacy ratio, ratio of balance of loans to balance of deposits not to exceed 75%, ratio of balance of liquid assets to

Table 4.2 (continued)

Item	Branch	Bank WFOE	Bank EJV	Domestic banking institutions with foreign minority investment
	other), minimum 8% ratio of RMB working capital plus RMB reserves to RMB risk assets	exceed 70% of total assets, ratio of RMB capital to RMB risk assets at least 8%		balance of liquid debts at least 25%
Speed of execution	Up to 14 months for new branch or FIE			Case by case
Availability of prospective entries	Onerous requirements			Very low requirements
Customer base	May provide services only to foreign individuals and foreign enterprises upon accession (since 11 December 2001) May provide services to Chinese enterprises by 11 December 2003 May provide services to all Chinese clients by 11 December 2006			
Qualifications to engage in RMB business	Three years PRC business operating experience, two consecutive years of profits			NA

Notes: WFOE refers to wholly foreign owned enterprises. EJV stands for equity joint venture. NA means not applicable.

Source: Author's elaboration on Howson and Ross (2003) and Implementation Rules.

key directors to have control over such niche divisions. This is a good learning process for the Chinese banker. True cooperation is difficult as there is often no control by the foreign bank. However there are a number of possibilities to limit this risk:

1. Preferred stock with priority votes and a seat on the management board.
2. Deliver managers in key positions.
3. Create a strong relationship that creates interdependency (for example, a mutually beneficial referral agreement where the Chinese bank can also benefit outside China where the international bank is strong). In practice this is, however, difficult to accomplish.
4. Well designed formal contract.

In order not to lose competitive advantage there is a need for caution in sharing knowledge and information systems. In practice, cooperation mostly focuses on the following areas: credit card and private finance business, helping Chinese banks to modernize and to respond to global issues, risk management and corporate governance.

Foreign banks favored the JV option due to various internal and external reasons. The intention to seek quick access to the local market and strategic banking assets (such as local client resources, network and local market knowledge) lies at the center of this strategic move:

> . . . at the initial entry stage, we were not given any clear [market] opening timetable. We considered that joint venture might have more advantages in getting political preferential support especially in applying for business license.

However several in-depth interviews with a joint venture bank in Shanghai reveal that it is difficult for a JV bank to achieve integration in managerial styles and corporate culture in the face of cultural barriers and differences in corporate objectives. The divergence in commercial interests and corporate objectives leads to competition rather than cooperation between two partners. The overlap in clients and product range increases the operating cost and intensifies the competition between two partners.

In distinguishing between acquisitions and start-ups in the wholly owned entry mode, there are several issues. First, policy issues are important. The PRC regulation states that foreign banks are not allowed to own more than 25 per cent of local banks. This figure was increased from the previous 20 per cent ownership limit. The PRC government also introduced strict rules for opening branches and establishing wholly owned subsidiaries. A rapid expansion is difficult given the local regulatory framework. Thus banks may adopt other entry methods such as minority acquisitions as second best choices. Entry methods and the pace of market development depend on MNBs' strategic motives and internal resources. Banks intending to seek local market development with relatively large local client resources usually prefer to explore the option of acquiring a local bank whilst at the same time pursuing greenfield expansion. The major reasons for this are to acquire business licenses and strategic local client resources.

Majority equity control by foreign banks in banking M&As are currently restricted by the Chinese government. However this does not reduce the attractions of minority equity control opportunity presented to foreign banks. One thing obvious is that the Chinese government will not offer invitations to all foreign banks. Only large and experienced banks with sound global reputation such as Citibank, HSBC and Royal Bank of Scotland are hand picked by the central government to take part. Meanwhile foreign banks are also cautious in choosing target domestic Chinese banks. Regional banks and newly developed shareholding banks are on the top of their list because these local banks are less burdened by NPLs and have higher CARs. Evidence shows that the principal reasons for choosing an equity based alliance are to reduce the learning period, increase the intensity of organizational learning and strengthen cooperation with Chinese banks in high value added banking services such as credit cards and personal finance. For example, some bank managers remarked:

> A 5 per cent share of SX (a local Chinese commercial bank based in Shanghai) does not mean that we have the intention to get control of that bank. It is mainly a strategic move for the future. We hope to distribute our credit card and other consumer banking services through SX's network. Meanwhile we are keen to know how local banks operate and to understand the local market and business environment.
>
> We must choose to enter the Chinese market through organic growth or through acquisition. Organic growth usually takes a longer time but is cheaper compared with acquisition. In addition, the bank can freely build its corporate image. In contrast, acquisition will offer you a quicker access to the targeted local market. However acquisition still faces a lot of problems in China such as policy restrictions. Currently, we are doing both. We have been proactively spending a lot of resources to expand our own networks. Meanwhile we are very patient to gradually buy the local market.

Through more intimate cooperation with local Chinese banks, foreign banks can share or even internalize more local market knowledge and strategic assets such as market know-how, client resources, trained human capital and distribution network. In addition, minority equity investments in Chinese banks may also create better opportunities for future takeovers when local policies are lifted for foreign banks.

Buying a stake in a Chinese bank when estimated bad loans account for over 35 per cent of total loans and where banking capabilities are well below the standard of Western banks is obviously fraught with difficulty. The valuation of a Chinese bank is difficult. The accounting standards in China are different from Western ones (and are less consistent). Furthermore, the credit models used in China are less sophisticated than European standards. The value of the bank is calculated by a market premium on book-to-market value. A detailed due diligence must include an evaluation of the loan portfolio. The NPLs will be excluded from the valuation resulting in the final book price. The market premium international banks are willing to pay in China is however high because demand is high and supply is low. Taking full control in a local bank will eventually improve the credit evaluation and monitoring procedures, decreasing the risk involved in the loan portfolio. The first period after the acquisition of a Chinese bank is however crucial and often contains many unpleasant surprises.

Choice of location

Does location matter for multinational banking? The answer is yes, however, factors dictating the choice of location differ from those in manufacturing industries and we need to shed further light on each banking product segment. Policy, client resources and cost of information are essential elements that determine the choice of locations of foreign banking in China.

The Chinese government has introduced a strict opening schedule for foreign banks including geographical expansion. A number of cities are listed that are allowed to have a foreign bank presence. These cities normally are located in coastal areas near SEZs or are important inland economic centers. Foreign banks also need to comply with the 'one city one branch' rule at their initial entry. Between 2002 and 2006, policy restrictions left foreign banks with limited choice for their location preference. The majority of foreign banks cluster in big cities and financial centers such as Shanghai, Beijing and Shenzhen. The infrastructure of large cities and financial centers is much better than most other Chinese cities. The local business environment is more friendly. The regulatory system is more transparent and local civil services are more efficient. This reduces the cost of accessing, collecting and transmitting information. Skilled labor and professional bankers are abundant in these open cities, which can facilitate the infrastructure building of foreign banks. Operating in developed regions can fulfill the requirements of foreign banks to have the most efficient communication with parent banks and keep their technological systems safe.

The geographical distribution of existing corporate clients is another dominant factor for branch building decisions. The number of high quality corporate clients often decides whether a bank will establish a branch in a specific city in China.

Geographical restrictions have been completely lifted since 2007. Foreign banks are pursuing steady expansion of their branches towards inner regions. This is particularly the case in retailing business. Cities with great economic development potential, active business environment and high personal savings rate are in the first tier targeted by foreign banks. Experience, resources and knowledge gained during the first couple of years in developed cities have equipped foreign banks with rich reserves and ammunition to seek fast expansion in inner regions, even the rural areas. For instance, HSBC established China's first rural credit JV bank in Hubei province and opened a branch in Chongqing rural area. A trend can be observed that foreign banks are entering into areas that were previously dominated by domestic banks. During the retreat of state owned commercial banks from China's rural areas, foreign banks obviously have sensed business opportunities and wanted to have to a try. Skilled and trained staff from open city branches are sent to inner regions to help initial start-ups. Getting approval from local banking regulatory commissions is no longer a headache issue because foreign banks have learned how to deal with local regulators and policy uncertainties from past experience. As a result, the pace of expansion is phenomenal.

Different banking segments vary in their location choice. Some banking services may be less location-bounded compared to others. Wholesale and investment banks are deal-driven in nature and they are less dependent upon local infrastructure as compared to traditional commercial banks, hence they can enter the market and make a profit at the minimum scale. Most of the wholesale and investment banking transactions are conducted offshore and supported by the global network and advanced technological platform. Although investment banks are not allowed to establish branches to conduct any direct investment banking business in the Mainland yet, profit from consultancy is already very considerable. For instance, Morgan Stanley earned 800 million HKD commission income for the public listing of Sinopec Co. by simply sending two professionals to Beijing for six months (*The 21st Century Business Herald*, 23 February 2004). To some extent, investment banking business is footloose so that financial experts can fly in from a distance at any time to complete deals.

In contrast, retail banking business requires the most sophisticated locational set-up and the business itself often comes along with corporate banking. Based on in-depth studies about local consumer culture, foreign banks need to establish high street branches and ATM networks in order to access targeted individual customers. Great effort needs to be spent on marketing in order to increase their brand awareness. For areas where they do not have a physical presence, banking sales personnel may have to set up promotion booths in order to attract customers.

Questionnaire Data

Motivations for entry

Table 4.3 shows the description of entry motivations of foreign banking in China. Trade-driven, FDI-driven (following the client) and local market seeking are identified as the most relevant motives that lead to foreign banking activities in the Mainland (with means higher than 3.5). Market entry driven by competitors is found to have a moderate significance with a mean of 2.52 and 21 banks regard competition as an important motive. Market seeking is still the dominant motive because of China's rapid economic growth and huge domestic market potential (overall mean 3.83). The evidence is strongly related to investment and wholesale banking business and Asian banks. Following the client is a nearly equally important motive, particularly for those banks having a large amount of source country FDI in China (overall mean 3.82).

ANOVA analysis (Table 4.4) on motives by source country suggests that market seeking motive deriving from local market demand or home market maturity or competition is the dominant entry motive across all source countries. Banks from Asia, mainly Japan and Hong Kong, are more local market oriented. Similarly, we find that banks operating as representative offices usually are strongly driven by trade flows and consider following the clients as the least important motive or not applicable. This is because of the limited FDI from home countries in China. In addition, some banks focusing on investment banking business consider market seeking as the only primary motive. It seems that trade-driven or FDI-driven motives can hardly be used to explain investment banking activities in China.

Two banks from Asia consider that global operation is strategically important. Being an international bank, it is essential to 'have a presence all over the world'. It is also argued by one bank that one should take the advantage of a sound relationship with local government. A well established political connection can sometimes offer the opportunity for a faster expansion. Finally, ethnic connection is a key motive for several Asian banks. For example, one bank argues that the major reason to establish a presence in China is that the majority of the shareholders are Chinese immigrants. As a result, banks prefer to invest in a market that is geographically close and shares a similar cultural background.

Discriminant analysis shows that following the client motivation is the most important factor that distinguishes representative offices from branches and subsidiaries. Foreign banks tend to be followers of their

Table 4.3 Market entry motives for foreign banks in China

Count	0	1	2	3	4	5	Total	Mean	St. D
a	13 (0.217)	15 (0.25)	12 (0.20)	13 (0.217)	4 (0.067)	3 (0.05)	60 (100%)	1.82	1.432
b	4 (0.067)	2 (0.033)	4 (0.067)	16 (0.267)	18 (0.3)	16 (0.267)	60 (100%)	3.50	1.396
c	3 (0.05)	3 (0.05)	5 (0.083)	11 (0.183)	20 (0.33)	18 (0.30)	60 (100%)	3.60	1.392
d	7 (0.117)	6 (0.10)	1 (0.217)	21 (0.35)	9 (0.15)	4 (0.067)	60 (100%)	2.52	1.372
e	4 (0.067)	1 (0.017)	10 (0.17)	10 (0.17)	13 (0.22)	22 (0.37)	60 (100%)	3.55	1.501
f	12 (0.20)	15 (0.25)	13 (0.22)	12 (0.2)	7 (0.12)	1 (0.02)	60 (100%)	1.83	1.368

Notes:
Percentage is in ().
0 = not applicable; 1 = not important; 5 = extremely important.
a = maturity and saturation of home market; **b** = trade-driven; **c** = FDI-driven; **d** = competitor-driven; **e** = local market seeking; **f** = international risk diversification.

Table 4.4 ANOVA analysis

Mean scores of entry strategies	European and American banks (n = 26)	Japanese and Hong Kong banks (n = 13)	Other Asian banks (except Chinese) (n = 14)	F-value
Maturity and saturation of home market	1.95	2.65	2.61	2.87***
Increasing amount of existing clients' trade with China	**3.57**	**3.95**	**3.67**	0.60
Increasing amount of existing clients' direct investment in China	**3.59**	**3.91**	**3.99**	0.67
Competitors' entry into China	2.80	3.30	2.45	2.51*
China's huge domestic banking market potential	**3.76**	**4.69**	3.05	9.03***
International risk diversification	1.91	2.47	2.25	1.61

Notes: N = 53; * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

corporate clients when they consider upgrading their representative offices. With the increase of local market commitment over time, foreign banks tend to be more local market oriented. This is in line with interview data that the focus of strategic orientations may switch over time. At the initial entry stage foreign banks may not be very familiar with the local market environment. Therefore they expand their market presence by following their existing clients as an emergent strategy although they may also have market seeking motives. Evidence is particularly strong in corporate banking. With the accumulation of local market knowledge and experience over time, foreign banks tend to be more local market oriented and may accelerate their expansion speed.

Entry mode

Data suggests that wholly owned entry mode, namely representative office, branch and subsidiary, is the dominant entry method. The difference lies in the timing to upgrade operation scale and switch the strategic motives.

According to the Chinese regulations, foreign banks have to spend a minimum of two years in representative offices in order to be eligible for upgrading to branches. Data shows that the average time for upgrade to take place is five years. Banks that entered after 1992 seem to have a shorter period of time spent on representative offices. Most of them upgrade to branches or subsidiaries at an average of 2.875 years. By contrast, banks that entered in a much earlier stage in the 1980s maintain a relatively longer period in representative offices. The average time banks spend in representative offices is 7.57 years. This is mainly due to the rapid economic growth after Deng Xiaoping's southern tour speech in 1992. China's trade flows and inward FDI have experienced a dramatic increase since 1992. As a result, many banks have been aggressively expanding their local operations. China's accession to the WTO presents a much clearer timetable of liberalization for foreign investors. Reduction in uncertainties shortens the waiting time that banks spend at representative offices.

Forty one responses address the reasons for the upgrade decision. The majority of the motivations relate to seeking local market growth. This implies that banks may follow their clients to develop local business. Without enough clients to support local business, it is unlikely for banks to cover the cost of branch banking. For some banks, their business focuses are not in China. Representative offices only operate to facilitate the correspondent banking transactions that are mainly trade related. Thus they will not pursue any aggressive expansions in the local market.

CONCLUSIONS

This chapter discusses several findings. We are able to triangulate since our interview data confirms the statistical data about strategic entry motives and entry methods. First, foreign banks enter China with multiple entry motives and the dominance of these strategic motivations switches over time with the accumulation of local market knowledge and local client resources as well as the development of local market liberalization. Following the client is strategically important at the initial entry stage. Policy and the amount and quality of the source country FDI to a large extent determine whether banks would adopt an opportunistic approach or more aggressive expansion stance. Interview evidence suggests that there can be both aggressive and conservative attitudes behind the trade-driven banking services.

Second, banks still prefer wholly owned entry mode in their foreign market expansion in China. This is partially due to the less developed infrastructure for communication and uncertain regulatory framework in China that induce higher transaction costs. Protecting firm specific assets such as client resources also lies at the center of the internalization decisions. There is also an increasing trend for banks pursuing locally incorporated subsidiaries in order to tap into the local retailing market. Evidence from the JV bank indicates that simple combinations of two banks' resources without taking into account their corporate objectives and culture increases the possibility of business failure. Some foreign banks choose to gradually win over the local market by acquiring minority ownerships from local Chinese banks. By doing so foreign banks have quicker access to the local knowledge and distribution networks. More importantly, it is a 'milder' way to establish trust with local counterparts and to learn the local corporate cultures. The knowledge and experience accumulated from minority equity sharing are crucial for future possible acquisitions.

Third, different banking segments respond differently to location choice. One thing in common is that banks tend to cluster in financial centers and large developed cities. Shanghai is the number one choice followed by other open cities in SEZs. Corporate and retailing banks require a more sophisticated local set-up. Following full market liberalization, foreign banks gradually extend their presence into China's inner regions including some rural areas. Their attention is clear which is to establish a nationwide distribution network by covering major cities or areas.

Our empirical study also suggests that a bank undertaking a following the client entry type is expected to be more knowledgeable than one that enters a foreign market to serve foreign customers. Firms are more willing to team up with external entities, especially in the foreign markets, in order to compensate for their market knowledge deficiency. The variation among client followers and market seekers could be attributed to differences in market knowledge. However we assume that the entry mode choice is affected by multiple factors at the same time. It is difficult to conclude which factor always outweighs others in the context of a dynamic market environment like China. This requires further investigation on how MNBs cope with policy restrictions to best exploit competitive advantages.

NOTE

1. By the end of 2003 there were 178 foreign banks authorized to establish 160 branches, 216 representative offices, seven wholly owned subsidiaries and six JVs in China.

5. Market development and determining factors

INTRODUCTION

The Chinese government has introduced strict entry criteria, both quantitative and qualitative, that to a large extent limit the options of MNBs' operational mode in China. Wholly owned operation still dominates MNBs' entry mode selection. China's financial market is in transition. The markets for knowledge and client relationships are still imperfect; therefore a bank has strong incentives to internalize their ownership specific and location specific advantages through the establishment of wholly owned branches or subsidiaries in China. However over a number of years some foreign banks have established multiple branches across the major cities of China, some foreign banks still maintain their operation at representative office levels. In some rare cases, foreign banks have chosen to exit the Chinese local market. This chapter examines the market development of foreign banks in China using data collected from a postal questionnaire survey of 178 foreign banks in China in 2003. Based on the survey data we investigate the factors that differentiate and dictate the post-entry development of foreign banks.

The structure of this chapter is set out as follows: literature is discussed in the next section, followed by the development of hypotheses. Section 4 discusses data and presents statistical models. A discussion of findings are presented in Section 5. We conclude in Section 6.

LITERATURE REVIEW

Casson (1990) argues that one important issue in studying market entry strategy is to examine how banks cope with the fast changing external environments and to identify the determining factors of the development of market presence in the host country. The existing literature on market expansion of banking in different countries has suggested that the process of market development is affected by various factors that are both internal and external to the entrant banks. Cho's (1986) study of US multinational banking identifies several important determinants of MNB growth in the onshore market. These determinants include the availability and lower costs of intra-bank fund transfers, efficient and extensive customer contacts, transfer pricing manipulation, larger and improved networks of market information and commercial intelligence, the potential for reduced variability in earnings, the size of the bank, effective lending rate differentials and the size of the host banking market. Terpstra and Yu (1988) indicate that host country market size, host country geographical proximity, firm size, firm's international operation experience, oligopolistic reaction and presence of home country customers have great impact on market entry and post-entry development for service firms. Fuentelsaz *et al.* (2002) investigates Spanish banking activities after deregulation. The study suggests that organizational size, organizational competence and organizational experience are the key factors in explaining the pattern of geographical diversification. Learning and experience are providers of key capabilities to secure successful growth.

Empirical studies of banking internationalization built upon internalization theory have concentrated on a few developed countries such as the USA, UK and Japan. Transitional countries and emerging markets have not been given sufficient attention (Sabi, 1988; Goldberg *et al.*, 2000; Scott-Green, 2002). Bol *et al.* (2002) argue that the existing evidence of banking internationalization so far is confusing and cannot be generalized since the existing empirical literature covers only a few transitional countries. This makes it difficult to develop relevant hypotheses associated with the Chinese banking market or to test readily available hypotheses in the Chinese market context. Research concerning inward FDI in China's banking sector is still rare (see, for example, Chan and Wong, 1999; Leung *et al.*, 2003). Most of it consists of descriptive studies (for instance, Chen and Thomas, 1999; Cho, 2001; Balfour and Clifford, 2002; Ross, 2002; Tsang and Wong, 2002; Howson and Ross, 2003; Guerrera, 2004). The existing empirical studies on foreign banking activities in China appear to be incomplete and cannot be generalized to explain inward FDI in China's banking sector in general.

Studies by Leung and Rigby (2003) and Leung *et al.* (2003) on foreign banking in Shanghai have found that particular attributes of foreign banks such as size of assets and number of branches have significant impacts on banks' decisions to engage in business transactions in China's domestic currency. In addition, these attributes also help foreign banks to manage liquidity and credit risks more effectively when dealing with their Chinese customers. Foreign banks have a competitive edge in both retail and corporate banking in the areas of financial soundness, risk management and financial innovation that constitute the ownership advantages.

DEVELOPMENT OF HYPOTHESES

Drawn from the existing empirical studies on banking internationalization, we are able to identify several general categories of factors that greatly affect the market entry of foreign banks. These factors are mainly firm and location specific. These factors were included in our pilot study and refined after pilot interviews. Since China enforced strict control over its foreign exchange and interest rate, this reduced short-term arbitrage activities of foreign banks. Many factors such as interest rate differentials as suggested by some of the previous studies may not be applicable in China. Variables (see Table 5.1 variable descriptions for details) such as local client resources, local human assets, product innovation, cultural proximity and bank size are found more relevant to the market entry and development of foreign banks in the Chinese context.

We are particularly interested in understanding the factors that affect MNBs' local market expansion from representative offices to branches and/or subsidiaries. Therefore we develop the following hypotheses:

H1: *The probability of upgrading the initial entry (a representative office) to a branch or subsidiary is dependent on firm specific factors, host country specific factors, diversification motives, size, operating cost, time since entry and following the client motives.*

H2: *The scale of foreign banking activity in China is dependent on the same determining factors as H1.*

DATA AND MODELS

Data

Table 5.1 gives the descriptions and measurements of all variables derived from the questionnaire data. UPGRADE is a binomial variable that measures foreign banks' upgrading decisions (from representative offices to branches/subsidiaries). SCALE is an ordinal variable that measures the degree of local market commitment of foreign banks in China. Foreign banks with a large number of staff[1] usually have established a multi-branch network and are more deeply committed in the local RMB business. During the pilot studies bank managers also agreed that the number of staff was a relevant and better measurement for local market penetration/commitment compared to using total assets. This is because PBOC has erected a benchmark for capital endowment for all foreign banks. Therefore using accounting figures such as total assets in the local market

Table 5.1 Variable descriptions

Dependent variables	Description and measurement
UPGRADE	1 = has been upgraded to higher scale of operation, e.g. branch 0 = otherwise
SCALE	Number of total staff in China measured by three scales. 0 = (< 50, Low[d]); 1 = (50–150, Medium); 2 = (>150, High)
Independent variables	
Motivations[a]	
MA	Motivations driven by the maturity of the home market
MB	Following the trade flow
MC	Following the FDI (following the client)
MD	Following the competitors
ME	Motivations driven by host country market potential (local market seeking)
MF	Motivations driven by international risk diversification
Determinants[b]	
DA	Size of the parent bank (in terms of total assets)
DB	Support from the parent bank
DC	Experience of operating in a Chinese context
DD	Ability in product innovation
DE	Ability to develop potential key customers
DF	Ability to adapt technology to local standard
DG	Ability to recruit local specialists
DH	Persistence in trying to receive customer acceptance
DI	Early entry
DJ	Location choice
DK	Ability to meet the latent demand of the Chinese banking market
DL	Policies and regulations of the local market
DM	The general stability of China
DN	Credit and risk evaluation on local clients and projects
DO	Operating costs
DumHK[c]	1 = Hong Kong banks; 0 = otherwise

Notes: N = 60; [a,b] are measured by six scales. 0 (not applicable); 1 (not important); 2 (some importance); 3 (important); 4 (very important); 5 (extremely important); [c] is used as a cultural proximity variable; [d] banks operating as representative offices are all grouped in this category.

(as suggested by the literature) may not provide accurate measurements and classifications.

Pearson bivariate correlations implied the existence of a multicollinearity problem. Variance Inflation Factors (VIFs) for independent variables were computed. The results confirmed the presence of multicollinearity. Therefore factor loadings[2] were performed in order to identify the key determinants and to eliminate redundancy among the stated determinants. Since extracted factors were orthogonally rotated, multicollinearity was also eliminated. A total of six factors, explaining 67 per cent of the total variance with eigen values bigger than one, were extracted for our statistical modeling (Table 5.2).

The Models

Logit regression

Logistic regression is probably the most commonly used procedure when analysing data with categorical variables (Hair *et al.*, 1979). The key issue associated with the logistic (logit) model is the measurement of the dependent variable. Modeling techniques are different for ordered and unordered dependent variables. The existing literature (McCullagh, 1980; Amemiya, 1981; Winship and Mare, 1984; Simonoff, 1998; Greene, 2000; Menard, 2002) suggests that the following models should be employed for variables UPGRADE (binomial or binary) and SCALE (ordinal), respectively.

Modeling strategic mode change The probability that a bank will upgrade its representative office π is assumed to satisfy:

$$\ln[\pi(x)/(1 - \pi(x))] = \beta_0 + \beta_1(F_1) + \beta_2(F_2) + \beta_3(F_3) + \beta_4(F_4) + \beta_5(F_5) + \beta_6(F_6) \qquad (1)$$

where $x = (x_1, \ldots\ldots x_i)$ is the set of predicting variables and $\pi(x)$ is the probability of upgrading the representative office given x. The dependent variable UPGRADE is assumed to follow a binomial $(1, \pi(x))$ distribution so that $y = 1$ represents upgraded and being upgraded banks and $y = 0$ represents non-upgraded banks.

Modeling market commitment SCALE is an ordinal variable measuring the degree of foreign banks' local market commitment. Menard (2002) argues that some categories such as 'high, medium and low' are rough measures for socio-economic status or intelligence. For such estimations, Menard suggests that one should employ an ordered logit model using SPSS's PLUM.[3] In the ordered logit model there is an observed ordinal

Table 5.2 Factor loading

Strategic orientations and determining factors	Factor loading[a]	Eigen value
F1. Firm specific factor		6.544
1. Product innovation	0.580	
2. Local client resources	0.664	
3. Technological adaptation	0.622	
4. Local human capital	0.811	
5. Persistent Chinese market related corporate policy	0.751	
6. Location choice[b]	0.642	
7. Cultural proximity[c]	0.556	
8. Ability to meet the latent demand of the Chinese banking market	0.688	
F2. Host country specific factor		2.233
1. Policies and regulations of Chinese banking market	0.761	
2. The general stability of China	0.809	
3. Local credit culture	0.767	
F3. Motive for diversification of market		2.013
1. Maturity of a bank's home market	0.661	
2. Following the competitors	0.719	
3. Local market seeking	0.640	
4. International risk diversification	0.693	
F4. Bank size related factor[d]		1.425
1. Size of the parent bank in total assets	0.867	
2. Support from the parent bank	0.737	

Table 5.2 (continued)

Strategic orientations and determining factors	Factor loading[a]	Eigen value
F5. Operating costs and early entry		1.271
1. Early entry to the Chinese market	0.690	
2. Local operating costs	0.718	
3. Following the trade flows[e]	0.524	
F6. Following the client motivation		1.219
1. Following the direct investment	0.823	
2. Following the trade flows	0.571	

Notes:

[a] Factor loadings greater than +/− 0.50 are considered significant. See Hair *et al.*, (1979), p. 234.

[b] Since the decision to choose the right location is mainly subject to the distribution of clients, the right location choice can also be considered as the result of firm specific advantages.

[c] Nationality is an uncopiable competitive advantage for foreign banking which becomes firm specific in the local competition.

[d] Factor four is highly correlated with the bank size variables. Bank size factors are grouped separately from the firm specific advantages. This is perhaps because bank size is considered as a fixed attribute in relation to banking strategy.

[e] It is worth noting that the motive to 'follow the trade flows' is moderately correlated with both factor five (0.54) and factor six (0.59). This implies that there may be both aggressive and conservative (following) intentions behind. Williams (2002) argues that the classification of following the trade motivation is always problematic. It is very difficult to identify if the bank is dealing with general trade flows or follows the trade transaction of a specific client. Our interview evidence also confirms the complexity of interpreting trade-driven banking activities.

variable, *y*, which is a function of a latent variable y^*. The latent variable y^* is a continuous and unmeasured variable whose values determine what the observed ordinal variable *y* equals. Therefore the ordered logit model is built around a latent regression.

$$y^* = x^* \beta + \varepsilon \tag{2}$$

What we observe is:

$$\begin{aligned} y(\text{SCALE}) &= 0 \quad \text{if } y^* \leq 0, \\ &= 1 \quad \text{if } 0 < y^* \leq \mu_1, \\ &= 2 \quad \text{if } \mu_1 < y^* \leq \mu_2 \end{aligned} \tag{3}$$

The μs are unknown parameters to be estimated with β. We assume ε is normally distributed across observations. We normalize the mean and variance of ε to zero and one. We then have the following probabilities:

$$\begin{aligned} &\text{Prob}(y = 0 \mid x) = \Phi\,(-x^*\beta), \\ &\text{Prob}(y = 1 \mid x) = \Phi\,(\mu_1 - x^*\beta) - \Phi\,(-x^*\beta), \\ &\text{Prob}(y = 2 \mid x) = \Phi\,(\mu_2 - x^*\beta) - \Phi\,(\mu_1 - x^*\beta). \\ &0 < \mu_1 < \mu_2 \end{aligned} \tag{4}$$

FINDINGS AND DISCUSSION

Table 5.3 shows the results of the binomial logit regression for UPGRADE. The results suggest that following the client motivation is the most significant variable followed by the diversification of market motive. Firm specific factors appear to be the least significant variable. The model chi-square 23.589 is highly significant (<0.01). This indicates that the logit model is fitted well. The positive coefficient for the following the client motivation means that the more the bank is motivated by the following the client intention the more likelihood there is for the bank to upgrade its representative office to a branch or subsidiary. The positive coefficient for the diversification of market motive suggests that banks' decision to upgrade representative offices may also be motivated by seeking local market growth, following the competitors and risk diversification purposes.

The results of the ordered logit model for SCALE show that firm specific factors, the motive for diversification of market and following the client motivation have significant effects on the degree of local market commitment/penetration. For well resourced banks, they are more likely to be engaged in a higher level of local market commitment than banks that are

Table 5.3 Logistic regressions results for UPGRADE and SCALE

UPGRADE (Binomial Logistic Model)

	B	S.E.	Sig.
Firm specific factors	0.364	0.037**	0.758
Host country specific factors	0.318	0.335	0.306
Diversification of market	0.365	0.029**	0.797
Bank size related factors	0.336	0.036**	−0.705
Operating cost and early entry	0.345	0.644	0.159
Following the clients motivation	0.405	0.007***	1.099
Constant	0.327	0.524	0.208

Model fitting information: Chi-square = 23.589, df = 6, Sig. = 0.001

SCALE (Ordered Logit Model)

		Coefficient	Std. error	Sig.	95% Confidence interval	
					Lower bound	Upper bound
Threshold	[SCALE1 = 0]	0.033	0.301	0.912	−0.556	0.623
	[SCALE1 = 1]	1.575	0.375	0.000	0.841	2.310
Location	Firm specific factors	1.094	0.331	0.001***	0.444	1.743
	Host country specific factors	0.152	0.279	0.586	−0.394	0.698
	Diversification of market	0.665	0.294	0.023**	0.090	1.241
	Bank size related factors	−0.173	0.275	0.531	−0.712	0.367
	Operating cost and early entry	−0.306	0.283	0.280	−0.860	0.249
	Following the clients motivation	0.520	0.286	0.069*	−0.041	1.081

The reference category: 2. Model fitting information: Chi-square = 22.344, df = 6, Sig. = 0.001

Notes: * significance at the 0.1 level; ** significance at the 0.05 level; *** significance at the 0.01 level.

not strong in firm specific advantages. Banks intending to serve Chinese market clients appear to be more committed to the local market. Meanwhile Chinese market penetration may also be driven by serving existing clients. The model chi-square equals 22.344 and is significant at 0.01.

Several implications emerge from the estimation results. First, following the client motivation is the most important factor that distinguishes representative offices from branches and subsidiaries. Foreign banks appear to be followers of their corporate clients in the Chinese local market particularly at the initial entry stage when banks consider upgrading their representative offices. Firm specific factors appear to have the least significant effect on upgrading decisions. This implies that upgrading representative offices does not necessarily require banks to be strong in firm specific competitive strengths since foreign banks may simply follow their clients in order to protect the existing bank-client relationships. This is in line with our pilot interview findings that most of the foreign banks in China initially focus on serving FIEs, that is, the ones that the banks have already been serving for years in home or international markets.

However banks may be multi-dimensionally motivated rather than single factor motivated in their foreign expansions. Foreign banks have multiple motives when initially entering the Chinese market and the dominance of strategic orientations switches over time. The ordered logit model for SCALE downgrades the significance order of the following the clients motivation. The increase in local market penetration requires banks to be more competitive in firm specific advantages and become more local market oriented. Protecting existing knowledge via internal transfers as suggested by internalization theory may not be the sole factor that supports long-term development in foreign markets.

Second, comparing the results of the logit regressions for UPGRADE and SCALE, we find out that the significance order has dramatically changed. The results of logit regression for SCALE suggest that firm specific factors become increasingly important with an increase in local market commitment. Banks in different local operational scales may share some similarities in attributes such as motives. However the difference in firm specific strengths leads banks to pursue different strategies. The difference in significance order for logit models indicates a clear shift of motivations over time. When banks are considering upgrading their representative offices, banks are primarily motivated by the following the client motivation. With an increase in local market commitment over time, banks seek diversification of the market by serving local clients or following competitors. The shift of the motivations suggests an incremental expansion style undertaken by foreign banks. Interview data also indicates that foreign banks gradually increase their local market commitments with the accumulation of local market knowledge and client resources. At the initial entry stage, foreign banks may not be very familiar with the local market environment; therefore they expand their market presence by following their existing clients as an emergent strategy (although they may also have market seeking motives). With the accumulation of local market knowledge and experience over time, foreign banks become more local market orientated and may accelerate their speed of expansion.

Third, market development is dependent upon firm specific advantages (ownership advantages) that a bank possesses. In order to increase the local market commitment in China, foreign banks need to be competitive in the following attributes: product innovation, ability to develop key clients, ability to adapt technology to the local standard, ability to attract and recruit local expertise, ability to meet the latent demand of the Chinese banking market and cultural proximity. Meanwhile foreign banks need to have a persistent long-term strategy in China. Many of these attributes are central to the adaptation process in China. The ability to learn and organizational routines are strategically important for MNBs. For instance, foreign banks with an excellent learning culture can usually more efficiently deliver innovative financial products that are compatible with local market regulations and demand. Banks from Hong Kong and Southeast Asia appear to be advantaged because of their cultural and language proximity. They demonstrate a faster pace of local market penetration.

Finally, bank size related factors are negatively related to branch building decisions and have insignificant impact upon local market commitment. This suggests that large-sized foreign banks may not necessarily achieve a better market development position faster than smaller banks. Our finding differs from some empirical studies that bank size has a positive effect on market development (for example, Leung *et al.*, 2003; Ursacki and Vertinsky, 1992). China as a unique emerging market may present some special characteristics at a specific time. Bank size is indeed an important factor that affects foreign banking activities particularly from a long-run perspective. However it may not play a dominant role at a specific period and/or location. Pilot studies suggest that a large bank size may not be the only key determinant during the initial market entry. Bank size related factors may also be conditional on other issues such as the strategy of focusing on a niche market, conservative corporate strategy adopted by the headquarters and cultural distance. It can be observed that some Hong Kong banks such as the Bank of East Asia are not big but they demonstrate a more aggressive expansion style than many large-sized MNBs. Many Hong Kong banks focus their businesses in south China where they have close economic connections with the Mainland. They are usually more sensitive to the changes of local market conditions than large-sized banks. These medium-sized banks are flexible in adapting to the local market. Cultural proximity offers them advantages to penetrate faster into the local market. However in the long term, when majority equity control by foreign banks is allowed in local M&As, large-sized MNBs will have more advantages.

CONCLUSIONS

This chapter examines the market development of foreign banks in China. Logistic models are conducted to investigate the evolution of MNBs' strategic orientations and to examine the determining factors of local market expansion. The findings confirm that foreign banks enter China with multiple motives and the dominance of these strategic motivations switches over time. For branch building decisions, foreign banks are mainly motivated by the intention of following existing clients. With the accumulation of local market knowledge, banks tend to increase their local market commitment and become more local market oriented. The findings also imply that the expansion of the market presence of foreign banks tends to be gradual and incremental.

Firm specific attributes are identified as the most important factors determining the post-entry development strategy of foreign banks as they dictate and differentiate strategic options of banks. Well resourced banks demonstrate a higher degree of local market commitment and a speedier pace of local expansion. The success of local market penetration depends on a bank's capability in product innovation, local client resources, technological adaptation, quality of local human capital stock, the persistence of China market related corporate strategy and cultural proximity. The research findings to a large extent provide support to the existing empirical studies on banking internationalization and offer important insight and implications to the understanding of multinational banking in emerging markets.

NOTES

1. See also the study by Fisher and Molyneux (1996) in which they adopt the number of staff as a proxy measure of MNBs' foreign market penetration.
2. Factor analysis is appropriate for exploring the underlying dimensions of a construct and selecting the minimum number of independent variables which explain as much of the common variance as possible in the final solution.
3. Alternative techniques can also be used to model SCALE such as the probit model and the multinomial logit model. However none of them seem to present a better result than the current ordered logit model. For the multinomial logit model, Menard (2002) argues that the key problem for ignoring the fact that the categories are ordered is a loss of

efficiency. One fails to use some of the information available and estimate many more parameters than is necessary. This increases the risk of getting insignificant results. The results of the multinomial logit model using SPSS's NOMREG (Kinnear and Gray, 2003) proved Menard's argument. Only firm specific factors seemed to be significant. As for the probit model, Chambers and Cox (1967) and Amemiya (1981) argue that the probit and logit models usually give similar results and it is difficult to distinguish between them statistically unless one has an extremely large number of observations. Given N = 60, the results for probit and logit models are virtually the same.

6. Evolutionary development strategies

INTRODUCTION

The operations of foreign banking activities in China are under the tight control of PBOC. On the one hand, foreign banks have limited access to their targeted clients. On the other hand, the range of banking products is largely confined to the low-order traditional commercial banking services such as trade finance products, including payments, collection, foreign exchange and letters of credit. The market for high-order financial products such as derivatives and complex capital market instruments is still in its infant stage because the local capital market has not been well developed and the local Chinese banks are not competitive enough to confront the challenge. Without a license and sufficient reserve of local currency RMB, foreign banks can only compete against local Chinese banks in foreign currency related business. Since the lending rate is only allowed to float within a narrow range around the benchmark rate designated by the PBOC, foreign banks can hardly win the price competition in RMB related business. In addition, other policy restrictions as well as the immature business environment keep foreign banks from diversifying their client base and product range. Facing the increasingly intensified local competition, foreign banks employ different strategies or tactics to survive and develop in the local market. Based on interview evidence, this chapter develops an evolutionary framework of the development strategies of foreign banks that offers important implications for business practitioners.

The rest of the chapter is set out as follows: the next section presents the data; Section 3 presents the evolutionary framework of development strategies of foreign banks; discussions are presented in Section 4, which is followed by conclusions.

DATA

Primary data was collected from 37 in-depth interviews in Beijing, Shanghai and Shenzhen using a case study approach. During the process of data transcription and analysis, we found that many banks presented similar attributes in many aspects. In order to best discriminate between

Table 6.1 Categorization of the interviewed banks

Group	Descriptions (core business in China)	No.	Names
G1	Wholesale banking and investment banking (focusing on the capital market, inter-bank business and serving financial institutions)	5	Blay, Sima, Geu, Upm, Serb
G2	Corporate banking (serving corporate clients)	13	Nroa, Aua, Fabris, Tok, Uaa, Gcer, Sais, Skda, Pimil, Brsn, Fgs, Twco, Gwel
G3	Universal banking (including the whole spectrum of banking segments ranging from corporate banking to retailing banking, asset management to investment derivatives)	4	Hea, Uic, Bsk, Bcs
G4	Offshore banking (focusing on correspondent banking, business research and consultancy)	10	Acb, Ichiena, Cic, Roy, Ubc, Saneco, Enpt, Spino, Uac, Fic

Notes:
1. For the purpose of confidentiality, names of the interviewed banks are anonymized.
2. Bank of Khli is not included since it has quit the Chinese market.
3. Sais was a joint ventured bank and was later restructured to a wholly owned subsidiary of Fabris Group in China.

the interviewed banks, we categorized the 33 banks into four different groups based on their core business ranges in China (Table 6.1).

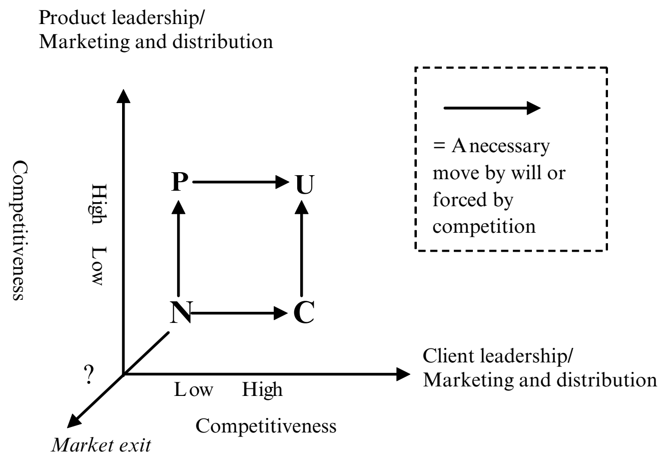
Group one focuses on capital market and serves mainly the financial institutions. Their products are mainly inter-banking related services and complex capital market instruments such as financial derivatives. Group two is mainly engaged in serving corporate clients. Products are mainly trade finance services including payments, foreign exchange, collections, letters of credit and working capital loans. Although some services are money market activities, the business focus is still targeted at corporate clients. Group three provides universal banking business with an active involvement in the local consumer banking market. The business scope covers the whole spectrum of traditional commercial banking services including wholesale, corporate and consumer banking. Group four concentrates on correspondent banking, offshore business, local market research and consultancy services. Banks within this group operate as representative offices.

We argue that it is reasonable to group banks by business focus in that different business lines characterize different motivations and development strategies. Through such a categorization, the total number of banks is reduced to four different categories and the efficiency of the analysis is also improved by comparing and contrasting these four groups. We also find it easier to deal with the replicated comments that constantly appear in the interviews. The analysis is conducted at both inter- and intra-group level that allows the existence of heterogeneity among individual banks.

THE EVOLUTIONARY DEVELOPMENT FRAMEWORK

Due to the weakly developed financial market, the operation of foreign banks is highly restricted by local regulations. The Chinese government designates specific geographical areas for foreign banking activities and restricts the number of branches that MNBs can establish. It also requires strict quantitative controls on required capital for branches and subsidiaries. Most of the foreign banks focus on foreign currency related services with FIEs, individuals and a limited number of Chinese companies. There are many other invisible ways for the government to affect the pace of foreign banks' penetration such as encouraging large state owned enterprises to use domestic banks, setting obstacles to the use of domestic networks by foreign banks, and complicating and prolonging the procedures for approving the specific business of specific foreign banks. In addition, China's government still controls its interest rate and foreign exchange rate. The liberalization and development of China's capital market is likely to progress slowly. This limits foreign banks' strength in product innovation. In the traditional banking market (mainly interest based business) Chinese banks have been catching up quickly in recent years. This intensifies local market competition. Foreign banks adopt different development strategies with respect to their mix of firm specific attributes and environmental factors. Based on the interview data, we develop an evolutionary framework of foreign banking strategies in China (Figure 6.1).

The competitiveness of banks is defined by two domains that are product leadership and client leadership combined with specific marketing and distribution tactics. At the initial market entry foreign banks establish representative offices and operate as new (N) entrants in the local market. The competitiveness of foreign banks in product and client in the local market are very low as banks can only conduct offshore banking services. Different banks may adopt different strategies to pursue leadership in either client (C) or product (P) or both. The definition of each strategy is based on the



Note: N = new entrant in the local market; C = client; P = product; U = universal banking services.

Figure 6.1 An evolutionary framework of foreign banking strategies in China

focus of the banking resource allocation. It does not mean that client-driven and product-driven strategies are totally segmented. Achieving leadership in either client or product benefits the other.

The Chinese market is relatively new to foreign banks. For the regular banking market, local circumstances complicate the credit playing field. The legal framework is less developed and transparent and there is little experience with local collateral valuation and legislation. Most foreign banks take precautions when entering the market by limiting product offering and customer focus. This lasts until more local experience will allow for deepening the local penetration.

For specialized finance (for example, commodity financing) the market is less risky as the value of the collateral is determined by global market prices and contracts often subjected to international law. These departments of financial institutions do focus on customer leadership.

Economies of scale will ultimately be reached through the accumulation of high quality clients. Client-driven banks gradually develop from N to C to seek diversification of the client base. The majority of the banking resources are used to retain existing clients and develop new clients. Following the client is often employed by MNBs as an emergent strategy to establish a foothold in China. Since most of the banking products can hardly be differentiated, sound management of client resources is vitally important. Successful banks usually establish a well designed client portfolio. They stay close to their core clients and make great efforts to improve their service delivery capacity by closely cooperating with domestic Chinese banks. Client satisfaction is not purely determined by whether the bank can offer high-order advanced banking products (for example, financial instruments in capital markets). More often it is about price, efficiency and satisfaction derived from interpersonal marketing. Banks can stick to standardized banking products and still be successful if they can develop a stable and diversified client base. However diversification of the local client base in China is difficult and costly. The primary barrier is local policies and regulations. In addition, credit scoring techniques used by MNBs for corporate lending may not be suitable for use with Chinese corporate clients, partly because information on such borrowers is more difficult to obtain. As a result, foreign banks are often more conservative and risk-averse than domestic banks and lending to domestic Chinese firms involves higher risks than lending to FIEs. Although a consistent strategy is essential for successful implementation, in general one can say that banks also follow market trends. If the market trend changes, the strategy does not prove successful, or if a new CEO has a different view on strategy, the strategy might be adjusted accordingly. Implementing a strategy successfully does however involve significant financial investments and requires patience and persistence, particularly in China.

Alternatively, banks adopt a product-driven strategy by focusing on designing individualized products, innovatively marketing their high-order financial products, expanding the product range via cross-selling and seeking a wider range of distribution channels. More individualized banking services require a more stable and long-term bank-client relationship. By offering more specialized banking products, a bank can strengthen its connections with the existing clients. Among the major players, there is a split between financial conglomerates offering a wide range of financial services under one umbrella brand and specialized financial service providers. For both types, a well designed, efficient internal coordination mechanism and sound risk management are critical. Since banking, insurance and securities services are practiced separately in China, coordination at both inter- and intra-firm level and a more sophisticated marketing strategy are required for cross-selling. Distribution is the key issue in increasing product sales. Since the direct sales of high-order products is not allowed for foreign banks, many banks look for indirect sales opportunities through cooperation with local Chinese banks or outsourcing part of the business to more specialized banks. The evidence shows that certain banking products, mainly investment instruments not designed specifically for any individual client, can be sold in the local market via contractual arrangements with local Chinese banks.

The ultimate objective of foreign banking activities is to achieve leadership in both product range and client base. In this case, banks become mass market players rather than niche market players and eventually conduct universal banking services (U). To achieve the position U, banks may choose to focus on either a product-driven strategy or a client-driven strategy in different stages. It is evident in the interviews that several banks have switched their strategies over time from client-driven to product-driven. Alternatively, banks may also adopt a multi-strategic approach to integrate both strategies at the same time. Adopters of the multi-objective strategy attempt to seek synthesized benefits by simultaneously combining the strength of client-driven and product-driven strategies. Banks practicing this complex strategy are also more adaptive and responsive to the local Chinese market and demonstrate a more aggressive expansion style.

Finally, banks that are unable to improve their competitiveness in either products or clients would eventually maintain the position N or exit the market.

Due to the differences in bank specific attributes, banks adopt various tactics. Most of the banks do not have the strength to achieve both economy of scale and economy of scope. They may focus on one strategy at a specific time and move to the other strategy at another time. In this dynamic framework banks may pursue different strategic focuses over time and their paces of development vary greatly due to the heterogeneity of bank specific attributes. Based on this framework, we further categorize the four groups with regard to their strategic focus (Figure 6.2).

Figure 6.2 suggests that the strategy of wholesale and investment banks does not purely rely upon how many clients banks can develop but rather the ability to offer professional financial services. Professionalism, reputation and rich experiences in the global capital market are key determinants that help them to win deals. Investment banks are currently not allowed to establish wholly owned subsidiaries in China. Their operational scales are still restricted to representative offices with a few of them already engaged in joint stock banks with local Chinese banks.

Interview data reveals that product-driven and client-driven strategies are evident in both group two and group three. However the difference is that only group three displays a constant and strong integration and combination of both strategies. Group three seeks multi-strategic positions by developing both economy of scale and economy of scope at the same time. Their operations present a strong diversification in both client base and product range. In addition, group three shows a much faster pace of local market penetration. Some of them have acquired equity stakes in local Chinese banks. Their local market commitment is the highest among the four groups. In contrast, group two attempts to focus on one strategy at

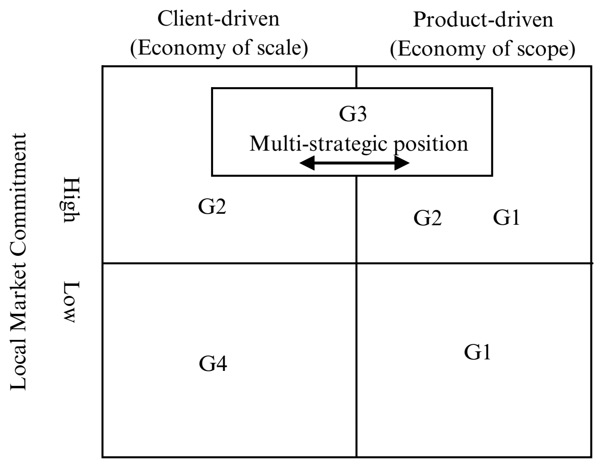


Figure 6.2 Strategy focuses of the four groups

one time and is more niche market oriented. Their development strategies switch over time once they become more experienced.

Group four is a client-driven type with low market commitment. Banks still operate as representative offices. The primary barrier for development is the lack of sufficient clients in the local market resulting from the limited FDI from home countries. Banks mainly provide trade related services to their existing clients. Most of the banks do not have the competitive strength in product innovation and hold an opportunistic approach to development. Typically they do not have any clear development strategies.

DISCUSSION

Client-driven Strategies

Interview data suggests that following the existing clients has been extensively adopted in corporate banking as an entry and development strategy. Banking internationalization is the extension of existing market relationships in host country markets. The paramount importance of preserving existing clients pushes banks to establish and expand their local presence. Client knowledge offers banks a competitive advantage that one can use to overcome the barrier of being a foreigner in overseas markets. The importance of a stable and long-term bank-client relationship is one of the key elements of competitive advantages for banking. Foreign banks establish their footholds and expand their business in China by sticking to their existing clients. The evidence is particularly strong for corporate banks, for instance, one bank manager remarked:

> Our corporate clients are mainly multinational companies with many years of relationship with us. For example, Ericsson is our old client and we have been doing business together globally for many years. For such clients, we know exactly what they want. Our responsibility is to help them develop in China faster and better.

There are two major ways to set up connections with your existing clients' Chinese subsidiaries or affiliates. One is that a global client controller refers the global client to the local regional office. The other way is more straightforward. Local regional managers pay a visit to the client. In either case establishing a contact is easier if you can refer to a track record of doing business. Differentiation in traditional commercial banking business is very difficult, hence relationships play a crucial role. Products and services can easily be copied, but relationships and trust take a long time to establish and build. Some banks have established their network in the Chinese market. However intensified competition resulting from the local policy restrictions can still squeeze them out of certain client groups. Client knowledge, business processes and an understanding of the local market in terms of, for example, policies and consumer culture are important elements in facilitating banking services to local clients and should ultimately also help foreign banks maintain a sound relationship with existing contacts.

In practice, banks prefer to stick to initial local clients and only focus on local high-end clients. Interview evidence shows that foreign banks prefer to allocate the best resources to the best clients. Some bank managers noted that 'we mainly target those high-end corporate clients that are large in size with sound performance. In most of the cases, our targeted local clients are leaders of an industry.' Such a strategy in managing the client portfolio is referred to as the 20/80 rule by many bankers. Since 20 per cent of key corporate clients contribute to the majority proportion of the revenue, a successful management strategy is to allocate most funding and the best managerial team to support these 20 per cent of clients. In order to identify the right client segments, careful design and management of the client portfolio is required based on a detailed classification of the local client base. Such selection is a 'cream-skimming' process of the best clients. The selection has been confined to a small group of local clients including large-sized SOEs, banks and financial institutions, and clients with strong governmental backgrounds. Among the internationalized local Chinese companies, large-sized SOEs are considered as the primary target client group. However serving these large-sized SOEs is not easy since these companies are also strongly supported financially and politically by local Chinese banks and governments. Compared with SOEs, privately owned Chinese companies have become increasingly attractive to foreign banks.

Banks with worldwide coverage normally find themselves more competitive in developing local clients because they are information rich and efficient in handling Chinese clients' requests and can offer better services using their global network. For most of the other banks, developing local connections and maintaining a constant engagement with local clients is difficult. Sometime banks focus on key regional markets and serve core corporate clients. Group two focuses on Shanghai, the financial center and its surrounding areas. Many of these banks have been granted local currency licenses and are proactively involved in local banking activities. A series of cost saving plans and reallocation of banking resources in the Chinese market have been carried out in order to maintain their competitive strength in the regional market. Their strategy is to serve a specific market at a specific time and location while keeping operating cost low.

Group three identifies more detailed client segmentation compared to group two. As a result, their local expansion is more aggressive. 'For foreign multinational clients, large local Chinese clients and medium to small local clients, we certainly have different treatments in terms of communication and services tactics', says one bank manager. Corporate clients are also distinct by country of origin. The nature of the businesses of the clients influences and shapes the products and services that banks offer. In Shenzhen most of the companies are from Hong Kong, Taiwan and other Asian countries. They import components for manufacturing and assembling and then re-export the final products to international markets. Banking services specialize in foreign currency trade finance for those export oriented firms. In Shanghai banking services focus on local currency products and cash management services for local market oriented FIEs and their domestic subsidiaries. In order to serve different types of clients in different regions, group three highlights local marketing strength and an effective networking mechanism among local regional offices. Through an effective internal coordination among regional offices, banks can cover a much wider geographical area and reach more local client resources.

Group three is also distinguished from the other groups in that banks aggressively seek diversification of their local client base. According to one bank manager, local corporate clients have accounted for 60 per cent in their corporate business stream, an increase of five times compared to one out of ten in corporate deals several years ago. In order to avoid direct competition with domestic banks, foreign banks target niche markets, for instance, small to medium local enterprises which domestic banks have not paid much attention to in the past. China's private enterprises have developed very rapidly in recent years and most of them intend to develop overseas in future. Given the existing global network and worldwide service coverage, foreign banks definitely see an opportunity here. 'Our global brand name helps a lot', says one manager.

Rural areas used to be a neglected and restricted market segment. With the lift in geographical restrictions and permission to do RMB business, serving the rural market is no longer an issue. In one of our follow-up interviews in 2007, the same manager from group three commented:

> Except basic services, such as deposit and lending, we also launch services of unsecured loans of small amounts for peasants, secured loans for township enterprises, discounted notes, accounts receivable financing and other trading services. We want to give it a try, starting from loans of small amounts to local peasants. We also set up regular dialogues with peasants and help them reduce risk. This is warmly welcomed both by local peasants and local governments. Meanwhile we have to make sure we make a profit. This is also a good learning process for us.

The above comment mirrors the great determination and effort of foreign banks in trying to tap into the domestic market even in the remote areas. Strategy needs to be planned well in advance but business will inevitably develop incrementally based, to some extent, on trial and error. From the policy perspective, preferential tax treatment for foreign investors and governmental support also stimulate the shift of foreign banking activities towards inner regions.

Banks from group three have also been making great efforts to develop the local consumer banking market by establishing high street branches or even sub-branches in major cities, not only in coastal areas but also in inner regions. They design different private finance packages in foreign currencies, mainly in USD and HKD, to attract rich individual customers. A RMB license will only further boost the retail business. Foreign banks can increase their local RMB reserves and reduce potential liquidity risks by absorbing individual savings. Given the 40 per cent savings rate in China, the retail banking market is no doubt a potentially profitable niche market. With a population of 1.3 billion, the total number of credit cards in issue has only reached 25 million in 2007. Empirical evidence shows that mainly Hong Kong based banks and some big MNBs are actively developing their consumer banking services. The success of consumer banking is largely built upon a solid local infrastructure backup including the development of tangible and intangible assets, such as networks, technology support and professional staff, and so on. 'We have over 20 retail outlets nationwide and this figure will double in the next several years and we are planning to hire up to 1000 local staff over the next two years time', says one bank manager.

Given the set-up and operating costs of the retailing business, foreign banks concentrate on high-end local customers and focus on high value added financial services such as credit cards, investment products and mortgages. A typical amount for a local individual to open an account in a foreign bank branch is half million RMB. Foreign banks have also introduced global wealth management services aiming at more wealthy local clients with net assets of over 10 million USD. According to one general manager, local citizens have accounted for over 56 per cent of their personal wealth management business. Local individual customers very much favor personalized banking products and services. 'Apart from a higher return [compared to domestic Chinese banks], foreign banks offer better services. After making an appointment and filling out the paperwork, you can just wait while your own bank manager sorts out the rest', says one customer at HSBC Beijing branch. Wealthy customers enjoy not only personalized services but also prestige, care and privacy that are absent in the services provided by local Chinese banks. In addition, the market represented by an increasing number of young Chinese students intending to study abroad cannot be underestimated. With existing worldwide branch networks, foreign banks are clearly better placed than domestic Chinese banks.

Foreign banks need to be culturally close to the targeted market because consumer banking services demand a more accurate grasp of the consumption behavior of local individuals. For example, one bank manager remarked:

> . . . since banks will have face to face communication with local individuals in areas such as private finance, cultural issues appear to be increasingly important because it is the central element in successful sales and marketing. Even language would matter. . . Relationship managers or account managers must possess in-depth understanding of the Chinese local market such as local regulations and individual consumer's investment behavior, for example, expectations or even habits.

Cultural proximity offers MNBs a deeper understanding of the local consumption behavior, hence a quicker access to the local retailing market. Evidence also supports the notion that experience and reputation gained in other international markets can also act as an 'ice breaker' and facilitate entry into the local retailing market.

Distribution is critical in retail banking services. Several banks such as HSBC, Citibank, Standard Chartered and the Bank of East Asia have established over 100 retail outlets across China. However the consumer banking business in China is costly because it requires strong local infrastructure support. The majority of investment is spent on building high street branches and ATMs, and training staff. Interview analysis indicates that successful expansion in the retailing market is likely to require acquisition of the market share in significant chunks. Organic growth will not suffice. Several MNBs have invested in Chinese local banks in order to develop their retailing and corporate business. Having noticed the dominant position of state owned banks in the local banking market, foreign banks have realized the importance of working closely with local banks in order to maintain their own market shares. The majority of banks across the four groups emphasize that they will further strengthen their cooperation with local Chinese banks in terms of expanding the local client base.

Product-driven Strategies

'The biggest advantage of foreign banks is product', some managers note. Product-driven strategies are supply side strategies. Product quality is not all about price but rather the efficiency of information flow and communication, the relationship with the client and after sale support. More specifically, product competition is about service delivery capacity, which refers to what the bank can provide (product); where the bank can provide it (network) and how the products are provided to end users. Empirical evidence strongly suggests that group three takes the lead in this aspect. Banks in group three demonstrate the highest adaptive characteristics among all interviewed banks and are the most competitive in creating innovative and personalized banking and financial products to match local market demands.

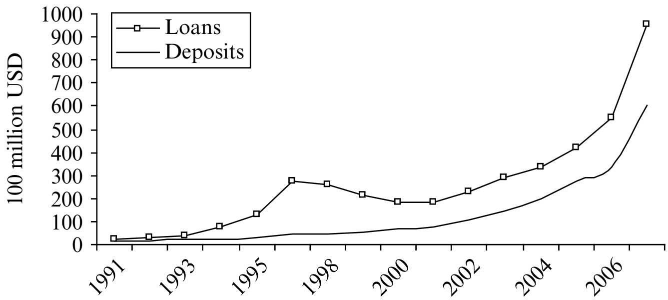
Product innovation can be client specific to design personalized banking services or market specific financial products that match the local market conditions. Interviews show that group one and some banks from group two intend to focus on the latter type. Some banks consider that product innovation is essential but cannot be fully explored in the current conditions in China given the tight control over the launch of new products. However our findings reveal that strong R&D and internal coordination play a crucial role in innovation. In addition, innovation is affected by corporate policy and attitude from parent banks. If parent banks are highly committed to the Chinese market, normally their local subsidiaries are strongly incentivized to achieve leadership in terms of their product offering. Banks are highly leveraged so that a small difference may lead to a significant difference in their profit. Such a difference may not necessarily be a differentiated product but improved efficiency. For instance, one bank manager notes, 'in the last year, we introduced up to 77 new products and services including structured investment products, investment portfolios and efficiency-improving working methods. The result was good. Our revenue increased 80 per cent.'

Product adaptation lies at the center of the innovation process. Banking strategy should start with the needs of the individual customers in order to provide individualized services. It is essential to adjust these generic products to the specific local market conditions in order to provide individualized banking services. Many product concepts must be modified in order to match local market conditions. For instance, one bank manager comments, 'our products offered in China are different from that we offer in global markets. The principle is the same but the structure is rather different. We cannot simply transfer our matured products to the Chinese market directly. Our products must experience a repackage process before entry.'

Diversification is required based on the adaptation of products, services and marketing methods. Foreign banks need to identify areas that Chinese banks have not capitalized on. There is a clear shift of business from traditionally interest based services to high-order services that are mainly fee based or capital market related financial products. The introduction of QFII also allows foreign banks and financial institutions to exchange a certain amount of local currency and engage in the local stock market. In traditional banking business the advantages of foreign banks are diminishing over time since local Chinese banks are catching up very quickly. Local banks have accumulated rich foreign currency savings and corporate clients can borrow from local Chinese banks at a cheaper price. Local Chinese banks have successfully copied all products from international banks. Figure 6.3 shows a rapid decline of foreign bank lending between 1997 and 2001.

Many foreign banks such as HSBC have adjusted their revenue structure accordingly by increasing the proportion of fee based services and becoming less reliant on pure interest based business. HSBC reported that fee based services had increased 21 per cent and reached 212 million RMB in 2002. Pure lending business declined dramatically from 692 million RMB in 2001 to 367 million RMB (*The 21st Century Business Herald*, 12 May 2003, p. 18). Similarly, in our interview sample some foreign banks have created a new business function called PCM (payment and cash management) which is designed to handle cash flows and account receivables for multinational firms. An efficient management and supervision on cash flows saves a lot of money for companies that have many account receivables with local wholesalers and retailers.

Apart from specializing in high-order fee based banking services, there are other methods to achieve product leadership. Well resourced MNBs intend to establish 'financial supermarkets' so that they can cross-sell their financial products including banking, insurance and investment services to the targeted corporate clients. This leads banks to seek synergistic links with other organizations offering complementary specialisms rather than



Notes: This table consists of foreign bank branches, subsidiaries, joint venture banks, foreign invested finance companies and joint venture finance companies.

Source: Author's calculation based on the *People's Bank of China Quarterly Statistical Bulletin*, various issues.

Figure 6.3 Lending and deposit curve of foreign banks in 1991–2007

diversifying away from sectors in which they can capitalize on their skill base. For example, some bank managers remarked:

> We are different from other international banks. Most of them focus on certain specific markets or products or regions. Although they are professionals in one specific area, the trend is that we need to set up a platform in China which offers universal financial services.

> In most of the cases, our corporate banking division conducts cross-selling. During the meetings with some corporate clients, we often bring in our investment banking team and insurance team. Different divisions will then work together to design and deliver a full banking service package.

Cross-selling is based on effective networking among different strategic units. In doing so, banks can optimally establish and diversify their product range. Since commercial banking business, investment banking business and insurance are operated and regulated separately in China, large financial institutions need to obtain business licenses separately and enter China as a financial group. In our sample evidence is mainly from group three.

A distribution network is a key factor in developing local market presence and causing barriers to entry of competitors. 'Network is the priority for the future development of foreign banks. Network coverage directly determines whether we are able to successfully sell our banking products', says one bank manager. Product and distribution are two key elements of service delivery capacity. Branches continue to remain the cornerstone of banking strategy. Some banks have adopted multiple branching strategies to develop their business and clients in China. However our findings suggest that multiple branching can hardly be regarded as a commonly employed strategy in that network building in China is very costly. In addition, network expansion is largely subject to the quality and quantity of the local client base. Only large-sized MNBs and several Hong Kong and South Asia based banks are keen to expand their networks across China. For example, one bank manager remarks, 'expanding network is very difficult in China. First, we need to have enough clients and business to support our local offices. Second, we need to invest a large amount of capital as required by the local government. Third, we need to hire professional banking employees.'

Although some foreign banks have successfully established multiple branches or even sub-branches across major Chinese cities, they still cannot compete with local banks in terms of the number of branches and geographical coverage. In order to tackle this problem, some banks from group three have developed intangible networks, mainly e-banking services including internet banking and telephone banking. Bsk and Uic are among the first few banks to launch internet banking services. However due to policy restrictions, internet banking services are currently restricted to designated regions and services are limited.

Outsourcing appears to be an effective way to improve efficiency in product offering and expand the target demographics for new products. Banking operation typically involves three key functions: front-end, middle-end and back-end offices. The front-end office deals with sales and marketing, compliance and technology support. The back-end office specifically handles all banking transactions and operations. The middle-end office works to coordinate and connect the front-end with the back-end office. It normally involves client services. Foreign banks may outsource some of their functions, such as sales and marketing, to a domestic custodian bank via contractual arrangements that allow local Chinese banks to sell the advanced financial products through their domestic distribution network. Sometimes the cooperation can be based on a more informal style such as a letter of intent. However this is subject to a degree of trust between foreign and local banks. There are several advantages of outsourcing. First, it increases the revenue of foreign banks. Empirical evidence shows that around 30 to 50 per cent of annual sales revenue in our sampled banks is generated by outsourcing services to local banks. Second, it assists foreign banks to diversify their product range. Third, it diversifies and reduces business risk. Unlike Chinese banks who always want to get monopolistic control of a big project, foreign banks think more about sharing risk. 'Not a single bank, even the most professional universal banks, can do everything by themselves. We need to team up with an experienced local bank who can help us with the business and policy side as well', says one banker. During the outsourcing process, more attention should be given to local Chinese banks in helping foreign banks bypass certain policy barriers. Based on our observation, outsourced business functions have extended from front-end offices to middle-end or even back-end offices in recent years.

Improvement in efficiency is not simply measured in terms of specific product segments but also measured in terms of the total operation. This requires the bank-end office to be flexible and responsive to any market changes. For instance, any changes in lending policy made by the CBRC may affect the working process of the whole back-end operations. The workload and cost involved in making such a change is enormous. Coordination between different office functions appears to be vital.

Another essential element in back-end office operation is the risk control over a product portfolio. Key issues include how to design a proper credit rating system in China to balance risk and return and how to manage a portfolio to avoid industrial volatility and uncertainty. These issues are critical in terms of lending to new local clients and introducing new products.

Multi-objective Strategies (Complex Strategies)

Banks from group three are adopters of multi-objective strategies. Comparing the financial performance across the four groups, group three also demonstrates a better performance. The Mainland revenue of Hea increased 17 per cent in 2002 and reached 194 million HKD (Hea Annual Report, 2003). The net income of Bsk increased 31 per cent in 2002 and reached 156 million RMB. The total assets of the Mainland operation of Bsk was 19.1 billion RMB. Compared with the year 2001, total assets increased another 6 per cent (Bsk Annual Report, 2003).

Multi-strategy-driven banks are more diversified in both product range and client base. They adopt complex entry and development strategies to increase both economy of scale and scope at the same time. As one bank manager noted:

> We have made marketing plans to prepare for the future RMB business. An important aspect is to maintain existing customers and make them RMB business clients when it is allowed; while at the same time attracting new clients through various channels. We are also developing new products and expanding outlets as part of the preparation efforts.

The development path demonstrates a clear consequence of internalization with key factors including knowledge, network and economies of scale. Banks adopt both organic and acquisition based growth strategies. In the meantime when they aggressively expand their wholly owned branches and subsidiaries across China, they are actively seeking equity investment opportunities in sound local Chinese banks. They carry out cooperation with domestic banks at all levels ranging from sales and marketing to product design and risk management. They are taking a lead not only in branch expansion but also in the introduction of new products compared to their foreign peer banks. These banks put a much higher weight on local marketing and networking capacity. Great emphasis has been put on staff training, team building and establishing the right communication channel with clients. They explain that this can lead them to a more flexible and adaptive position in local market competition. Meanwhile a good organizational learning culture contributes to more efficient exploitation of external knowledge, client management, product innovation and creative marketing. Empirical findings also suggest that banks may switch their strategies over time and constantly refine or readjust their strategic objectives. Evidence is strong in group two, mainly the European banks.

CONCLUSIONS

Based on primary data collected from MNB subsidiary level, we develop an evolutionary framework of foreign banking strategy in China. The adoption of client-driven, product-driven or multi-objective strategy mirrors the dynamic process of the post-entry development of foreign banks.

Client-driven strategy focuses on managing key existing clients and diversification of the local client base. Product-driven strategy concentrates on product innovation and adaptation, and improvement in service efficiency. Client-driven and product-driven strategies are interrelated and can interdependently serve the same objective. For example, sophisticated marketing and management designed to handle the key clients and the specialization of products both play their part in preserving the existing client resources. Multi-objective strategy is a complex strategy in search of a synthesized multi-strategic position by integrating both client-driven (economy of scale) and product-driven (economy of scope) strategies at the same time. Banks practicing the complex strategy are more local market oriented and demonstrate a more aggressive local market expansion style. Constraints that prevent banks from adopting a complex strategy are mainly internal. Reputation, bank size and experience are obvious attributes at the most general level. More essentially, at the firm level, product innovation, creative marketing, efficient internal coordination and a good organizational learning culture are strategically important factors that differentiate business strategies. Market entry is a dynamic process. There is no 'one size fits all' strategic approach to the market entry of foreign banks and those strategies will continue to evolve as foreign banks become more familiar with the local banking market.

7. Environment, adaptation and competitive advantages

INTRODUCTION

Following the discussion of market entry and strategies of foreign banks, this chapter pays attention to the interplay between determinants and banking strategies, and to banking competitive advantages that shape and differentiate entry strategies.

The dynamics of adaptation in a host market are the result of various combinations of stimuli. This factors are attitude based (managers' attitude), internal environment based (strategy, resources and new management), external environment based (environment and acquisition opportunity) and performance based stimuli. In a more dynamic external environment, it appears that attitudes play a more important role in determining the internationalization path (Calof and Beamish, 1995). The right attitudes should help firms move more directly and appropriately along the internationalization path. Firm characteristics include items such as firm size and degree of international experience, while the environmental factors typically include items such as the cultural distance between markets, the nature of the competition in the market and the stage in the product life cycle (Lawrence and Lorsch, 1967; Venkatraman, 1989; Carpano *et al.*, 1994).

The institutional environment of China influences the investment behavior of foreign banks. Banks in their international expansion make incremental adjustments to the changing conditions of the bank and its environment. Changes in the bank and its environment expose new problems as well as opportunities. Constraints on the solution to the problem are the lack of business routines in management and the lack of market information (knowledge) and the uncertainties thereby associated (Johanson and Vahlne, 1977). Knowledge is a key resource to the establishment and performance of any foreign operations. The better the knowledge about a market the more specialized are the resources and the stronger is the commitment to the market. In the absence of market knowledge, a bank has to either acquire the knowledge through a long learning process in relation to the current activities or hire personnel with experience to interpret information from inside the bank and from the market.

Adaptation is closely related to performance. In 2003 the PBOC reported China market write-downs of foreign banks resulting from non-performing loans. A total of 24 foreign banks had a NPLs ratio higher than 20 per cent and seven exceeded 90 per cent (*China Business*, 15 September 2003, p. A3). Meanwhile several banks such as the Bank of East Asia, HSBC and Citibank reported a great increase in their local revenue in China. HSBC China CEO Richard Yorke noted that the bank had plans for setting up more than 30 outlets by the end of 2007 and would recruit at least 1000 employees a year over the next two years to support its expansion that included corporate and private banking services. The bank's new branch offered a comprehensive range of corporate, commercial and retail banking services. HSBC's premier services (global wealth management) for its retailing banking customers were also available at the new branch to meet increasing local demands. ABN AMRO also announced the important appointment of a new director in charge of credit cards business in China in order to capitalize on the tremendous local growth opportunities. The difference in the performance of foreign banks mirrors different degrees of success in local market adaptation. When operating in international arenas, the question is not whether to adapt or not to adapt but rather how much to adapt. Adaptation is a process of establishing relationships in the foreign market. Knowledge of foreign market opportunities is commonly acquired via existing interpersonal links (guanxi in China) rather than collected systematically via market research (Ellis, 2000).

Culture and language difference as part of the physical distance prevents the flow of information from and to the market and influences the time order of the establishment of various operational modes. Cross-cultural problems may be manifested in the market place when individuals fail to understand and accept the local consumption and market practices due to different cultural backgrounds. It is not the cultural differences themselves but the internal processes used to cope with the differences that are important to successful cultural adaptation.

This chapter discusses how institutional changes in the local regulatory environment affect the entry strategy of foreign banks in China. Several issues lie at the center of the analysis of the post-entry adaptation process. They include both external and internal factors such as the regulatory framework and business environment, government relations, partner selection, management and control, cross-cultural issues and competitive advantages. We shed further light upon issues at firm level that relate to the post-entry adaptation of foreign banks in China, in particular the internal resources that influence banks' perception of the Chinese market and their development strategies. By examining the operation of a JV bank in Shanghai, we explore the dynamics involved in the strategic alliance of foreign banking in China. Discussion focuses on the identification of reasons that lead to the failure of this joint bank and issues relating to partnering skills and management of the JV.

The rest of the chapter is set out as follows: the next section presents the regulatory environment and hidden entry barriers for foreign banks. Section 3 discusses partnering skills and management control of strategic alliance. Cross-cultural issues are discussed in Section 4. Section 5 analyses the competitive advantages of foreign banks. Conclusions are in the final section.

GOVERNMENT REGULATIONS AND HIDDEN ENTRY BARRIERS

According to the WTO agreement signed in 2001, the financial market should be fully opened to foreign banks. However the 20 per cent ownership limitation will be maintained and policy is still the major concern for foreign banks. For instance, China recently introduced a policy stating that certain business licenses can only be granted to MNB subsidiaries in China. Becoming a subsidiary (a locally incorporated bank) is subject to strict government approval and quantitative and qualitative examinations. There remain policy restrictions in banking related industries such as foreign exchange and interest rate controls. On the demand side, large local Chinese enterprises are constrained to bank with MNBs. MNBs are regarded as foreign investors and thus are governed under FDI/FIE laws in China. In addition, local governments may introduce certain soft policy barriers to the entry of foreign banks into certain regions and may wish to aid the development of local Chinese banks. Local protectionism has become a 'gray barrier' that prevents foreign banks from accessing their targeted clients. Due to the imbalanced economic development across regions, policies sometimes become segmented and inconsistent at local government levels. Some regions, particularly the inner part of China, are still not very receptive to foreign banks. Banks often have to make compromises to the local government in order to protect their local business interest. Such an intangible entry barrier is difficult to handle and usually takes a long time to disappear.

The foreign debt quota remains an entry barrier for foreign banks. Banks are only allowed to fund a maximum (yearly fixed) amount from abroad for their local lending activities in China. Local funding is not involved in this debt quota but is only possible through local USD deposits. All foreign entities are subject to GAP regulation which represents a barrier for customers. Companies are only allowed a maximum amount of debt (predetermined by the Ministry of Commerce based on their total approved maximum investment in China) secured by foreign debt. Finally, there remain non-quantitative entry barriers. Banks can only establish one branch per year per city and even then only when they have been present for at least two years consecutively with a representative office.

The opening up of China's banking sector is phased in by two major steps: the opening up of corporate banking business in RMB with Chinese enterprises in two years and the opening up of consumer banking business with Chinese residents in both RMB and foreign currencies in five years. Currently, because Chinese banks have a small international network and weak international reputation foreign banks indeed enjoy some advantages in foreign currency business. In addition, foreign banks enjoy a 15 per cent income tax rate as compared to 33 per cent for Chinese banks. The latter is also subject to an 8 per cent business tax. However these advantages of foreign banks will not last long for three reasons. First, discrimination in tax policy disappeared when national treatments became effective in 2007. Foreign banks will not enjoy a lower income tax rate. Without cost advantage, foreign banks will have to survive a more intense price competition. Middle and western regions are exceptions where foreign banks can still enjoy some preferential tax treatments or cost reductions. This will push foreign banks to China's less developed areas, where business potential may be huge but risks are also higher. Second, Chinese banks are becoming increasingly competitive over recent years. Third, many restrictions still remain which prevent foreign banks from seeking large-scale local market expansion.

One of the key restrictions would be the number of branches that foreign banks are allowed to establish, for which currently the 'one city, one branch' principle applies in China. There are many other invisible ways for the government to affect the pace of foreign banks' penetration, including encouraging large SOEs to use domestic banks, setting obstacles to the use of domestic networks by foreign banks, complicating and prolonging the procedures for approving the specific business of specific foreign banks. With the questions in China's domestic interest rate liberalization, tax policy and the development of capital market, the actual opening of the banking sector is likely to lag behind the schedule.

Traditional banking business still dominates the local banking market. A survey conducted by Standard Chartered Bank in 2001 shows that loans still account for about 75 per cent of all banking services with 85 per cent for state owned commercial banks. Over 80 per cent of revenue, with about 90 per cent for the state banks, relies on interest income, while the contribution from fee based income is below 10 per cent. In traditional banking services local Chinese banks, particularly the state owned commercial banks, remain in the monopolistic position because they enjoy the most of the advantages including the huge domestic network, long established customer relationships, the understanding of the Chinese market, government support, cultural recognition and liquidity. From the perspective of Chinese enterprises, there would be no other reasons to switch from state banks to foreign banks other than if the latter offered a lower risk of loans and cost of capital. However state banks will continue to have an advantage over foreign banks in providing low cost capital to Chinese enterprises. Compared with the USA and the EU, where 50 per cent of financing comes from the equity and debt market, the major capital sources of Chinese enterprises are loans from state banks. Table 7.1 presents the business and customer coverage of domestic commercial banks.

Reforms in China's capital market are slow. Based on our recent observations, the situation has not changed much. Loans from banks are still the primary source of funding for local enterprises. The opportunities for foreign banks to finance Chinese enterprises are limited. Foreign banks usually employ very strict internal credit and risk control schemes. In contrast, local Chinese banks do not have such high risk-awareness and their operations do not fully comply with international practice. Local Chinese banks often do not take the cost of capital into considerations so that a local company with average performance can finance at the rate of a multinational blue chip. Hence foreign banks face intensified price competition. In the car financing market, only non-bank financial institutions are permitted to offer such products upon WTO accession. At the moment, only Chinese banks are authorized to conduct auto financing. Meanwhile lack of a market based interest rate system, centrally controlled lending rate and a vast difference between Chinese and Western accounting standards would all make it unlikely for foreign banks to price and assess credit risk of the potential borrowers. It is not easy for foreign banks to tap into China's corporate market.

The consumer banking market, especially the credit cards market, is still an untapped area. A total of 40 per cent of total banking profit was contributed by personal savings between 2000 and 2001 (*People's Daily Overseas*, 9 June 2001). Consumer credit accounts for only 5 per cent of the total outstanding loans in 1999 (*Standard Chartered report*, 2001). However foreign banks' local currency business with Chinese individuals was only permitted in 2005. In addition, a limited local distribution network appears to be the major bottleneck for foreign banks to develop local consumer banking business. An electronic banking service is expected to overcome the weakness in distribution but e-banking has its own limitations. One banker noted:

Table 7.1 Business and customer coverage of domestic commercial banks

	Corporate loans/Deposits			
Banking segment	Industrial conglomerates and large infrastructure projects	Large-sized corporate	Medium-sized corporate	Small-sized corporate
State banks	●	●	◖	
Nationwide shareholding banks	○	●	○	
Regional shareholding banks		◖	●	○
City banks			○	●
		Retail		
Banking segment	Current account	Credit card	Savings deposits	Consumer loans
State banks	○	●	●	●
Nationwide shareholding banks	○	○	●	●
Regional shareholding banks	○		◖	○
City banks	○		●	○

Notes: ● Primary focus ○ Secondary focus.

Source: Author's elaboration on Liao (2001).

> . . . in online corporate banking services, what we can provide is only online inquiry. We are not allowed to introduce online transactions yet. However even if we are finally permitted to do online transactions, we will still be under tight control of the State Administration of Foreign Exchange [SAFE]. For instance, we need to get permission from SAFE first in order to proceed the foreign exchange transactions. As a result, internet banking service loses its real meaning.

Furthermore, the strengths of Chinese domestic banks and their capability to make progress in their reforms amid the WTO competition should not be underestimated. By the end of 1999 ATMs had grown by 39 per cent a year over the past five years reaching 26 424 units (Liao, 2001). Electronics remittance is becoming increasingly common. The innovative products such as 'all-in-card', 'all-in-net', 'all-in-counter' and 'all-in-mobile' as well as phone banking have been launched by Chinese banks and received a heated welcome. The internet banking service is emerging in China. Almost all the major banks are providing basic internet banking services such as the introduction to and news and reports on the bank, users' guides to banking services and some statistics, analysis and consulting services. The Merchants Bank, CCB and BOC are able to provide payment and fund transfer services, with the Merchants Bank being the best with its 'all-in-one-net' product and a nationwide online payment system covering both corporate banking and consumer banking businesses. Market differentiation has been emphasized in China and differentiated banking products are emerging. Brand recognition has been developed and brand competition intensifies.

Local Chinese banks are becoming increasingly competitive, particularly in local currency business. Foreign banks do not have any advantages in local currency business for three major reasons. First, they do not have enough RMB capital. Their primary channel of local currency is to borrow from the inter-bank market and this obviously increases the cost. In contrast, local Chinese banks are over-liquidized in RMB reserves. Second, PBOC fixes the interest rate that narrows the space for foreign banks to adjust their prices in accordance with their costs of capital. Third, the Chinese government is gradually lifting the control on RMB business for foreign banks, but not every city is eligible for local currency services. In addition, the RMB license is very expensive. Each license costs a total of 600 million RMB as registered capital which is considered by some bankers as 'ridiculously high'. Even if a license is granted, there is still a long way to go until full retailing business services are practically allowed due to China's control over foreign exchange. Local currency is not freely exchangeable, which causes difficulty for foreign banks to design high-order financial market instruments. Some foreign bank managers note, 'foreign banks could no longer survive the local competition by only having several big local clients'.

Inconsistency and ambiguity of policy and regulations increase the uncertainty of market development and cause the greatest difficulty in local practice. Foreign banks often spend most of their time and energy in interpreting and understanding the local regulations in order to adjust their local strategies. In many cases foreign banks fail to adopt a consistent local policy. Complicated regulatory hierarchy also creates a less transparent legislative framework and causes further problems in policy making. For instance, some bank managers note, 'for us, the biggest question and problem is the uncertainty of the Chinese market. We are not sure when policy would lift. In most of the cases, we are waiting for the regulatory system to develop.'

The general business environment in China is not good enough. In particular, the free dissemination of information is nearly non-existent and the local accounting system does not comply with international practice. Banks can only set up proper credit quotas in accordance with an accurate knowledge of the accounting and management information of local corporate clients. However MNBs also find it extremely difficult to obtain the true information of the local corporate clients. Lack of credit worthiness is also a prominent problem. One German bank manager in Shanghai commented:

> Lending to the local Chinese firms is very tricky. Many foreign banks have incurred loss due to the non-repaid loans. The attitudes of the Chinese local companies are very strange. They borrow money but they never think to pay the money back. They never care about the contracts and they never inform you how they allocate the money. It is really disappointing. I think that this reflects more serious problems of China's legal system.

Evidence also shows that foreign banks lend to local red chips without examining credit risks carefully. NPLs occur because of the mistaken assumption that in the event of cash flow problems the government supported parent companies in China would eventually honor the payments. The bond default of Guangdong International Trust and Investment Corporation (owned by the local government) awakens foreign creditors that lending to local clients with a governmental background can also be risky. Foreign banks are expecting an overall improvement of China's business environment, in particular the legislation and patent protection system.

China's economic reform also brings some side effects and unfortunately foreign banks sometimes have to bear such kind of burdens in order to serve a particular important client. In some cases, the cost is so high that foreign banks simply cannot afford it. For instance, one bank intends to finance a client to establish a Volvo factory in Tianjin by taking over an existing state owned car manufacturing plant. During the negotiation with local government, it is discovered that the precondition for obtaining approval is to employ the existing 5000 employees of this local car manufacturer. Based on the bank's due diligence and business projection, the maximum number of employees they need is only 900.

China has promoted a series of new regulations and policies attempting to stimulate foreign investment in banking and financial service industries. Some areas seem to offer the best prospects of success for foreign banks. First is investment banking. The Chinese government has opened capital markets to foreign invested stock enterprises, providing FIEs access to the public equity market through JVs with PRC securities firms to take advantage of the expected surge in local IPOs (Initial Public Offerings) over the next few years. The new rules lowered the minimum foreign shareholding ratio to 10 per cent, thus giving a larger number of FIEs access to the public equity market. In addition, the Chinese government also approved foreign financial institutions to directly invest in China's A shares as QFII in 2003.

Second, there will be an increase in trade finance related business. After China's accession into the WTO, greater or full market access is permitted to foreign firms in some previously closed/semi-closed sectors in particular banking and financial services, telecommunications, retail and distribution. Given a more predictable and transparent trading environment, both direct and indirect foreign investment will be boosted.

Third, business in asset management and personal finance such as credit cards and mortgages will increase dramatically. Although around 60 per cent of China's population are farmers earning less than two USD a day (*China Statistical Yearbook*, 2001, p. 140), this still leaves about 500 million people, 10 per cent of which represent the total population of a country like South Korea. Given the huge market size and potential, consumer banking will probably become the major battlefield for foreign banks and domestic banks to compete.

PARTNERING SKILLS AND MANAGEMENT CONTROL

Partner selection is an important variable affecting JV performance and the success of the post-alliance adaptation because it influences the mix of skills and resources that will be available to the venture and thus the JV's ability to achieve its strategic objectives (Porter and Fuller, 1986).

Each partner should offer a complementary set of selection criteria including resources, operational skills, management style and cultural background. In addition, past working experience with each other, similarities in corporate cultures, mutual respect and a basic understanding of the other's capabilities contribute to the success of JVs (Spekman *et al.*, 1996).

Our empirical findings suggest that seeking quick access to the local market and acquiring strategic assets such as local client resources, network and local market knowledge lies at the center of the JV decision. Establishing a joint bank with a local Chinese bank may also help foreign entrants to bypass certain political barriers during the expansion. Such a strategic alliance also helps Chinese banks to become a global market player by learning advanced credit and risk management and modern corporate governance from foreign partners. As one senior manager from the JV foreign partner bank commented:

> Why did we set up a JV in China? One reason was that the initial opening up of China's banking market was very slow. Many banks were restricted in developing their business in China and it was very difficult to apply for a business license. *C* was one of the biggest local banks in China. Its countrywide network and client base were what we were really interested in. We were not very familiar with the Chinese market. Through the JV we could have quick access to the local market resources and knowledge.

Our case study of the JV bank consists of four in-depth interviews with JV top managers and their parent banks. This joint bank was formed in Shanghai between a big four state owned commercial bank and a well known European bank with each holding a 50 per cent stake in the JV. In 1997 the joint bank became among the first group of foreign funded banks authorized to do RMB business in China. By the end of 2003 the Chinese bank partner announced the transfer of all its shares in the joint bank to its foreign bank partner, which declared the end of the JV agreement.

Empirical findings suggest the business failure of the JV bank is mainly caused by the following factors. First, overlap in clients and product range increases the operating cost and intensifies the competition between two partners. Interviews show that client resources, particularly the key clients, can hardly be shared among banks. If there is a potential threat of competition between partner banks, tensions will arise which prevent partners from trusting each other and sharing information. Complementarity in capabilities, compatibility in management strategies and low risk of becoming a competitor are important partnering criteria in the initial formation of the JV. The general manager of the JV bank offered a detailed description of the problems he had encountered:

> One of our intentions was to share our clients together. At the initial stage, they [Chinese partner] indeed introduced some local clients to us. As part of the cooperative agreement, we also referred some of our clients to them. . . Many years later, it proves that those clients we introduced to them have become their key accounts and their business has grown very well. Our clients are mostly big in size with sound performance and management. However as to those clients they introduced to us, very few of them became our clients. It is mainly because Chinese companies are very different from international companies. Their accounting system, management style and operational methods are far away from international practice. We do not understand their operations. Our Chinese partner seems to have little risk awareness, whereas we have very strict credit risk controls. . . After years of operation, we realize that most of the clients are not what we want. We gradually withdraw from these clients. However we by ourselves indeed developed some local clients that mainly lie in the pillar industry and some are very big state owned companies. Then the relationship between us becomes very complicated finally. Since we share many big local companies with our local partner, our relationship is not pure cooperation but to some extent competition. From their perspective, they do not want to bring a new competitor into this market. As a result, the local partner will not contribute much to the joint bank and certainly will not help us to develop.

Second, the foreign bank partner lacks prior knowledge to successfully design a learning organization in China to optimally exploit external knowledge. Lack of trust between the partners and the absence of consensus over goals increase transaction costs in equity JV and thus diminish absorptive capacity, which is considered as the key ability to evaluate and utilize outside knowledge to achieve innovative performance (Cohen and Levinthal, 1990). Prior knowledge such as basic skills or even a shared language is essential to recognize the value of new information, assimilate it and apply it to commercial ends. Interviewee responses show that the foreign bank partner lacks comprehensive knowledge of the Chinese market. When the foreign partner made the JV decision, they had not had much practical experience in the local market. Meanwhile, the local Chinese partner had no prior experience in IJV practice. The more inexperienced the partner banks are in the formation and operation of JVs, the greater the rate of new learning is likely to be. Data from interviews emphasizes the importance of cultural issues in relation to the lessons learned in managing JVs. The nature of these lessons is likely to vary with the cultural distance between the partners. Where cultural distance is great it is likely to promote a greater learning experience than where cultural distance is small. The language barrier itself would lead to great operational tensions. Performance objectives are more likely to be met in the joint bank where the partners have absorbed the lessons of managing the JV.

Third, Chinese and foreign bank partners lack compatibility in management style and operating culture. One lesson is learned concerning operating culture that relates to the careful allocation of parental responsibility for the various functions of the joint bank such as marketing, human resources, product and sales, finance, reporting mechanism and so on, as well as the limits of the joint bank autonomy. The interview responses show that there is a great concern that parent banks are not comfortable with the operational aspects of the joint bank, for instance, their divergent working methods in credit and risk control in corporate lending. If this is so, danger of tension would arise between partner banks and the risk of the joint bank failing is likely to increase. The formation of a JV implies mutual forbearance on the part of parent companies that needs to be balanced with the moral hazard implicit in a JV contract (Buckley *et al.*, 2004). There are two main types of moral hazard: actions taken by one parent to the detriment of the other and actions taken by the JV management that are detrimental to one or both parents. Both stem from insufficient information and, consequently, the JV contract is inherently incomplete, which will therefore increase the risk of a breach of trust between two parent banks. Attention needs to focus on contract drafting and exit strategy so that the potential threat of opportunistic behaviors would to a large extent be reduced.

Difference in the compensation system and incentive scheme makes it unlikely for top managers in the JV to establish the same strategic orientations. If the joint bank does not enforce a standard performance related compensation scheme to managers from both parties, this could cause deterioration in morale and effort on the part of the affected managers. Interviews suggest that management efficiency of the JV is low and Chinese bank managers in the JV are under-performing on purpose because their compensation package is still decided by their parent bank and is much less attractive compared to managers appointed by the foreign partner bank. As a result, no local Chinese managers would be responsible for the long-term development of the joint bank and are reluctant in accepting a new corporate culture and applying new managerial know-how. Chinese bank managers may also have personal concerns. Such managers could feel frustrated if they believe they are being kept in the joint bank management team because they are performing well, but at the same time this constrains them from being considered for career advancement elsewhere in the parent bank. The joint bank cannot produce and implement a consistent strategy simply because the Chinese partner bank frequently changes their managerial staff in the joint bank:

> . . . establishing a new corporate culture is extremely difficult. Transferring the know-how to the joint venture is fairly easy compared with trying to get feedback from local managers. The joint venture eventually becomes a training center for the Chinese partner bank. I really don't mind doing this. But you just

> don't get what they think. Changes in their working style are slow and small. As far as I am concerned, two corporate cultures can hardly merge together.

The above comment suggests another factor causing barriers in managing the JV. The problem lies in the difference in national culture and corporate culture. Language barriers cause operational tensions and lack of basic understanding of each other's capabilities becomes a major obstacle for efficient information exchange. It is crucial that a clear vision should recognize the synergy between the partners so that there is a clearly identified common purpose, and such purpose should be well communicated between parent banks and the JV and within the JV management team. Objectives that are hidden from a partner may create major disappointments or misunderstandings when attempts are made to achieve them. 'Communication should not be in one direction. The local Chinese partner should be more open-minded and proactive in sharing information', says one manager from a foreign partner bank. Successful management of a joint bank needs to be built on maximum exchange of information between the two parties and the understanding of each other's needs so that the common purpose can be identified and translated into the JV. The willingness and ability to provide information are seen as important in confirming an honest attitude and developing trust. At the same time as providing information, partner managers should be open to receipt of information.

Our primary data also reveals that cultural awareness greatly influences inter-firm collaborative activities. Partner managers need to have an understanding of the different cultural issues such as language and national work routines or they need to be able to pick up these differences relatively quickly. Respondents note that showing respect for and being sensitive to the national culture of the partner constitutes important partnering skills. The foreign partner bank also recognizes the importance of localizing their management team. They believe this can facilitate cultural adaptation.

The above empirical evidence and observations give rise to a number of propositions:

P1*: The potential threat of competition between partners will give rise to concern for issues of trust.*

P2*: The potential conflicts in commercial interests will focus attention on the integration of operating cultures of partner banks.*

P3*: The lessons of managing the joint bank vary with the motives for JV formation.*

P4*: Learning how to manage the joint bank will vary with cultural differences of partners.*

P5: *The extent of prior JV experience of the partner banks will contribute to better management of the JV.*

CROSS-CULTURAL ISSUES IN MANAGING A DISTANT OPERATION

Corporate and national cultures are crucially important in adopting management methods, strategies and structures. Banks of different nationalities will tend to introduce distinctive management practices. Cultural distance gives rise to differences in accepted management practices and policy orientations. Meanwhile banks from different cultures are able to gain much from each other in terms of learning. Since Chinese national culture has different settings compared to Western ones, it is practically important for us to identify certain cultural factors and their managerial implications for foreign practitioners.

Chinese 'Guanxi' and Other Cultural Factors

When crossing national boundaries, businesses are under pressure to develop cross-cultural management abilities and skills. Cultural shock is no longer a trendy academic topic but a hard reality whose effect on a business begins like almost unnoticeable drops of water only to turn into hammer blows later on. In a highly centralized and bureaucratic state, the use of personal contacts is the primary way to get things done. Guanxi is the counterpart of a commercial legal system. Guanxi refers to a Chinese system of doing business on the basis of personal relationships and it represents the way that business is done throughout much of the non-Western world (Lovett *et al.*, 1999). In contrast to the Western transaction based business culture, Chinese business society is relationship based. Guanxi is characterized as a shared pattern of being and Chinese ways of thinking and behaving, which have formed and sustained the Chinese cultural system. In the Chinese business context, relationships are a form of social capital owned by business people and associated with the companies they run. Networks of informal relationships and exchanges of favors still dominate business activity throughout China. Guanxi remains an important social mechanism in the business context. Reliable information may not be available through official channels and guanxi networks are often used to provide it. An important benefit of guanxi networking for business is the protection it offers from threats and uncertainty. The Chinese use guanxi to make up for the lack of the rule of law and transparency in rules and regulations. Speaking the same language and sharing cultural values is a vital lubricant for any serious transactions. Strong guanxi can shield companies from unexpected challenges or it can minimize costs. Guanxi is often misunderstood as a form of relationship relating to corruption. Although some of the guanxi relationships have been misused or abused, guanxi is grounded in trust, mutual obligations and shared experiences. Understanding guanxi is strategically important in doing business in China. Based on our empirical observations and interviews, we identify some of the cultural factors that may offer useful insights to practicing managers in the Chinese banking market.

1. Western thought is dominated by linear logic where managers tend to look for clear alternatives such as option A instead of option B, whereas Chinese thinking is influenced by early philosophers who saw a paradoxical balance of opposites in all things. The understanding of such a way of thinking requires foreign entrants to be patient in front of a murky business environment and keep a certain degree of flexibility in decision making.
2. Westerners normally build transactions and if they are successful a relationship will ensue. However the Chinese believe that prospective business partners should build a relationship and if successful commercial transactions will follow. Once a foreign entrant understands this, establishing an initial dialogue with local government and counter partners will not appear to be difficult. Some foreign bank managers commented that banks have to pay 'patient money' in order to show your candor to get an entry ticket.
3. Western and Chinese management practice lies in the emphasis placed on written contracts and procedures in the former compared with personal relationships in the latter. The early appearance of a draft legal contract may be seen as inappropriate or more likely irrelevant because it carries no sense of commitment. Returning home with a signed piece of paper is a symbol of progress but nothing more. The Chinese may sign a contract to honor their guests. To them, a completed contract may merely be the proof that both sides have grown close enough to develop a trusting relationship. Further concessions may then be requested. As one German expatriate bank manager in Shanghai noted, 'Chinese clients hold a very strange attitude toward legal contract. I can never understand that contract is not that important to them even if they have signed one. They seem to never pay much attention to terms and conditions. Default on contract seems to be a common thing.' The Western standard of risk management based on contract and quantitative calculation still has its merit and works in China but not all the time. There is likely to be more emphasis on

non-statistical ways of thinking about risk. That means being more rigorous about imagining what could go wrong and thinking through the effects.

4. The Chinese are acutely sensitive to gaining and maintaining face in all aspects of social and business life. Causing someone to lose face could ruin business prospects or even invite recrimination. Westerners need to pay extra attention to details such as how to make appointments and conduct formal introductions with officials, how to entertain Chinese guests, how to establish proper communication during a conversation and so on. The Chinese and foreigners often have different perceptions upon what is a small issue and what is not. Several interview responses suggest that some foreign banks lose their potential business prospects simply because they fail to send Christmas and New Year cards to governing authorities or their local clients.
5. Being patient and persistent mirrors confidence and commitment in the local market. In return, more trust and support can be earned from the Chinese government. Mistakes sometimes are inevitable in China but foreign banks can never reduce their faith in the Chinese market. For example, one bank manager remarked, 'persistence is very important in China. The short-term profit may not be very big, but we need to establish a platform for our long-term development. We need to pay "learning fees" in order to enter our targeted niche market. This is the way of doing business here.'
6. China is geographically diversified. Westerners need to pay attention to customary variations in different regions.

How Foreign Banks can Relate to the Government

Building up solid government relations is vital in doing business in China. Government relations are the most important guanxi networks that any foreign banks have to pay extra care. Our empirical evidence shows that lobbying and brand building need to be undertaken at three different levels. First, the central government bodies such as the State Council and Party organizations are lobbied at a high level. For instance, foreign delegations visit Beijing in missions led by their Premier or senior government officials. One of their important tasks is to promote their banks and help their companies to develop business in China. This is important in gaining trust and support from the central government. Second, governing organizations and provincial governments such as the Central Bank, regulatory ministries and provincial governors are lobbied by organizing industrial seminars or conferences, by inviting important government officials, by providing constant updates on banking market development overseas and by sponsoring research collaborations with regulatory organizations to promote better communication and understanding. Finally, strong relations are necessary with Chinese domestic banks. The Chinese government looks for foreign banks that are strongly committed to the Chinese market with long-term development plans. Banks that bring in advanced technology and knowledge to help the development of Chinese banks are particularly welcomed, especially those that contribute to the improvement of governance of Chinese banks.

COMPETITIVE ADVANTAGES

Our interview responses imply several major reasons leading to the business failure of foreign banks in China. First, banks lack understanding of the local market and the specific demands of the clients. The learning process should be dynamic and built upon instant communication with clients. Foreign banks must react quickly to the local market signals and efficiently adjust the product design. Second, the bank may not be strong in designing suitable products and providing technological support. Third, the failure can also result from poor coordination among different banking divisions. Intensive competition challenges the product design and efficiency of internal coordination.

From our case studies, we understand that some banks do not concentrate on the China market because they believe they do not have the capabilities and resources for being successful in such a distant market. For example, one bank manager noted, 'China is not our global focus. In addition, we don't think we can compete with the Chinese local banks and other multinational banks such as HSBC in China or in Asia.' Therefore the underlying questions are what internal resources constitute the core competitive advantages and influence the strategic choices of foreign banks in China.

Bank Size Related Factors

Empirical findings confirm that firm specific generic factors such as financial assets, reputation and global diversification constitute the competitive strength of foreign banks in China. Many interviews categorize such generic factors as bank size related attributes. Several bank managers note that it is easier for large MNBs to establish good local infrastructure. Such infrastructure can be both tangible and intangible assets including physical network, license, human capital, technological platform, brand awareness and local capital reserve. In many cases intangible assets such as reputation and brand names are more valuable than other banking assets in the competition. Reputation increases the creditability and brand awareness, which will in turn help foreign banks to develop local clients.

A large-sized MNB usually has a larger global client base and is strong in financial strength and product innovation. This will contribute to host market expansion. Financially well resourced banks can differentiate local competitive structure by capitalizing on areas that competitors are not capable to achieve in or take a longer time to catch up. Such strength creates barriers for entry to competitors. Examples are establishing multiple branches, receiving RMB business licenses and higher foreign exchange quotas. Interview data also suggests that large-sized MNBs are more advantageous in developing local clients. Diversity in client base and global presence enable the bank to easily manipulate and adjust its strategy in a foreign market. Experience accumulated from other international markets can contribute to local market operations. Constraints in client resources is the major reason causing the shift of development strategies. For instance, one bank from the Middle East echoes, 'we did not have enough Arabian investment in China. As a result, it is unlikely for us to pursue a long-term consistent strategy in China. Our new CEO finally decided to quit the Mainland market and concentrate on the home market.'

Product Innovation

Banking services lack differentiation. It is not surprising to see that banks have difficulty differentiating themselves or making customers believe that it makes sense to deal with one bank rather than another. Many banks try to differentiate themselves by the customer markets they target and the services they offer. However there are ways to innovate – maybe not big breakthrough innovations but innovative approaches to products and to the way banks market them. Innovation can be achieved by introducing innovative products and marketing them in an innovative way. As one bank manager notes, 'we have successfully developed five new series of financial products. The majority of these products are of Chinese features. Compared with our global products, they are the same in structure but different in concept and design.'

Some banks such as Citibank try to reduce the time needed for getting CBRC approval on new products so that they can launch products more quickly than their competitors. Many banking products are not innovations but the way banks bundle and address them to the target segment is a marketing innovation. Some major market players such as Citibank make great effort in cross-selling their financial products, including banking, insurance and investment services, and seeking synergistic strength by integrating different financial services and operations. By 2003 Citibank had applied for 19 patents in China regarding special commercial working methods. These commercial working methods are information and knowledge intensive, consisting of the most advanced marketing know-how and banking techniques. Innovative banking relies heavily on the examination of operations that clearly differentiate the services that they can provide and how they can deliver those services to customers as efficiently as possible – more effectively than their rivals do.

Product adaptation and localization is an essential part of product innovation. A bank's innovative capability derives from its in-depth understanding of the local market, strong product R&D and innovative marketing force. Products offered locally need to comply with Chinese banking regulations. An innovative corporate culture will focus attention on a careful design of organizational structure that is optimally responsive to local market demand and on stimulating enthusiastic managerial attitudes towards innovation so that product innovation can be translated into daily working methods. One bank manager notes that the launch of new products will widen the bank's product portfolio as well as pave the way for future RMB business; and the strategic importance is more than simple sales results. In addition to traditional branch banking methods, foreign banks have adopted more creative marketing methods in order to increase their brand awareness among targeted client groups. For instance, provision of leaflets at financial and commercial central areas, telephone banking and setting up promotional booths are becoming popular. HSBC launched a branding programme in the Beijing Capital International Airport. Under the program, HSBC makes its brand most obvious to travelers by allowing the airport to carry its brand name on the 47 exterior air bridges.

Cultural Proximity

Grubel (1989) argues that national origin provides an uncopiable advantage for multinational banking. Cultural proximity is found to have a great impact upon the development of foreign banks in China. Interview data reveals that banks from Hong Kong and Southeast Asia present a more aggressive expansion style than Western banks. This is reflected by a faster expansion pace and higher local market commitment. These banks establish multiple branches and many of them have been engaged in equity investment with local Chinese banks. The proximity in culture and location offers Hong Kong banks the best pre-existing knowledge for organizational learning. Prior knowledge including basic skills or even a shared language would greatly increase one's innovative capability and accelerate the organizational learning process. Banks from Hong Kong share a similar language and cultural background. This helps them to better understand the local market and speeds up the learning process. In addition, geographical closeness of their headquarters and R&D centers to the Mainland market enables them to be highly responsive to local demand and flexible in decision making. 'We are rooted from China. So we have a much clearer and in-depth understanding of the local market than Western investors. This makes our decision making more prompt, accurate and confident', says one bank manager.

'You have to try to become a Chinese bank in order to do business well' is frequently commented by Western bank managers. Interviews suggest that cultural difference causes tension in local operation and barriers in successful adaptation. Problems more often occur at headquarters level rather than local branch or subsidiary level, where decision makers are not familiar with the host country market. Cultural barriers cause misunderstanding of local market conditions and deficiency in decision making because there is lack of autonomy and trust in the local management team. Prior experience of international operations in the cross-cultural context may to some extent reduce the tensions derived from cultural barriers as banks are more experienced in dealing with another cultural context and are more capable of operating in a different cultural background. Cross-cultural training for managerial staff is an effective way to merge two different national and corporate cultures. Successful foreign banks such as Citibank and HSBC have introduced consistent training programs every year to their middle and top local managers. Empirical evidence also shows that on-job training is more effective and multiple cultural elements can be simultaneously incorporated in the training session in order to avoid direct cultural confrontation of two specific cultures. As one bank manager noted:

> The trainee needs to get familiar with not only home market culture but perhaps also corporate cultures and working methods from our experience gained from other markets such as India, because they are all part of our corporate culture. The purpose is to introduce a global 'mix' so that our managers are constantly reminded of our global awareness. Meanwhile, this will facilitate the internal transfer of our cross-culture experience and knowledge.

Quality of Local Managerial Resources

The process of internationalization can be legitimately described in terms of establishing relationships in foreign markets (Johanson and Vahlne, 1990). Relationship marketing and network theory also focus on relationship development in the growth of firms. Foreign market expansion is a process of acquisition of an individual's existing social network. Buckley *et al.* (2003) argue that if a firm aims to develop new products, whatever the market or location, a strategy for knowledge creation is needed. Social networks facilitate the creation of new knowledge within organizations (Kogut and Zander, 1992; Tsai, 2001). Doing business in China is all about establishing and extending relationships. Decision makers in practice respond to the inherent risks associated with foreign market entry by placing more, not less, reliance on their social networks as a means of economizing on these higher search costs. Decision makers are social actors who must make investment decisions based on incomplete information. Foreign market entry invokes an exchange between individuals possessing complementary resources and information, and the economic exchange is preceded by the communication of information regarding entrepreneurial opportunity. Social structure affects competition by creating entrepreneurial opportunities for some people and not for others. In particular, there are unique information benefits available to those players who are connected by exclusive or non-redundant ties to distant clusters. Knowledge of foreign market opportunities is contingent upon the idiosyncratic benefits of each individual's social network. In other words, information search activities would appear to be selectively influenced by those existing social ties (Ellis, 2000). Awareness of foreign market opportunities is commonly acquired via existing social ties. Knowledge of entrepreneurial opportunities abroad is dependent on the particular information benefits of an individual's social network. Entrepreneurial resources have become important internal resources of firms and often constitute the core of competitive advantages in foreign market expansion. Managerial resources are the main driver or constraint to facilitate effective knowledge transfer, which therefore enables the firm to maintain a competitive edge in international expansion. During the expansion process, managerial expertise is gained to facilitate the new operations. There is a strong tendency for banks possessing extensive and versatile internal managerial resources to continually expand, not only in their existing fields but also into new products and new markets as opportunity arises.

Foreign bank subsidiaries maintain separate legal entities and are subject to the laws and regulations in China. They adopt local management to obtain access to the local business market. A pool of highly qualified local staff is a strategic asset for a bank to successfully adapt into the local market conditions and it may have a leverage effect in the long run. Our empirical evidence shows that foreign banks emphasizing on acquiring managerial expertise demonstrate a faster pace in local market adaptation and business expansion. Western banks and banks from Hong Kong are taking the lead in localizing their local management team. Japanese and South Korean banks are found to be highly reliant on foreign expatriates to manage local business. Time spent on learning is relatively longer and mistakes often occur because of the culture shock experienced by their senior decision makers. In our interview responses, one Chinese middle level manager from a South Korean bank branch in Shanghai remarked:

> We have already changed two general managers in the last eight months. Both of them have the same problem that they do not understand the Chinese market at all. They cannot formulate any consistent local development strategy but try to copy standard international practices in China. That will not work given the local commercial culture. . . The first general manager left because he made several loans to local clients which incurred large amount of NPLs. Based on his evaluation criteria, those clients looked fine but in fact he could not access to and would not understand much inside information of these clients . . . meanwhile, our opinions were not taken into consideration seriously.

Our empirical findings suggest that most foreign banks look for two types of local expertise that can introduce great entrepreneurial opportunities to the bank. One is former government officials from finance related departments, senior political decision making groups or regulatory departments such as the State Council, Ministry of Finance, PBOC, CBRC, SAFE and so on. This group of people have broader local networks and have strong bargaining power to influence Chinese decision makers. They normally work as compliance officers or public relations directors and advise foreign banks on important regulatory and legal issues and facilitate government lobbying. Sound government relations play an essential role in successful business development in China. Several interview cases have suggested that with the help of this group of people foreign banks can obtain business licenses more smoothly within the required timetable and political barriers have to some extent been reduced. Another group of people are bank managers from local Chinese banks, in particular from corporate banking divisions. This group of people has accumulated a wide client network and rich experience in managing local clients. They contribute mainly to the maintenance of existing clients and development of the local client base. Experience, educational background, communication skills and good English proficiency are key criteria in foreign banks' recruitment plans. One British bank manager comments, 'about 98 per cent of our staff are recruited locally. In our locally incorporated bank subsidiary, 85 per cent of the employees have bachelors degree qualifications and 25 per cent have a minimum masters degree. The quality of our local staff in China is the highest in terms of educational background across our global offices.'

Many foreign banks are supporting their expansion in China by importing trained personnel from within their banks. Based on our observation, there are already over 3000 expatriates working in the industry. Over the next few years, this number is likely to increase by another 20 per cent. However, evidence also shows that foreign banking strategy has heavily depended upon a localized management team. 'A major challenge for foreign banks is staffing. Last year we recruited over 1200 employees and the great majority of them were hired locally', says one foreign bank manager. Foreign banks' recruitment and localization strategy centers around the question of how to develop a pool of young, professional and loyal managers for long-term development. The program sometimes starts with second year university students. Students from Chinese top universities may be offered a job in their third year university life after their short summer interns. Some foreign banks have introduced managerial training programs specifically designed for the best caliber of young graduates. Full-time training and on-job training can last for two to five years until it is convinced that the managerial trainee has become a qualified professional bank manager. During this training process, work locations vary across foreign banks' global offices from Shanghai, Hong Kong to London or New York. It helps these young trainees to merge into the multinational culture and work as an incentive to increase staff loyalty. The training program can also facilitate the successful transfer of skills, managerial know-how and market knowledge that in turn improves the overall management and innovative capability of the bank. Common corporate objectives of the bank are understood clearly by local staff and translated into local practice. Although enormous time and money has been spent on these training programs, foreign banks still reckon that managerial staff training is worth doing because they believe performance and business expansion rely heavily on a rich reserve of highly qualified staff, especially the managerial staff.

Organizational Learning and Internal Coordination

In an uncertain environment, learning capacity affects expectation formation. A well designed organizational learning structure guarantees knowledge reuse and knowledge creation and permits the bank to predict more accurately the nature of the commercial potential in a local context. As a result, banks with good learning cultures can usually employ more persistent strategies and tend to have high growth ambitions. Organizational learning can add further resources which can be transferred within the bank to create more value in order to facilitate either diversification or specialization on core resources. Prior knowledge of the structure of communication and networking among organizational units are critical in transferring existing knowledge, accessing heterogeneous knowledge and creating new knowledge (Johanson and Mattson, 1987; Tasi, 2001;

Blazevic and Lievens, 2004), thereby improving overall managerial and innovation performance (Dufey and Giddy, 1981; Morgan *et al.*, 1995; Rodan and Galunic, 2004). Organizational effectiveness is important to banking innovation and is vital for a bank to ensure that internal operations respond to and conform to the demands of effective service delivery.

Effective internal communication channels help to achieve synergistic benefits through networking. Our interview analysis indicates that corporate attitudes from top decision makers greatly influence the efficiency of internal communication. Misunderstanding or unfamiliarity of top decision makers regarding the local Chinese market conditions sometimes may block useful information flow from local bank offices. In severe cases this can adversely affect the strategic choice that foreign banks may choose. One way to identify whether foreign banks create new knowledge is to investigate the process of decision making. Banks that are actively generating new knowledge usually require a high intensity of involvement of local offices during the decision making process. In addition, it is more often the case that the decision making process starts from the local offices. Such bottom-up decision making enables the headquarters to optimally utilize local external information and have a better understanding of local demands and market conditions in advance.

Organizational learning capacity is one of the primary factors that affects the innovative and adaptive ability of the bank. The ability to recognize the value of new, external information, assimilate it and apply it to commercial ends is critical to its innovative capabilities. Knowledge sharing and knowledge diversification across individuals affects the development of organizational learning. For example, one bank manager remarked:

> Product innovation is built upon an accurate understanding of the local demands and a quick response to the change of local market conditions. Being a successful innovative bank, an efficient communication channel and internal coordination scheme must be established. Intensified competition urges us to better our products and service in a short time. A well designed operational structure will help a lot.

Organizational learning capacity tends to develop cumulatively. Successful banks pay more attention to internal coordination and efficient flow of information at both inter- and intra-unit levels. In particular, many changes have been made in marketing and human resources that are critical to improve the efficiency of internalizing information. The learning capability of a bank is largely a function of the level of preexisting knowledge. At the most elemental level, this prior knowledge includes basic skills or even a shared language. Banks from Hong Kong and Southeast Asia obviously enjoy more advantages in learning the local business environment. With much clearer and in-depth understanding of the local demands, banks find it 'much easier to penetrate the local market and design suitable products'.

Deficiency in knowledge transfer and networking prevents advanced marketing skills and managerial expertise being optimally exploited in the local market context. The capability to deal with external information and efficiently manage and transfer information and knowledge within internal networks is decisive in the pace and level of local market penetration. A well designed organizational structure to stimulate local market learning and for efficient communication between the external environment and the organization, as well as among the subunits of the organization is found to be essential. Product development is strongly influenced by the communication and coordination across organizational units. Many interviews particularly emphasize the importance of the product manager being an integrator within a bank to create a successful cross-functional task link. When a knowledge creation strategy is implemented, personalization is more appropriate. Such a 'people-to-people' approach is reliant on human interaction and tacit knowledge transfer. Performance appears to be superior for banks that know how to design a more sophisticated local organizational structure with particular emphasis on the strength of the local marketing division. Some foreign banks have specifically highlighted the importance of networking at both inter- and intra-organization level where marketing officers or relationship managers act as key integrators or coordinators. For instance, one bank manager remarked:

> We have a crucial position called relationship manager. It plays a very important role in communicating with corporate clients and our product team. Relationship managers are not only responsible for introducing new products but more importantly for understanding the demand of our corporate clients. The advantage of this function is particularly prominent when serving a big multinational client. In such a circumstance, relationship managers work to ensure the effective communication and coordinate different divisions to work together efficiently to serve one key customer. We have a regular meeting called VOC (voice of customer) which every division must attend. During the meeting, different divisions can share the latest information about some specific clients. Such coordination is cross-regional and business line.

By linking different units together, a network arrangement provides a flexible learning structure. An optimal sharing of local market knowledge can accelerate the learning speed. Through the development of inter-unit network links, horizontal transfer of knowledge broadens organizational learning. Networking allows organization units to access new knowledge from each other and may increase their cost efficiency through dissemination of best practices within organizations. Efficiency sometimes becomes a competitive advantage since it improves the responsiveness of the bank. The efficiency differences between banks result from knowing more accurately the relative productive performances of those resources rather than having better resources. As a result, a well functioning networking scheme can benefit the bank in designing more individualized and price competitive products. In addition, sharing information and resources will fuel the unit's innovative capacity by providing the external information necessary to generate new ideas. Networking is not only an important element of product strategy but also critical to retain the existing clients and attract new customers. A coordinated operational framework presents clients with an impression that they are being served by the whole banking group rather than a single regional office. Banks with good corporate learning cultures usually have a more solid and loyal client base, and can more easily develop new clients.

CONCLUSIONS

Policy restrictions and the general business environment appear to be the primary external barriers to the further development of foreign banking in China. The transition of the Chinese economy brings huge business opportunities for foreign investors as well as many uncertainties resulting from the imperfection of information systems and some side effects of the economic reforms. These factors are region specific factors or location factors that create imperfect competition. Policy is always a key issue in entering a new market. A total of 13 banks in our survey sample state that they will not open more branches in China in the short run due to high entry and operating cost. Data suggests that prudential requirements erected by the PBOC have become the apparent barrier for further expansion. Ten banks explicitly mention that PBOC's prudential requirements on performance, operating duration and capital endowment are major obstacles that prevent banks from actively seeking local market penetration.

Complementary capability in resources and compatibility in management styles prove to be vital in successful JV operations. Possession of complementary resources reduces the potential threat of two partners becoming competitors. Compatibility in management facilitates the establishment of common corporate objectives and the convergence of corporate culture. A good organizational learning culture mitigates the pressure in management caused by cross-cultural issues. Partnering skills are fundamentally about leveraging in resources and capabilities in a synergistic mix that will produce benefits for both sides. To produce this synergistic mix between the partners, the partnering skills themselves must be complementary.

Partner banks need to have clear visions and common objectives and have the capability to foster partner relationships. Such capability derives from their skill sets of managers and prior experiences.

Cultural awareness is essentially important for foreign banks to extend their business networks in China. Expansion is built upon extension of social ties of local managerial staff. A correct understanding of Chinese guanxi is the first step to establish trust and understand local culture. Being respectful and sensitive to local culture may prevent banks from experiencing culture shocks, hence will reduce unnecessary mistakes. Building up strong ties with both central and local governments is the key to doing business in China.

Our empirical examination also identifies bank size, product innovation, cultural proximity, quality of local managerial resources, and organizational learning and internal coordination as key competitive advantages. They dictate and differentiate the development strategies of foreign banks in China.

8. Summary and conclusions

Chapter 1 identifies six key issues in the analysis of banking internationalization. They are motivation, mode of control, determinants for market entry, development strategy, management and adaptation, and competitive advantages. Policy and host country environment greatly affect the market entry. Learning and cultural differences are crucial elements in the adaptation and development of foreign banks. Interrelations of these variables are of great importance and will be highlighted in this final chapter.

Chapter 2 develops a theoretical framework using internalization theory as a synthesizing element and integrates other theoretical concepts from strategy literature. Emphasizing knowledge as a key factor that drives the growth of banks, we rely on primary data collected from subsidiary level to examine the dynamics of banking internationalization in China's emerging economy.

Our findings and our contribution to the existing literature must be taken within the specific circumstances of our empirical investigation. The sample is drawn from 37 in-depth interviews and 60 postal questionnaire surveys of 178 foreign banks in China. Banks from different nations operating at different modes (representative office, branch, subsidiary and JV) are included in our sample, which provides triangulation of all findings. We can be confident of the robust and reliable nature of our results. This conclusion encapsulates our findings on the identified key issues.

STRATEGIC MOTIVES

Foreign banks exhibit a mix of motives including both market seeking and following the client and other motives of which driven by competition, being the first mover, geographical diversification and cultural connection are the most important. Banks often simultaneously combine several strategic motives and the dominance of these motives may switch over time with the accumulation of local client base and market knowledge. Entry motives vary across different business segments. The market seeking motive is still the dominant strategic orientation in market entry decisions across the whole banking business segments. Investment banks and retail banks are purely driven by seeking local market development. For corporate banks, following the client is still important. Many foreign banks consider following the client as an emergent strategy during the initial entry. The amount and quality of source country FDI strongly influences a bank's decision to open a branch. For trade related banking business, there can be both aggressive and conservative motives. In addition, partners that have different motives for the formation of JVs need to make greater effort on seeking common corporate objectives and adopting common performance criteria. Motives are determined by firm specific attributes and influence the entry methods banks may pursue. Market seeking banks normally adopt multiple entry modes combining both organic growth and acquisitions. Driven by different strategic orientations and needs for growth from various business segments, universal banks employ more sophisticated entry strategies. The context for examining universal banking activities is more dynamic and complicated. If banks do not understand the market and do not have a clear picture of their internal advantages, they cannot set correct corporate objectives, hence will increase the likelihood of business failure.

MODE OF CONTROL

Organic growth remains the most attractive option of foreign banks to increase their market presence in China. Equity acquisition in local commercial banks is the second best option. Creating a new financial entity has become popular since the government adopted policy to encourage local incorporations in late 2006.

A less developed regulatory framework and local infrastructure creates market imperfections that foreign banks need to internalize in order to protect strategic resources such as client information. Establishing multiple branches is critical for serving corporate clients and for local retail banking. The best practice to explore the local market and establish brand awareness is via branch banking. In our sample the majority of foreign bank managers regard the market as 'far from overcrowded'. The number of branches is likely to increase dramatically in the next few years. For retail business, a few foreign banks have made a concerted effort to establish a nationwide distribution outlet to cover major cities. The operational structure has a locally incorporated subsidiary at the top with a proper RMB license and a network of branches and sub-branches under the subsidiary. For universal banks, organic development is no longer sufficient to satisfy the needs for growth. M&As features are a recent trend of foreign banking in China. Even if it is only a minority equity investment, foreign banks are able to gain access to strategic local assets such as networks and a client base. The evidence is prominent in retail services where foreign banks and domestic banks are issuing co-branded credit cards. The Chinese government normally hand picks foreign banks for strategic alliance. Financial strength, reputation, track record, technology platform and risk control, and perhaps political connections are crucial elements that are being considered by the government.

The development of foreign banks in China has realized a stable transition from 'branched dominance' to 'corporate dominance' in recent years. It is known that by the end of 2007, CBRC had approved 21 foreign banks to reorganize their Chinese branches as foreign corporate banks, 17 of which had finished the process and run business. By the end of May 2008, about eight banks including HSBC and Citibank had established local entities with most headquartered in Shanghai. A few more like JPMorgan have applied for the same. Not all banks deciding to register as a local entity are aiming at retail business. The impact of local incorporation would have far reaching implications particularly in areas of capital requirements, supervision, transparency and product opportunities.

The case study of the JV bank indicates that simple combinations of two banks' resources without taking into account their corporate objectives, complementary set of resources and compatibility in management culture increases the possibility of business failure. The combinative capability to efficiently handle external information and to successfully integrate the corporate cultures and business routines of two partners is critical for JV strategy.

Outsourcing is also evident in local banking strategy. Efficiency receives increasing weight in foreign banking strategy when local competition intensifies. Foreign banks tend to capitalize on their specialized core business areas while outsourcing functions that do not add much value to their overall development strategy. By doing so, foreign banks can improve operational efficiency and reduce risks. Domestic Chinese banks can facilitate foreign banks' daily communication with local regulators and act as liaison to smooth business transactions. In recent years outsourcing has expanded from front-end office functions to back-end office functions. It mirrors that the cooperation between foreign and domestic banks deepens. Even for most professional and technologically advanced universal banks, improvement in efficiency via outsourcing makes a lot of sense in their product innovation and risk diversification.

When it comes to the choice of location, foreign banks do not have much option before restrictions on geographical expansion are lifted. Foreign banks cluster in financial centers and developed regions. Rural areas and inner regions appear to be the next target in forthcoming years. Market liberalization will certainly complicate the mix of criteria for location choice. Unlike several years ago, location choice is mainly determined by existing business, foreign banks need to take into consideration more factors relating to new business growth driven by local demand. In addition, foreign banks need to think of the pace of opening new offices. There are several questions for banks to consider. For example, how many new offices are required in total to cover the targeted areas? Which locations are the priority choices and which are secondary? When shall the bank expand to the secondary choices of location? How long will it take to recover the start-up costs? Will each office have its own business focus differing from other ones and how will these offices be managed? How long will it take the market to get overcrowded? What is the exit strategy if things go wrong? Obviously, the strategy needs to be built on a dynamic analysis rather than a static model. The answers very much rely on the interplay of both internal and external attributes. Local expansion tends to be incremental. Entry timing is partially determined by policy, but more importantly it is subject to how well banks exploit their internal resources and cope with the dynamic external environment.

DETERMINANTS IN MARKET ENTRY

Policy restrictions and the general business environment are primary external barriers to the further development of foreign banking activities. Many foreign banks remain critical of the regulatory issues, particularly in areas of coordination, consistency and clarity. They are also frustrated by the lack of credit history in China. Limited client resources are a crucial internal constraint. Without enough clients to support local business, it is very difficult for foreign banks to expand their local networks. In addition, product innovation, technological adaptation, quality of local human capital stock, the persistence of the China market oriented corporate strategy and cultural proximity are identified as vital firm specific attributes that determine the post-entry of foreign banks. Well resourced banks demonstrate a high degree of local market commitment and a speedier pace of local expansion. A shared language and common cultural background enable Asia based banks, banks from Hong Kong in particular, to develop more aggressively in the Mainland Chinese market.

DEVELOPMENT STRATEGIES

Based on our empirical findings, we develop an evolutionary framework of the development strategies of foreign banks in China. The framework exhibits three main strategic options: client leadership, product leadership and multi-objective strategy. Client and product leadership strategies are interrelated. The difference lies in the allocation of core banking resources and strategic objectives that banks pursue. Banks may perceive the external environment differently and may possess different bundles of internal resources, hence they may choose to adopt one strategic option over the other. In our sample banks switch their strategies over time with the development of local market conditions.

In pursuit of client leadership, foreign banks first focus on maintaining their key existing clients by introducing sophisticated client portfolio management. The client base diversifies with the development of the local market. In order to avoid direct competition with domestic banks, foreign banks tend to target a niche market or neglected client segment such as the rural market and small to medium-sized local private enterprises. Although diversification of the client base takes place gradually, a trend can be observed that local corporate clients are taking over FIEs in terms of revenue contributions. For specialized retailing banks, they are seeking aggressive local market expansion by establishing locally incorporated subsidiaries and nationwide retailing outlets.

Intensified local competition pushes foreign banks to rethink their product strategy. Traditional interest based banking products lack differentiation. Any new change can be easily copied by domestic banks in a short period of time. A static foreign exchange rate and interest rate also squeeze the profit margin in traditional commercial banking business. Product innovation and a restructure in product portfolio appear to be the only sensible solution. Foreign banks need to shift product focus from traditionally interest based services to high-order fee based banking products. Product innovation does not merely refer to the introduction of new products. It can also mean a modification of existing matured products, innovative solutions in sales and marketing, and improvement in efficiency. In practice, it means that banks may need to market their products in an innovative way. Sometimes a proper outsourcing strategy may offer foreign banks a short-cut solution and leave banks to concentrate on core strategic business functions. Adaptation is required when a matured and advanced product is meant to be introduced to the local market. Adjustments involve not only product concept but also the technological platform at the back-end office in order to comply with local market regulations. Technological adaptation is strategically important. An advanced technological platform facilitates efficient internal coordination among different business units within the bank. It also enables the bank to respond more effectively to local market dynamics, in particular, the regulatory changes. For instance, when CBRC introduces a new lending ratio that affects banks' credit analysis and the whole lending procedure, a bank can only make the most efficient changes in its back-end office operation with an advanced technological platform in place. China's less developed information system further accentuates the importance of safety and efficiency in data transmission.

For both client and product leadership strategies, location, distribution network, understanding of the local market and a proper technological platform to facilitate efficient internal coordination are critical. Univeral banks, particularly those specializing in retailing business, tend to achieve synergistic leaderships in both client and product by establishing multiple branches and integrating various entry routes. A good organizational learning culture contributes to more efficient exploitation of external knowledge, client management, product innovation and creative marketing. There is no 'one size fits all' strategic approach to the market entry of foreign banks. Market expansion develops incrementally and strategies need to be understood and implemented under the notion of dynamism and pragmatism.

MANAGEMENT AND ADAPTATION

Cultural differences do exist. The impact of cultural distance on the ability to manage an overseas operation and causing entry barriers has been strongly evident in our sample. Banks from Asian countries, especially Hong Kong, show stronger capabilities in local market adaptation. This is mainly because of the shared cultural background and language. The ability to learn is a key intangible asset determining a bank's adaptive capability in foreign markets. Local managerial resources play a key role in a successful localization process and adaptation. Social ties of local managers assist foreign banks to relate to governments. Proper staff training increases cultural awareness of the local management team and helps in setting common corporate objectives, hence reduces cross-cultural differences. With a stock of high quality local managerial staff in place, foreign banks need to design more carefully the organizational and governing structure that ensures proper monitoring, on the one hand, and places enough incentives and enthusiasm to the job functions, on the other hand. Incentivized and enthusiastic managers normally take the lead in product innovation, which in turn improves overall bank performance.

In managing the JV, attention is paid to formation objectives, partnering skills and operational management. These elements are interrelated and their influence on the performance and successful operation of the JV is complex. Learning takes place in selecting partners, interfacing with partners and managing the JV. Each partner should offer a complementary set of selection criteria including resources, operational skills, management style and cultural background. Shared objectives and vision among the managers helps to create solidarity across the various management teams involved. The potential conflicts in commercial interests will focus attention on the integration of operating cultures of partner banks. Areas such as differences in compensation system, credit analysis in lending decisions and risk control mechanism require most of the attention. Prior experience in JV practice, similarities in corporate cultures, mutual respect and a basic understanding of the other's capabilities also contribute to better management of the JV. Performance objectives are more likely to be met in the joint bank where the partners have absorbed the lessons of managing the JV.

COMPETITIVE ADVANTAGES

How can banks adapt to the local market by minimizing their risk exposure without losing opportunities for growth? The answer to the question very much relies on how banks cope with external knowledge and maximally exploit their competitive advantages accordingly in the foreign market. Discussion of competitive advantages lies at the center of the research of internationalization. Both qualitative and quantitative analyses show that bank size and client resources are obvious factors that affect the growth of foreign banks in China. We further identify that product innovation, organizational learning and internal coordination, quality of managerial resources and cultural proximity are vital in dictating and differentiating the development pattern of foreign banks. Each factor features different development stages and their roles affecting the degree and timing of local market expansion vary.

Banks come in all shapes and sizes, large and small, conservative and risk-hungry. Clearly larger and more complex financial institutions are more difficult to manage. Universal banks, armed with their balance sheets, are always likely to be less disciplined about extending credit, whether to traders inside the bank or clients dangling investment banking fees. Although pure investment banks and retail and commercial banks delivered greater returns to shareholders than did universal banks over the ten years to the end of 2006, diversification does look smart in front of crisis. More diversified banks are able to solve their own problems. Bigger banks not only enjoy the advantage of diversity but also have much more scope to sell off assets in times of trouble. In theory, they should be better in credit analysis too because they have more data to comb through and more opportunity to spread the cost of investment, for example, in IT systems. The benefits of scale and diversification are much more apparent when the going is tough. Universal banks can diversify risk more easily than smaller-sized specialized banks and find themselves open to more options in terms of entry route choices. Organic growth or 'buying the market' is costly in China, let alone doing both at the same time. Setting up a locally incorporated entity and applying for multiple RMB licenses requires strong financial strength and a prestigious reputation. In some occasions cultural proximity can compensate smaller banks for their weakness in financial strength and worldwide network. Cultural closeness is an uncopiable advantage that offers banks quicker access to the local market. An in-depth understanding based on similar cultural background and a common language facilitates business innovation and adaptation in post-entry development.

Client resources play an essential role during the initial entry stage, particularly when banks decide to establish branches or subsidiaries. Banks tend to develop faster by relying on and extending their existing client networks in China. For market seeking banks, the capability to cultivate a sound local business environment and develop local clients lies at the center of sustainable long-term growth. Differentiation of banking services very much depends on innovation in client management and product services. Individualized services, price-competitive products and delicate care of client relationships determine whether a bank can retain old clients, continuously engage in new client relations and deliver new products to the end users more efficiently and effectively than its competitors. Banking services are highly leveraged. A small difference even in improvement in efficiency would lead to differentiation, which in turn can cause a barrier of entry for other market players.

How banks cope with external knowledge and being innovative in creating new knowledge for sustainable growth is an essential element in shaping developing strategies. High quality managerial resources facilitate knowledge transfer and the creation of new knowledge. The effectiveness in knowledge absorption and generation is the key to banking innovation and adaptation. Better training and a pool of qualified managerial staff also ensure good communication internally and with clients or regulators. Ultimately this can enhance performance and speed up the pace of expansion.

IMPLICATIONS FOR BANKS

According to CBRC's latest news release, foreign funded banks' RMB services have been growing at an average annual rate of 92 per cent since the end of 2001. Eighty per cent of our surveyed banks indicate that profit has been growing above 40 per cent in the last two years. Seventy five per cent of the respondents predict that profits will be higher in the next three years reaching 80 per cent or even higher. The majority of banks have indicated that they will increase the number of local branches or subsidiaries and the number of local staff will perhaps double in the next two years. The optimism of foreign banks is evident. The business of foreign banks operating in China is booming and will continue to expand with a growing Chinese middle class, soaring foreign investment and the opening up of the regulatory environment. But surely there are lessons to learn from past experience.

Foreign banks that capitalize on specific opportunities and market growth in China need to be very clear about their corporate objectives. Based on our research findings, only a handful of foreign banks have a clear and genuine long-term strategy for China. This study identifies that banks making great inroads in the Chinese market tend to be those that have been embedded in China for decades since or even before the establishment of the PRC in 1949. Their past experience has accumulated rich client and government contacts, a pool of managers, and a deep understanding of the Chinese culture and market. Cultural issues and understanding of the corporate and private customer are vital in constructing banking strategy. Such knowledge can only be acquired and developed through an incremental learning-by-doing process. There is no alternative route to skip this learning stage. Foreign banks who want to catch up in the race of local market expansion will have to make a concerted effort over the medium to long term to build their infrastructure base including networks, client resources and human assets.

Any attempt to confront face-to-face competition with Chinese banks would come with extremely high cost and sometimes would lead to a failure of the whole business plan. Foreign banks may have to think about how to improve the quality of their current services to maintain the existing clients or identify niche markets to serve neglected client groups. The success of both strategies will have to rely on a close cooperation with Chinese banks. In order to succeed in China in the long run, foreign banks will need Chinese banks to be successful in their restructuring programs so that the market as a whole develops and matures. Therefore improving the competitiveness of the Chinese banking industry as a whole will bring a win-win outcome so that both Chinese and foreign banks can have a share of a bigger market.

Foreign banks also need to enhance their efficiency in communication and networking. Effective networking at both horizontal and vertical levels enables more efficient transfer of new knowledge. Thus a competitive edge is created. The exploitation of external knowledge is not only important at subsidiary level but more important at headquarters level where it can influence the perceptions of senior managers and corporate policies. Within a well designed internal coordination system, human assets become essential in managing the transfer of knowledge. Training, retaining and developing highly qualified local managers should be considered as a long-term strategy.

The recent US sub-prime crisis raises particular skepticism about whether large Western banks or their regulators truly understand the risks associated with derivative on their balance sheets. Luckily, a securitized product market is not yet open to foreign financial institutions thanks to China's tight control over its foreign exchange rates. However attitudes towards foreign financial institutions are hardening publicly in China. Credit Suisse, Citibank and Morgan Stanley have not yet had their deals approved and other banks that had hoped to be next now wonder whether the approval process has been shelved. Liu Mingkang, Chairman of the CBRC, indicates that China is likely to open up to international banks even more slowly than it has already.

The market has indicated that foreign banks should implement a more careful and smarter risk management strategy. Fierce local competition, limited RMB reserves and a volatile local capital market have pushed banks to balance their zealous search for yield and potential risks. Value-at-risk analysis leads to the illusion that you can quantify all risks and therefore regulate them. It has shown how hard it is to quantify risk in a less transparent market. Models still have their place. Credit analysis remains critical to the functioning of the financial system. No other institutions have the infrastructure, the people, the data and the reputations that the banks can call on to carry out that task. However 'know your customer' is the staple of banking that has largely been forgotten because of the disaggregation of the supply chain. There is now likely to be more emphasis on non-statistical ways of thinking about risk. This means being more rigorous about imagining what could go wrong and thinking through the effects.

Intensified local competition has pointed to the value of having stickier retail deposits, especially now that wholesale funding costs have rocketed. Banks need to avoid relying too much on wholesale markets to exploit the difference between borrowing cheap short-term money and investment in higher yielding long-term assets. Banks may seriously consider the need to expand their consumer savings accounts that help push up the proportion of funding they get from retail deposits. Funding will be more expensive for all banks as they fight for retail customers' money and issue costlier long-term debt. Some costs will be passed on to customers as part of a general repricing of risk. In more competitive areas it will be more difficult to pass costs on. In investment banking it may mean a reduction in the amount of proprietary trading. In retailing banking the emphasis is likely to be on efficiency gains. Even if foreign banks are successful in bringing new money in, two deeper questions remain. The first is whether the new money will stay. The deposit business is largely built on the laziness of customers who keep their money in accounts in defiance of the rate. Those who respond to higher rates are also the ones to move if a better offer comes along. Banks need to deliberately target less rate-sensitive customers or offer high-yielding products. The second question is how much money banks can make if they have to compete so hard to entice savers. There are ways to offset the higher costs of deposits, for example, the structured accounts where the payouts are linked to the performance of equity indices and where risks can be hedged, but such products are definitely not for the mass market and are limited by local market regulations.

For banks with long-term ambitions in China, realizing their vision will require local coverage. But creating the necessary distribution network will not be achieved by simply opening more branches. Shortage of skilled banking staff will provide a practical restraint to aggressive expansion plans for many years. Foreign banks will therefore be pushed in the direction of electronic banking, higher value products (wealth management as opposed to targeting workers' savings) and the formation of alliances and JVs with local banks. However this will only become realistic in the long term given the change of China's technological advancement and mentality of people.

From the perspective of Chinese banks, they have a five year 'grace period' to gear up to finally meet the global competition. Apart from the continuous handling of NPLs, Chinese banks will have a lot more to do to shape their competitive strength and maintain their existing market shares.

Public listing is only one of the means to mitigate the pressure caused by previous wrong lending decisions and push local banks towards real commercialization. More effort needs to be made internally. This includes the improvement of corporate governance, credit and risk management, product innovation, marketing, security and human resources management. A greater emphasis on capital and liquidity will have consequences for the business models of many banks. A strong capital base is going to be an important plus-point for banks for the foreseeable future. Adjustment in risk management strategy also means more selective lending in order to keep asset growth under control. There is plenty of scope to improve performance with operational changes. This signals more rights issues and in some cases it also means M&As activity. Banks with lots of capital are in a stronger position to deploy it but will be very careful with their due diligence.

Medium and smaller-sized Chinese banks should take a more domestic approach to focus on their existing markets. Their advantages are that they are less burdened than state owned banks and more flexible and efficient in adopting new technologies and marketing skills. This enables them to identify neglected market niches and make quick responses. Sometimes teaming up with multinational players can offer them a big leap forward. However potential partners need to be carefully chosen. For equity alliance, Chinese banks need to pay extra attention to the establishment of common interests and the reduced threat of becoming potential competitors. They also need to build up compatible management practices and maximally explore complementarities possessed by both partners while not risk losing bargaining power and diluting competitive advantages.

In terms of risk control, Chinese banks definitely need to learn credit analysis techniques from Western banks. Western banks normally issue non-collateral lending based on their credit analysis and they can still keep a balance between their risk and returns. In contrast, Chinese banks normally are only willing to issue collateral lending but still they encounter huge NPLs. Western banks adopt a mature system for portfolio management so that they can reduce or hedge risks effectively. How to best allocate banking assets and keep a minimum risk at the core of Chinese banking reforms. For state owned banks, the challenge is how to pass on good experience and best practices throughout their huge organizations. Chinese banks also need to pay more attention to people assets. Staff training needs to be strengthened. Staff exchange across business lines and regional offices needs to be encouraged so that new knowledge can be transferred and best practice can be translated to the daily operation of the whole organization. Training managerial staff should concentrate on modern banking techniques, corporate governance and cultivation of brand loyalty. Reforms of the compensation system should center around performance related evaluation and reduction of opportunistic behaviors.

IMPLICATIONS FOR CHINESE REGULATORS

The banking industry always has the highest government intervention. The liberalization pace of the Chinese banking and financial market is much faster than that of Japan and the USA. Drawing from experience, regulators have lessons to learn. The first is to take a broader view of risk. This means looking at off-balance-sheet assets and at gross exposures. The entry of foreign banks certainly brings new challenges to Chinese regulators.

One of the challenges lies in the treatment of innovative products. New products such as securitization widen access to capital for borrowers and to assets for investors. They can finance everything from water utilities to film studios. Leverage brings more lazy companies within reach of determined investors. New products do not just lack the historic data that feed models. They often also sit outside banks' central risk management machinery, being run by people on individual spreadsheets until demand for them is proven. Modern financial systems contain a mass of amplifiers that multiply the impact of both losses and gains, creating huge uncertainty. This makes it impossible to get an accurate picture of aggregate risk even if individual risks are being managed well. As one regulator from the central bank notes, 'we have all the sheep in the sheepfold but not the sheepfold'. Risk management will concentrate much more on the size of banks' absolute exposures. The quality of risk management at individual institutions does not necessarily provide enough information about the overall stability of the system. Many believe that private equity firms are about to begin making their presence felt in China. This will obviously increase the leverage in the Chinese financial market and further complicate the regulatory framework.

Second, regulators need to push banks to build buffers when times are good so they have stronger defenses when times are bad. The system has come to amplify the extremes of the cycle. This requires banks to increase the amount of capital and liquidity that banks set aside when risks are building, and reduce the amount of leverage they can take on. Risk is rarely understood until after the fact. Banks may actually run higher risks in order to compensate for the effects of tougher capital requirements.

Third, the world economic downturn and rise of inflation are issues that Chinese regulators and decision makers urgently need to tackle in order to keep macroeconomic stability. China's official rate of consumer-price inflation in the first quarter of 2008 is at a twelve-year high of 8.5 per cent, up from 3 per cent. The true inflation rate may be higher because the consumer-price index does not properly cover private services. The impact of China on global inflation depends on differences in price levels between countries, not on the rate of changes in its export prices. China has helped to hold down inflation in developed economies because its goods are much cheaper and they are gaining market share, replacing more costly goods. This also curbs wage demands in developed countries. China will continue to help hold down global prices although possibly by less than in the past as China moves up the value chain. When the central bank intervenes in the foreign exchange market to prevent a currency appreciating, it has to print money to buy dollars, which boosts domestic liquidity. The US Federal Reserve's recent interest rate cuts have made it even harder for emerging economies to tighten policy. If China raises interest rates, the country attracts bigger capital inflows and the extra intervention required to hold down their currency fuels inflation further, defeating the rate rise. A rise in interest rates and the expectation of a further appreciation in the exchange rate could perversely exacerbate inflation by sucking in more capital. Setting the exchange rate free risks massive overvaluation. The central bank of China has raised banks' reserve requirements several times this year to try to mop up excess liquidity but it has left interest rates unchanged. The more the US Federal Reserve cuts, the stronger the growth in liquidity and domestic demand in developing countries. In turn, this means higher commodity prices, which further squeeze American incomes and spending, prompting the Fed to push interest rates even lower. China may need to allow more flexibility in its exchange rates. The revaluation may also encourage investors to expect further appreciation, which may attract more inflows of speculative money and so exacerbate inflation. Evidence can be found in China's QFII market, where foreign financial institutions hold large amounts of sitting-in cash after being granted QFII quotas. This is not in line with China's foreign exchange regulations and the initial introduction of the QFII scheme. Recently some foreign banks such as UBS and Lehman Brothers have been warned by the SAFE and central bank, and are urged to use their quotas to invest in China's A share market.

The Chinese banking and securities market generated 225 billion USD in revenues in 2007. Western firms receive no more than 7 per cent. The global firms, foreign banks in particular, would like to manage funds, raise capital and trade securities including shares, debt and derivatives. All these activities are still heavily restricted. A state-driven financial market means state firms tend to do best. Financing for start-ups remains largely informal, which stifles entrepreneurship. Chinese citizens try to put away money for retirement, for their children's education or other personal needs. They are given a bleak choice of subsidizing the financial system through deposits yielding less than inflation or speculating on highly volatile shares.

Fourth, entry of foreign banks urges reforms in China's governing and legal systems. Frictions have increased while foreign banks have deepened their local market penetration in the last several years. Banks operating in different jurisdictions need time to adapt their banking practices into the new market. Problems also arise from China's complex governing structure. Banking, insurance and securities are governed separately in China. The cross-selling strategy currently adopted by foreign banks obviously introduces new challenges to the governance of financial services. There have not been any rules or regulations specifically relating to such complicated financial service packages. In addition, it is very often the case that rules erected by different governing bodies, namely CBRC, China Insurance Regulatory Commission, China Securities Regulatory Commission, PBOC and SAFE, clash with one another or at least are not consistent. The complication in governing structure reduces the transparency and efficiency in governance. It further leaves many unexplained 'gray areas' for financial practices that both regulators and business practitioners find difficult to cope with.

There are doubts about the ability of the regulators to monitor and to save huge banks, especially when they operate across borders. Chinese regulators need to fulfill the following urgent tasks. First is to improve the transparency, consistency, efficiency and accuracy of policy and regulations. Banking, insurance and securities will continue to be governed separately in the foreseeable future. However there are other actions that can be made at the current stage, such as increasing interactive communication with foreign and Chinese banks to understand the real needs and problems and encouraging dialogue across different governing bodies. This would lower the transactions costs borne by both foreign and Chinese banks. Second is to improve the professional skills of regulators and people who supervise banking activities. They should be fully aware of international practice and banking operations. Third, central government needs to strengthen the legislation to establish a system for creditability on which the whole business practice is built. Finally, it is urgent for government to upgrade technology and improve hardware facilitates such as cross-regional networking and the transmission and dissemination of information.

SUMMARY

This study examines multiple issues surrounding the market entry and post-entry development of foreign banks in the PRC based on a nationwide database using a sample of 37 interviews and 60 questionnaire surveys. It identifies and highlights the key issues in banking internationalization (motives, entry mode choice and determinants), some of which have previously been examined in the literature. It concentrates on the emerging issues of evolutionary development strategies and management and adaptation in the mix of factors that surround the complexities of multinational banking.

The market entry and development of foreign banks in China is a phenomenon that will demand greater attention from both academics and practitioners as China's economic status further strengthens. We believe that the banking sector in China provides grounds for generalizing our identified results to other financial service institutions. First, banking is an important sub-sector of the services industry and shares most of the service features in general. Second, the banking sector has been used in prior studies to analyse trends in the financial service industry. The mainstream international business literature focuses on the analysis of the nature of the banking industry. Finally, the opening up of the regulatory environment in China makes it attractive for financial institutions to invest. Hence the findings we propose on internationalization drivers, evolutionary entry strategies, management and adaptation, and competitive advantages provide practitioners of financial service firms with relevant information and recommendations about future strategies.

Appendix: Research methods

SAMPLE/DATA SOURCES

This study investigated multinational banking in China. The research questions were examined using a sample of foreign banks in Mainland China. Analysis focused on subsidiary level including representative office, branch, subsidiary and JV. A list of foreign banks was obtained from *China Statistical Yearbook of Finance*. The list was then verified with a database at the central bank. A total of 178 banks were surveyed. The number equaled the actual total number of foreign banks operating in China when this research was carried out. It was assumed that this source represented a good approximation to the population of qualifying banks and that any selection biases would be minimal.

Our sampled banks for interviews were selected based on the criteria of location, nationality and local market commitment. We targeted banks located in major cities such as Beijing and Shanghai where foreign banks clustered and local economic activities were active. This decision was also driven by the need to keep the interview costs of the project relatively low. A total of 33 foreign banks were interviewed, accounting for 18.5 per cent of the total number of foreign banks. The country of origin of these 33 banks was diversified across 20 different nations that accounted for 53 per cent of the total 38 source countries.

At the initial stage of the fieldwork, four banks were introduced by the Ministry of Finance and the PBOC. We later found out that being introduced from top supervision bodies might have disadvantages. Sometimes interviewees could be alerted and were reluctant to offer any in-depth opinions. Approaching targeted banks through personal relationships proved to be more efficient and successful than formal appointment as bank managers were found more open-minded and willing to communicate. This could avoid the loss of potentially valuable information. Using such an internal recommendation method, we successfully interviewed 18 banks. The rest of the sample banks were randomly chosen. While randomly selected, the sample should be viewed more as a 'purposeful sample'. The logic of purposeful sampling is to select information-rich cases for study in depth (Patton, 1990). In the qualitative study we are seeking more for quality than quantity, more for information richness than information volume (Erlandson *et al.*, 1993).

PROCEDURE OF ANALYSIS

All interviews were transcribed verbatim. The anonymity of the interviewees eliminated the respondent biases (Berg, 1998; Miles and Huberman, 1994). To enhance the reliability of the findings and interpretations based upon them, the study adopted the techniques of triangulation. Data sources were triangulated by comparing secondary data with primary data and by comparing interview data with questionnaire data. Triangulation allowed the researcher to see or hear multiple instances of the findings from different sources by using different methods. Different data sources that had different biases and different strengths could complement each other (Miles and Huberman, 1994). Semi-structured interviews allowed the researcher to compare and contrast the findings of one bank to another by questioning some standard key issues to all respondents. By doing so, similarities and differences among foreign banks could be easily identified. Miles and Huberman (1994) and Yin (1994) argued that looking at a range of similar and contrasting cases added confidence to findings.

A multi-method personal interview and self-administered questionnaire approach was used to obtain data from each sample bank. We also obtained and reviewed the annual reports of some sample banks' China operation. The personal interviews schedule and self-administered questionnaire were developed from pilot interviews with four foreign banks in Beijing. The employment of pilot interviews enabled the researcher to obtain some assessment of the validity and the likely reliability of the data that would be collected (Saunders *et al.*, 2003). During the pilot interviews, senior managers were asked to discuss a pre-designed questionnaire. Questions mainly derived from the literature and a wide research of secondary data. One of the objectives of the pilot test was to refine the questionnaire so that respondents would have no problems in answering the questions and there would be no problems in recording the data. In addition, the pilot study allowed the researcher to focus on particular areas that might have been unclear previously and to test certain questions (Janesick, 1998). It helped the researcher to develop and solidify rapport with participants as well as to establish effective communication patterns. Bank managers were asked to comment on two major sections in relation to entry motivations and factors influencing the post-entry development. Several questions were refined. For example, many bank managers considered some entry motives were not applicable for banking internationalization such as seeking cheap labor and financial resources. Meanwhile many of them argued that it was necessary to include risk diversification as a possible motive. Similarly some questions were added into or deleted from the original design. Managers were also invited to make comments on the format of the questionnaire such as whether the format was friendly and convincible enough to attract managers' attention and interest.

Thirty seven interviews were conducted over the period February 2003 to December 2003. Four banks with the most successful local market development in terms of presence, license and performance were revisited in 2007. Our interviewees were mainly the head of the office or headquarters or a particular department. Most of the managers were local Chinese. Three managers were foreign expatriates. Four were from Hong Kong. Two were from Taiwan and three were overseas Chinese. Most of the interviews were conducted in Chinese by the researcher and his assistant. Each personal interview lasted for approximately one hour. Interviews were usually conducted in the interviewee's office, which facilitated the consultation of relevant documents if the interviewee needed to check details of the bank. Most local senior managers were fully aware of most strategic decisions made from the top. This was quite understandable that banks with good corporate culture preferred to keep efficient flow of knowledge within the organization. Open-ended questions and probes were used to elicit each participant's views. However the interviews were highly structured following a predetermined pattern across the topic areas of the research. Only three respondents accepted to have the interviews tape-recorded. The majority of the interview conversations were recorded by note-taking according to Yin's (1994) proposed guidelines.

Following the completion of the pilot interviews, a questionnaire survey was conducted. The survey envelope contained a covering letter, copy of a self-administered questionnaire and a pre-paid return envelope. The covering letter outlined the purpose of the research and promised confidentiality to respondents. The questionnaire was designed in both Chinese and English. A total of 350 questionnaires were distributed. After one written reminder, a total of 62 self-administered questionnaires were returned, representing a response rate of 18 per cent. The job category of respondents suggested that they were all senior managers. We are confident that the two groups of respondents (from interviews and self-administered questionnaires) could demonstrate an overall perspective for foreign banking activities in China.

DATA ANALYSIS TECHNIQUES

Analysis was conducted by way of mixed analysis of qualitative (interview) and quantitative (questionnaire) data. The analysis of interview data started with the transcription of the interview notes including three tape-recorded interviews. Each conversation was first written in Chinese immediately after the interview. Each interview was then translated into English. This process was managed and verified with external assistance. Although this added significantly to the time taken for the analysis, it was essential to assure the validity of the research findings. All interviews were transcribed verbatim. The second step of the analysis involved coding the interview transcripts and identifying themes within the data (such as motivations, entry mode, timing, location, partner, client, competition, competitive advantages, management, adaptation, barriers and so on). For some of these codes, secondary or even tertiary codes were developed in order to build comparisons and contrasts at the most detailed strategic level. The final list of these codes was completed and some codes were further modified during the data analysis. To facilitate coding, data retrieval and qualitative data analysis NUD*IST 4 software was employed.

The analysis of questionnaire data began with the transfer of questionnaire answers into a separate data set. This was done by creating variables and keying the answers into the Excel spreadsheet. During this process, all answers must be transferred into numerical format for further statistical analysis. Each variable was saved in a separate working sheet. Missing values were identified and related variables were modified or excluded from statistical modeling. All variables were then transferred into a single Excel data set. Statistical analyses were performed using SPSS.

This study employed mixed methods that combined qualitative and quantitative approaches in the data collection stage. The majority of the existing literature focused on aggregate level data and thus adopted quantitative modeling for the investigation of banking internationalization (for example, Amel and Liang, 1997; Brealey and Kaplanis, 1996; De La Baume and Gupta, 1991; De Young and Nolle, 1996; Fuentelsaz *et al.*, 2002; Goldberg and Saunders, 1980; Goldberg and Johnson, 1990; Grosse and Goldberg, 1991). However macro level data often neglected the individual bank's expansion behavior and the dynamics involved in the process of market entry in the long run. Williams (2002) argued that research on banking internationalization required more firm level data to provide strong evidence rather than relying on pure macroeconomic indicators. Weston (2002) and Tripe (2002) used a case study method to examine the international expansion of Australian banks. Scott-Green (2002) also adopted case studies to investigate three foreign banks' (Citibank, ABN

AMRO and RZB) entry into Poland, Hungary and the Czech Republic. However their studies concentrated on only a few cases. The generalization of research findings to a larger population was problematic.

Saunders *et al*. (2003) suggested that there were two major advantages to employing a multi-method approach in the same study. First, different methods could be used for different purposes in a study. The questionnaire survey was designed to capture the general characteristics of China's banking industry whereas interviews were carried out for in-depth analysis for a group of selected banks. Since different methods would have different effects, it made sense to use different methods to cancel out the 'method effect'. Both interviews and the questionnaire survey had disadvantages. Qualitative research using semi-structured interviews would not be able to make generalizations about the entire population. The researcher might lose contact with the general context (Thomas, 1993). Ramaswami and Agarwal (1992) argued that the use of a postal questionnaire designed for cross-sectional study limited the ability to rule out alternative causal inferences. A multi-method approach overcame the methodological rigidity and blindness of the survey research and the 'groundedness' of the fieldwork study (Miles and Huberman, 1994). It led to greater confidence being placed on the conclusions.

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Index