Location Decisions of Foreign Banks and Competitive Advantage

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Introduction

- Aim of paper:
  - Test how institutional differences between countries are dealt with, using information on location decisions of foreign banks (as banking is an institutionally-intensive activity)
  - Specifically, examine whether banks seek out those markets where institutional familiarity provides them with a competitive advantage over other foreign competitor banks

Introduction

Several factors identified that affect decision to go abroad and enter a specific country :

- Internalization of banks is traditionally closely tied to internalization of non-financial firms
  - Several studies show positive correlation between FDI in banking and trade and FDI between host and source country (Grosse and Goldberg, 1991, Brealey and Kaplanis, 1996, Williams, 1998, and Yamori, 1998)
- Banks engage in FDI to increase profitability within acceptable risk profile and risk diversification goals
  - Preference for countries with high expected economic growth and inefficient domestic banks (Focarelli and Pozzolo, 2000)
  - FDI higher between countries with similar legal origin, banking regulations and institutional set ups (Galindo, Micco, and Serra, 2003)

Introduction

This paper argues that a bank’s competitive advantage due to familiarity with working in a certain investment climate can be another important determinant of foreign bank entry

Introduction

- Motivation (theory):
  - Internalization theory asserts that firms expand abroad to exploit knowledge advantage created within the firm (Casson, 1987).
  - To benefit most of this internal knowledge advantage, firms are best off to expand to an environment that is most equal to one they are already familiar with (Buckley and Casson, 1991)
  - For banks concept of internal knowledge relates especially to information asymmetries and principal agent issues, so theory would suggest banks enter countries with similar information intensities/ institutional environments (supported by empirical work of Galindo, Micco, and Serra, 2003)

Introduction

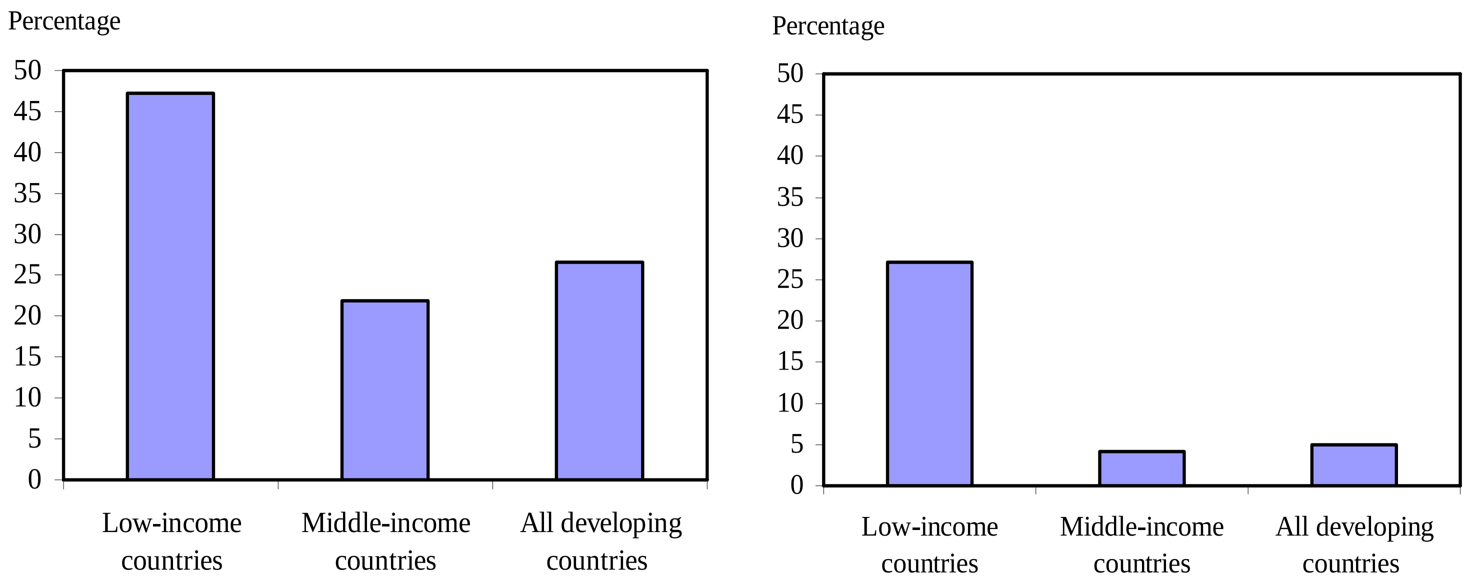
- Motivation (theory) cont'd:
  - However, argument implicitly assumes that location decision of individual banks is made independent of the location decision of other, competing, multinational banks. This is unlikely to be the case
  - So, to the extent that sources of internal competitive advantage are derived from the ability to work in a certain institutional environment, it should be the difference in institutional environment between host and source country taking into account institutional quality of competitors that matters

Introduction

- Motivation (practice):

Figure 4.5 South-South foreign bank entry in developing countries, by country income level

Share of banks in total foreign banks **Share of assets in total foreign assets**



a. Number of southern foreign banks as a percentage of all foreign banks (left panel).

b. Bank assets held by southern foreign banks as a percentage of total foreign assets, averaged over 2000-4 (right panel).

Source: World Bank Staff estimates based on Bankscope

Note: "Southern foreign banks" are those banks headquartered in a developing country. A foreign bank is one that had at least 50 percent foreign ownership as of December 2005.

Introduction

Results:

- Controlling for a large number of variables already established to determine bank entry, we find that
  - The level of institutional development in the host country itself does not impact cross-border entry activity
  - The same holds for differences in institutional development between host and source country
  - However, similarities in institutions between host and source country *compared to* competitors affect a bank's entry decision

So, it is not the absolute level of the institutional environment faced by a firm that attracts it to a certain market, but rather its ability to work within a certain institutional environment better than its competitors.

Indeed, competitive advantage related to institutional environment is an important driving factor in entry decisions made by foreign banks

Methodology

- Formally we test the following hypothesis :
  - Banks that are used to work in a country with relative weak institutions compared to their competitors will expand to countries with relative weak institutions, while banks that are more familiar with working in a country where institutions are well-functioning compared to their competitors will tend to enter countries with relative good institutions.

Methodology

Bilateral data on banking sector FDI

- Primary source is Bankscope, supplemented with information from bank websites, Central Bank websites and other internet sources
- Sample includes all active commercial banks, saving banks, cooperative banks, bank holding companies and middle and long term credit banks reporting to Bankscope in 2005
- Ownership is based on direct ownership structure in 2005
  - Bank is foreign owned if at least 50% of shares are owned by foreigners
  - Percentage of shares are summed by country of residence of shareholder. Country with highest percentage of shares is appointed as source country
- Countries in sample
  - Only developing countries included as host countries
    - To allow for variation in institutional quality
    - Investment in developing countries much more recent, limit bias due to endogeneity
  - Host countries that are offshore centers are excluded, host countries with <5 active banks are excluded, and Guatemala (due to lack of information) is excluded
- Information about 2,297 banks of which 35 percent is foreign owned in 98 developing countries.

4. Methodology

- Measure of foreign bank presence (dependent variable):
  - For each host country we construct country-pairs with all possible source countries in sample
    - Source countries are all developing and developed countries with presence in bank sector of at least one developing country
    - Source countries that are offshore centers are excluded
    - Total of 6,382 country-pair observations
  - For each host country we determine per source country the sum of assets of foreign owned banks and divide that by total amount of bank's assets in host country
    - Source data on assets: Bankscope
    - Based on consolidated balance sheets
    - Averages over 2000-2004 to minimize effects of particular events

Methodology

- Measure of competitive advantage:
  - Interaction of institutional quality host country with difference between institutional quality in source country and that of all the bank's competitors:

$$CompAdv_{ij} = Insthost_i(Instsource_j - Instcomp)$$

  - *Instcomp* is weighted average (based on economic size) of institutional quality in each of the possible source countries
  - Institutional quality in host and source country and of competitors is simple average of six governance indicators of Kaufmann, Kraay and Mastruzzi (2005), linearly transformed so value is not below zero
  - Data are for 2000 to minimize bias in estimation due to endogeneity
  - If hypothesis is correct the parameter should be significant and positive

Methodology

- Benchmark model includes as explanatory variables the institutional quality in the host country and our measure of competitive advantage. In addition, some standard gravity variables, a measure of economic integration, and host and source country specific characteristics

$$\begin{aligned}
ForCont_{ij} &= \alpha_1 Insthost_i + \alpha_2 CompAdv_{ij} + \alpha_3 Collinks_{ij} + \alpha_4 Border_{ij} + \alpha_5 Comlang_{ij} \\
&+ \alpha_6 Distance_{ij} + \alpha_7 Trade_{ij} + \alpha_8 LegalDif_{ij} + \alpha_9 GDPhost_i + \alpha_{10} FinDepthhost_i \\
&+ \alpha_{11} Entryres_i + \alpha_{12} GDPsource_j + \alpha_{13} GDPcapsource_j + \alpha_{14} DRegion + \varepsilon_{ij}
\end{aligned}$$

- Model is estimated using Tobit and standard errors are corrected for heteroskedasticity

Results

Competitive Advantage in Foreign Banking

	(1)	(2)	(3)
Insthost	-0.012		-0,004
	[0.429]		[0.788]
DiffInst		0,019	
		[0.133]	
CompAdv			0,042 ***
			[0.000]
No. Obs.	5.532	5.532	5.532

Note:
a. Coefficients are marginal effects. The robust p-values appear in brackets and ***, ** and * correspond to one, five and ten percent level of significance respectively.

- Both institutional quality of host country and difference in institutional quality do not explain cross-border banking activity
- Support for competitive advantage hypothesis
- Impact economic very relevant: Banks from the worst (best) institutional quality source countries are willing to decrease (increase) their presence by some 50 (20) percent if a country's institutional quality increases from the lowest to the highest

Results

Robustness test; individual indicators

	(1)	(2)	(3)	(4)	(5)	(6)
InstIndhost	-0,003	-0,006	0,010	-0,001	-0,003	-0,012
	[0.828]	[0.568]	[0.475]	[0.935]	[0.816]	[0.338]
CompAdvInd	0,027 ***	0,017 **	0,041 ***	0,026 ***	0,045 ***	0,038 ***
	[0.001]	[0.019]	[0.000]	[0.000]	[0.000]	[0.000]
No. Obs.	5.532	5.532	5.532	5.532	5.532	5.532

Note:
a. *InstIndhost* is one of six indicators of quality of institutions in the host country in 2000 as measured by Kaufmann, Kraay and Mastruzzi (2005). In the regression (1) this is voice and accountability, in regression (2) politial instability and violence, in regression (3) government effectiveness, in (4) regulatory quality in (5) rule of law and in the last regression *InstIndhost* indicates control of corruption.
b. Coefficients are marginal effects. The robust p-values appear in brackets and ***, ** and * correspond to one, five and ten percent level of significance respectively.

- Average measure of institutional quality can bias results as it might hide the fact that competitive advantage arises with respect to a certain kind of indicator but not with respect to others. Also it provides limited insight into source of competitive advantage
- For all individual indicators the result continues to hold that competitive advantage is an important determinant of location decisions of foreign banks. Decrease highest rule of law (0.35) and lowest political institutions and violence (0.19)

Conclusion

- Results indicate that banks that are willing to expand their business abroad seek out those markets in which their past experience in working in a certain business climate gives them a competitive advantage

- Result has important policy implication
  - High institutional quality is not necessarily a prerequisite to be able to attract FDI in banking. Since foreign banks tend to have a beneficial impact on the domestic financial system which is an engine for growth, this is potentially good news for low-income countries
  - However, some caution is warranted for as those banks might be immiserizing. Foreign banks entering low-income countries might be a source of instability if they lack supervision in source country. Also they might take advantage of the weak institutional environment and exploit safety nets by taking on excessive risks

End