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Entry mode choice of multinational banks

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ABSTRACT

When expanding abroad, a multinational bank faces a trade-off between accessing a foreign country via cross border lending or financial foreign direct investment, i.e. greenfield or acquisition entry. We analyze the entry mode choice of multinational banks and explicitly derive the entry mode pattern in the banking industry. Moreover, we show that in less developed banking markets, a trend towards cross border lending and acquisition entry exists. Greenfield entry prevails in more developed markets. Furthermore, we identify a tendency towards acquisition entry in smaller host countries and towards greenfield entry in larger host countries.

1. Introduction

The last few years have seen an impressive liberalization of banking markets.[1] While banks active in rather saturated, developed financial markets have looked for new investment and growth opportunities, banks in many emerging economies have been in need for fresh capital in the aftermath of banking crises. The privatization process in Eastern Europe provided further opportunities for multinational banks to expand abroad. Nowadays, in around 40% of all developing countries, more than 50% of banks are foreign owned. Strikingly, this figure rises to more than 80% in several Eastern European countries (Claessens et al., 2008).

This immense transformation of banking markets gives rise to several questions concerning both the incentives of multinational banks to enter new markets and the incentives of host countries as to how to shape foreign entry. Should a multinational bank grant cross border loans or rather access a new market via de novo investment or acquisition of a local bank? How do the development and the size of the local banking market affect a multinational bank's entry mode choice? What are the host country policy maker's preferences regarding different entry modes of foreign banks?

With the aim of addressing these questions, we set up a model of spatial bank competition à la Salop. Foreign banks may enter the host country via cross border lending, de novo investment or acquisition of a domestic bank. Banks compete in interest rates for potential borrowers that engage in investment projects of uncertain return. Foreign banks have access to a better screening technology and enjoy lower refinancing costs than local banks. However, besides market entry costs, foreign banks are at a disadvantage relative to domestic banks in that the latter hold soft information on borrowers due to prior lending relationships. Furthermore, granting cross border loans implies a rather limited knowledge of the host market. Hence, when multinational banks decide about their mode of entry, they face a trade-off between the size of market entry costs and their relative disadvantage in access to soft information and their knowledge of the local market.

We demonstrate that multinational banks choose their entry mode according to their efficiency in screening potential borrowers. If a bank is rather inefficient in screening, it chooses not to expand abroad. With increasing efficiency, cross border lending becomes feasible. As soon as the better market knowledge in the case of greenfield entry compared to cross border lending compensates for the larger fixed entry cost, the foreign bank shifts from cross border lending to de novo investment. Only if the screening technology of the foreign bank is powerful enough can it drive

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down the acquisition price to the point that acquisition entry becomes the dominant entry mode.

A major focus of our study is to explain how a foreign bank's entry mode choice is affected by the financial development and the size of the host banking market. Indicators for the host country's level of financial development in our model are the screening efficiency and refinancing conditions of local relative to foreign banks. As a further indicator, the importance of access to soft information serves as a measure of a market's transparency. A high level of competitive pressure is yet another sign of increased development. We show that in less developed host banking markets a wider range of foreign banks opt for cross border lending and acquisition entry whereas the range of foreign banks that prefer greenfield investment contracts. Interestingly, a wider range of foreign banks favors acquisition entry in smaller host banking markets whereas the attractiveness of de novo investment is enhanced in larger markets.

Our welfare analysis allows us to determine the preferences of the host country policy maker concerning foreign bank entry. The policy maker prefers a foreign bank not to enter the market when it is rather inefficient in screening borrowers. From the policy maker's point of view, cross border lending is strictly inferior to greenfield entry. Greenfield entry, in turn, is favored for intermediate screening efficiencies of foreign banks. If a foreign bank is highly efficient in screening borrowers, the policy maker prefers the foreign bank to acquire a local bank. Although the policy maker's preferences regarding foreign entry are similar to those of foreign banks, scope for regulation exists as the threshold values determining the preferred entry mode pattern of the policy maker and the foreign banks differ.

We find that the regulation of foreign bank entry is shaped as follows. Entry is permitted only to foreign banks that rather efficiently screen borrowers. Furthermore, the less competitive the market environment is, the more likely it is that foreign banks are denied entry. Cross border lending is not allowed for. Foreign banks that intend to expand via cross border lending or the acquisition of a local bank are forced to enter via de novo investment if their screening efficiency is insufficiently high.

The remainder of this paper is organized as follows. The next section reviews the literature. Section 3 describes the set up of the model. In Section 4, we study the entry mode choice of multinational banks. Comparative statics in Section 5 allow us to analyze the impact of the financial development as well as the size of the host banking market on the entry mode decision of foreign banks. We present the welfare analysis in Section 6. Empirical hypotheses are stated in Section 7. Section 8 concludes.

2. Related literature

The massive expansion of multinational banks into emerging markets and transition countries over the last years has spurred the analysis of how host banking markets are affected by the entry of foreign banks. For instance, Martínez Pería and Mody (2004) empirically analyze the impact of foreign bank entry on the efficiency of host banking markets. They find lower interest rate spreads of foreign relative to domestic banks and that increased foreign bank participation decreases overall costs in the banking sector. The influence of foreign bank entry on credit stability is addressed by De Haas and van Lelyveld (2006). Their study implies that the credit supply of foreign banks remains stable during crisis periods in the host country but that this effect is mainly driven by greenfield foreign banks. Dell'Ariccia and Marquez (2004) point to the trade-off between superior information of host country banks and lower refinancing costs of foreign banks entering the market. Sengupta (2007) incorporates this trade-off into a theoretical model in order to find out which market segment foreign banks serve. His analysis shows that foreign banks tend to serve large firms while domestic banks lend to riskier market segments. He concludes that stronger legal protection can overcome informational barriers of foreign banks and, in turn, facilitate entry. Claeys and Hainz (2006) analyze the impact of foreign entry on competition in the host country. In line with Sengupta (2007) they assume that foreign banks have a cost advantage, though here in the form of a better screening technology, whereas domestic banks have an informational advantage concerning old borrowers. In contrast to Sengupta (2007), they distinguish between two forms of market entry: greenfield investment and acquisition. It follows from their analysis that the mode of entry determines the information distribution between foreign and domestic banks which, in turn, affects the degree of competition. Claeys and Hainz (2006) conclude that greenfield investment leads to more competition in the host country than acquisition.

Our model builds on similar assumptions as Dell'Ariccia and Marquez (2004), Sengupta (2007) and Claeys and Hainz (2006) in that we also assume an informational advantage of domestic banks and superior screening skills of foreign banks. However, we do not focus on how foreign entry affects the host banking market but on how foreign banks decide to expand abroad. Although the impact of foreign entry on host banking markets has been studied quite extensively, the expansion of multinational banks and, even more so, their entry mode choice has received astonishingly little attention in the finance literature so far. Our aim is to fill this void. In contrast to Sengupta (2007) and Claeys and Hainz (2006) we explicitly derive under which conditions a multinational bank expands via cross border lending, greenfield investment or acquisition. Our analysis sets in one step before Sengupta (2007). We do not analyze how entry of foreign banks can be facilitated but whether and in which form the policy maker of the host country wants entry to take place. This allows us to derive some implications concerning the regulation of foreign bank entry.

Given that we account for a full range of possible entry modes of foreign banks, our paper adds to the so far relatively scarce literature on how foreign banks decide about their entry mode. Buch and Lipponer (2007) and García Herrero and Martínez Pería (2007) empirically analyze the decision of multinational banks to expand abroad via cross border lending or via financial foreign direct investment but do not explicitly distinguish between greenfield investment and acquisition. They find that the larger the host banking market, the more a foreign direct investment is preferred over cross border activities. Van Tassel and Vishwasrao (2007) as well as Beermann (2007) set up models to study the trade-off between greenfield and acquisition entry. Van Tassel and Vishwasrao conclude that a multinational bank generally favors acquisition over de novo entry. Beermann shows that the most efficient banks choose to expand via acquisition of a host country bank whereas less efficient banks opt for greenfield entry.

Our paper is related to two further strands of literature, namely trade theory and industrial organization literature. Trade theory explains a firm's decision to expand abroad via exports (the equivalent to cross border lending) or a foreign direct investment (the equivalent to a financial foreign direct investment). One of the first models in trade theory to study the export versus foreign direct investment decision of firms is Brainard (1993). She points to the trade-off between fixed and variable costs. Firms choose to export in case of high fixed and low variable costs and to serve the foreign market via foreign direct investment otherwise. Helpman et al. (2004) incorporate firm heterogeneity into this trade-off between variable and fixed costs. They show that when countries open up to trade, the least productive firms are forced to exit the market and the remaining firms engage with increasing labor productivity in exports before they start to operate in a new market via foreign