Market entry strategies of German financial services providers in China

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Friedemann Mrochen MBA

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I certify that the work presented in this thesis is, to the best of my knowledge and belief, original, except as acknowledged in the text and that the material has not been submitted, either in whole or in part, for a degree at this or any other university. I also certify that, to the best of my knowledge, any assistance and help received in preparing this thesis, and all sources used have been acknowledged in this thesis.
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Abstract

Context: During the last two decades several emerging market economies (EMEs) have lifted restrictions on foreign direct investment (FDI) in their financial systems and have invited foreign banks to enter their markets. In contrast, China continued to heavily restrict the entry of foreign financial services providers until the country’s accession into the World Trade Organisation (WTO) at the end of 2001. Ever since, the Chinese government has started to encourage foreign banks to enter the country’s financial services market and to invest in local financial institutions while gradually expanding the range of products and services that foreign financial services providers could offer and the clientele they could serve. From December 2006 foreign banks were allowed full competitive access to the Chinese market. Since then, many foreign financial services providers have embraced this liberalisation, and have started to increase their presence in China in various forms.

The German banking system is characterised by high levels of fragmentation and state ownership of banks. It is still dominated by many smaller regional banks which are owned by local municipalities (savings banks) or local businesses and individuals (cooperative banks). On an international level, these banks are usually represented by central savings banks (Landesbanks) and central cooperative banks, which provide a link between savings banks/cooperative banks and national and international banking systems by providing know-how in more complex products, joint ventures, efficient payment systems and liquidity management. In addition, they handle operations such as securities business and foreign payment transactions centrally for their associated saving banks/cooperative banks. Hence, these characteristics of the German banking system affect why and how German banks internationalise (DSGV 2008; Grill, Perczynski, Grill 2007).

Purpose: This study examines the market entry strategies used by German banks and automotive financial institutions (AFIs) in China. As such it seeks to investigate a range of issues which have been discussed in the literature with regard to the internationalisation of financial services providers: (1) the motive of German banks and AFIs for entering the Chinese market, (2) the entry mode used by the participating organisations, in-
including the choice of possible local partner, (3) their activities in the Chinese market, including the clients and geographic regions served, and the scope of product and services offered, (4) the factors or determinants which influence the choices of entry mode and activities, and finally (5) the challenges these organisations face in the Chinese market.

**Methodology/Approach:** This study uses case study research based on interviews conducted with managers of twelve German banks and AFIs active in the Chinese market. Case study is considered to be able to provide a holistic view of complex settings and processes. It can provide insights into the complexities of real-life situations, which may not be captured by other research methods. Case study research also allows the investigation of “how” and “why” questions and as such the investigation of possible causal links between the market entry strategy choices made by the participating organisations and certain factors influencing these choices. In addition, case study research is flexible and often develops as it proceeds, which is especially helpful when dealing with complex and dynamic research subjects like the ones under investigation here, as it does not require as detailed and pre-structured research designs as some other research methods like experiments or surveys. Moreover, case study works well when conducted within the context of its subject of analysis. It therefore permits the observations to take place in “natural settings” “at close hand”.

**Findings:** The main implication of this study appears to concern the effects that the corporate ownership structure, as an ownership-specific factor, can have on the internationalisation of banks. The findings of this study suggest that certain characteristics of the German banking industry are major factors influencing the internationalisation behaviour of German banks. Very significant of these characteristics are the ownership structures of the central savings banks (Landesbanks) and the central cooperative banks (especially the interests of their shareholding regional banks and German states in case of the Landesbanks), and the division-of-labour process applied in both banking groups. Since the regional German savings banks and cooperative banks lack the resources to enter the Chinese market themselves, they have an interest in having their associated Landesbanks or central cooperative banks being present in China because these institutions can act as outlets and agents for the savings and cooperative banks in the foreign market. On the other hand however, the regional savings and cooperative banks lack the resources to support local incorporation of their Landesbanks and central cooperating
banks in China. This strongly limits the range of activities these banks can engage in in China.

These effects of ownership structure, and particularly the influence of owners or shareholders on the internationalisation and market entry of banks, have received very little attention in theoretical literature or empirical research.

To “follow their customers” (and/or to support the clients of their associated savings and cooperative banks) is the most important motive for the participating German banks to enter the Chinese market. This is also reflected in their customer base in China which is mostly made up of German SMEs which are active in China. In contrast, only two of the participating banks named the potential of the domestic Chinese market as their main reason to enter the country. These results are in line with the results of several previous studies which indicate that German banks in particular often seem to follow their customers when they internationalise.

The entry mode most applied by the participating banks is the representative office, which is the entry mode that requires the least commitment of resources, but also strongly limits the range of products and services that can be offered and the clients that can be served. This reflects the business models applied by a majority of the participating banks (to offer trade-related products and services as well as consulting to their German clients in China), the country’s regulatory environment, as well as the banks’ assessment of the cost and risk associated with an investment in China. Earlier studies of the determinates of bank internationalisation found that greater cultural and geographic distance, as well as regulatory barriers lower the activities of foreign banks. The choice of a representative office as their entry mode seems to offer the participating banks a “compromise choice” which offers them a “low risk” option to maintain a presence in China without committing too many resources. Only those participating organisations which entered China to seek local business opportunities committed considerably more resources and chose to incorporate locally in China.

The clients served and the products offered (market strategy) by the participating banks reflect their motives for entering the Chinese market and the restraints imposed by their choice of entry mode. A majority of the financial services providers focus on foreign (mostly German) corporate clients. Most participating German banks don’t take “Chinese risk” into their portfolio, only a small selective group of highly creditworthy
Chinese companies is being served. In this sense the participating German banks appear to engage in “cherry picking” when doing business with local corporations. Only five of the 12 participating organisations also provide services to Chinese individuals.

Trade-related services, loans and financial market products are the main financial services being offered by the participating organisations. Deposits only play a very small role for the participating organisations. Government-determined interest rates and the lack of a wider branch network make it difficult for the participating German banks to compete for clients’ deposits.

The biggest challenges faced by the participating organisations in China are the regulatory environment and employee recruiting and retention. These results mirror the findings of previous studies about the challenges faced by foreign banks in general in China. Another major issue for the participating German banks was competition from other foreign and Chinese banks. This might reflect the size of the participating banks. On average they are considerably smaller than many other foreign banks active in China and they therefore feel the competition from large international players and the big Chinese banks more strongly.
Table of contents

Declaration .................................................................................................................. I
Acknowledgements ...................................................................................................... II
Abstract ..................................................................................................................... IV
Table of contents ........................................................................................................ VIII
List of figures ............................................................................................................... XII
List of tables ............................................................................................................... XIII
List of appendices ....................................................................................................... XV
List of abbreviations ................................................................................................... XVI

1 Introduction .............................................................................................................. 1
   1.1 Background to the research .............................................................................. 1
   1.2 Research problem, research issues and contributions .................................... 2
   1.3 Justification for the research .......................................................................... 4
   1.4 Research methodology .................................................................................... 6
   1.5 Outline of the thesis ....................................................................................... 8
   1.6 Delimitations of the scope of this study ....................................................... 9
   1.7 Situational context .......................................................................................... 10
      1.7.1 Development and deregulation of the Chinese banking sector and the conditions for foreign banks in China ........................................... 11
      1.7.2 Characteristics of the German banking industry ..................................... 23
   1.8 Conclusion ...................................................................................................... 28

2 Literature Review .................................................................................................... 29
   2.1 Introduction ..................................................................................................... 29
   2.2 Internationalisation and foreign market entry – a review of theories, models and frameworks ................................................................. 32
      2.2.1 Introduction .............................................................................................. 32
      2.2.2 Economic approaches ............................................................................. 35
         2.2.2.1 The transaction cost approach (TCA) and extensions .................. 35
         2.2.2.2 The resource-based view and the organisational capability perspective ........................................................... 39
         2.2.2.3 The eclectic framework .................................................................. 45
      2.2.3 Selected process approaches .................................................................. 49
         2.2.3.1 Stage and learning models, network approach ............................. 49
         2.2.3.2 Contingency approach ................................................................. 55
   2.3 Internationalisation and foreign market entry of banks – a review of empirical research ................................................................. 59
      2.3.1 Introduction ............................................................................................. 59
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.3.2</td>
<td>Deregulation and banking sector reform as a major background of the activities of foreign banks in China</td>
<td>60</td>
</tr>
<tr>
<td>2.3.3</td>
<td>Competition and performance of foreign and domestic banks in China</td>
<td>63</td>
</tr>
<tr>
<td>2.3.3.1</td>
<td>Performance of domestic and foreign banks in China</td>
<td>65</td>
</tr>
<tr>
<td>2.3.3.2</td>
<td>Competitive advantages and disadvantages of foreign and domestic banks in China</td>
<td>66</td>
</tr>
<tr>
<td>2.3.4</td>
<td>“Strategic investors” and the performance of Chinese banks</td>
<td>72</td>
</tr>
<tr>
<td>2.3.5</td>
<td>Motives for the entry of foreign banks into the Chinese market</td>
<td>76</td>
</tr>
<tr>
<td>2.3.6</td>
<td>Entry modes of foreign banks</td>
<td>81</td>
</tr>
<tr>
<td>2.3.7</td>
<td>Activities (market strategies) of foreign banks</td>
<td>87</td>
</tr>
<tr>
<td>2.3.8</td>
<td>Challenges of foreign banks (in China)</td>
<td>96</td>
</tr>
<tr>
<td>2.4</td>
<td>Development of a framework for the investigation of market entry strategies of financial services providers</td>
<td>102</td>
</tr>
<tr>
<td>2.4.1</td>
<td>Introduction</td>
<td>102</td>
</tr>
<tr>
<td>2.4.2</td>
<td>A framework for the investigation of market entry strategies of German financial services providers entering China</td>
<td>103</td>
</tr>
<tr>
<td>2.5</td>
<td>Conclusion</td>
<td>106</td>
</tr>
<tr>
<td>3</td>
<td>Research Methodology</td>
<td>107</td>
</tr>
<tr>
<td>3.1</td>
<td>Introduction</td>
<td>107</td>
</tr>
<tr>
<td>3.2</td>
<td>Justification of case study as research methodology</td>
<td>107</td>
</tr>
<tr>
<td>3.2.1</td>
<td>Characteristics and definitions</td>
<td>110</td>
</tr>
<tr>
<td>3.2.2</td>
<td>Advantages and strengths of case study research</td>
<td>111</td>
</tr>
<tr>
<td>3.2.3</td>
<td>Criticism and limitations of case study research</td>
<td>112</td>
</tr>
<tr>
<td>3.2.4</td>
<td>Criteria for judging the quality and integrity of case-based research</td>
<td>114</td>
</tr>
<tr>
<td>3.2.5</td>
<td>Combining inductive and deductive reasoning and the role of prior theory</td>
<td>119</td>
</tr>
<tr>
<td>3.2.6</td>
<td>Criteria for case selection and number of cases</td>
<td>121</td>
</tr>
<tr>
<td>3.2.7</td>
<td>Data collection and sources of evidence</td>
<td>126</td>
</tr>
<tr>
<td>3.3</td>
<td>Data analysis</td>
<td>130</td>
</tr>
<tr>
<td>3.4</td>
<td>Ethical considerations</td>
<td>134</td>
</tr>
<tr>
<td>3.5</td>
<td>Conclusion</td>
<td>135</td>
</tr>
<tr>
<td>4</td>
<td>Data Analysis</td>
<td>136</td>
</tr>
<tr>
<td>4.1</td>
<td>Introduction</td>
<td>136</td>
</tr>
<tr>
<td>4.2</td>
<td>Description of cases selected for this research</td>
<td>136</td>
</tr>
<tr>
<td>4.2.1</td>
<td>Types of financial service companies participating in this study</td>
<td>136</td>
</tr>
<tr>
<td>4.2.2</td>
<td>Characteristics of the participating organisations – services offered and customer segments</td>
<td>138</td>
</tr>
<tr>
<td>4.2.3</td>
<td>Characteristics of the participating companies – Size of total assets</td>
<td>139</td>
</tr>
<tr>
<td>4.2.4</td>
<td>Characteristics of the sample companies – links to Asia</td>
<td>139</td>
</tr>
<tr>
<td>4.2.5</td>
<td>Characteristics of the sample companies – international network</td>
<td>140</td>
</tr>
</tbody>
</table>
4.2.6 Characteristics of the sample companies – conclusion ...................... 140
4.3 Research Question 1: motives of German banks and AFIs to enter the
Chinese market ................................................................. 140
4.3.1 Motives of German banks to enter the Chinese market .............. 141
4.3.1.1 Follow the customer .................................................. 141
4.3.1.2 Serving existing clients of associated savings banks or
cooperative banks ................................................................ 142
4.3.1.3 Client retention / “protection” of the client relationship ...... 143
4.3.1.4 Potential of the Chinese market (“market seeking”) ........ 144
4.3.1.5 Looking for market niches based on special skills,
expertise, or experience ..................................................... 145
4.3.1.6 Networking with Chinese corporations / winning
Chinese clients in Germany ............................................... 146
4.3.1.7 Strategic considerations ............................................. 147
4.3.2 Motives of the participating AFIs to enter the Chinese market .... 148
4.3.2.1 Sales promotion .......................................................... 148
4.3.2.2 Client retention / strengthen of customer loyalty .......... 150
4.3.2.3 Dealership network support ............................................ 150
4.3.2.4 Potential of the Chinese market ..................................... 151
4.3.2.5 Strategic considerations ............................................. 151
4.4 Research Question 2: Market entry modes of German banks and AFIs in
China ................................................................. 152
4.4.1 Entry mode and asset size .................................................. 153
4.4.2 Entry mode and international experience ............................. 155
4.4.3 Entry mode and experience in Asia ..................................... 157
4.5 Research Question 3: The choice of market strategy/ activities of
German banks and AFIs in China ............................................. 158
4.5.1 Customer segments served by German banks and AFIs in China .... 160
4.5.2 Currency in which products and services are being offered ...... 160
4.5.3 Nationality of clients served .................................................. 162
4.5.4 Geographic reach or focus of operations ............................. 162
4.5.5 Scope of product and services being offered .......................... 164
4.6 Research Question 4: Factors influencing the choice of market entry
mode and market strategy/activities of German banks and AFIs in China ... 165
4.6.1 Regulation ................................................................. 166
4.6.2 Alignment of entry mode and market strategy with the applied
business model in China ..................................................... 167
4.6.3 Competition .................................................................. 169
4.6.4 Risk/cost considerations with regard to the investment in China .... 171
4.6.5 Economies of scale .......................................................... 173
4.6.6 Refinancing ................................................................. 174
4.6.7 Considerations of Chinese policy goals .............................. 174
4.6.8 Early mover advantage ..................................................... 175
4.6.9 Potential future mergers or acquisitions .............................. 176
4.6.10 Complexity of operations and considerations of “size” and “manageability” ................................................................. 177
4.6.11 Market entry mode choice of AFIs – doing it alone or with a Chinese partner .............................................................. 177

4.7 Research Question 5: Challenges which German banks and AFIs are facing in China ............................................................................................................................................ 180
4.7.1 Regulation ........................................................................................................................................................................... 180
4.7.2 Recruiting and retention of qualified Chinese employees .......... 184
4.7.3 Competition ........................................................................................................................................................................... 186
4.7.3.1 Competition from Chinese firms ................................... 186
4.7.3.2 Competition from foreign firms ........................................ 188
4.7.4 Lending and assessment of creditworthiness ..................... 189
4.7.5 Legal System / court system / law enforcement ................ 190
4.7.6 Refinancing / funding of foreign and local currency .......... 191
4.7.7 Management of relationships / partnerships with Chinese partners.... 192
4.7.8 Commitment and support from headquarters ....................... 194

4.8 Conclusion ........................................................................................................................................................................... 196

5 Conclusions and implications ................................................................................................................................................. 197
5.1 Introduction ........................................................................................................................................................................... 197
5.2 Conclusions about Research Questions 1 to 5 ..................... 199
5.2.1 What are the motives of German banks and AFIs to enter the Chinese market? ................................................................. 199
5.2.2 Which market entry modes are being chosen by German banks and AFIs when entering the Chinese market and which factors are influencing their choices? ........................................................................................................... 203
5.2.3 Which market strategies (activities) are being chosen by German banks and AFIs in China and which factors are influencing their choices? ........................................................................................................... 205
5.2.4 What are the challenges German banks and AFIs are facing in the Chinese market? ................................................................. 209

5.3 Implications for policy and practice ........................................ 214
5.3.1 Implications for policy ......................................................................................................................................................... 214
5.3.2 Implications for practice ......................................................................................................................................................... 216

5.4 Implications for theory and further research ........................................ 219
5.5 Limitations of this study .............................................................. 223
5.6 Concluding remarks ................................................................................................................................................................. 224

References ........................................................................................................................................................................... 225
Appendix ........................................................................................................................................................................... 249
List of figures

Figure 1.1: Outline of this thesis................................................................. 9
Figure 2.1: Structure of Chapter 2 (Literature review)................................. 31
Figure 2.2: Theories, models, and frameworks of internationalisation and
foreign market entry reviewed in this research........................................ 34
Figure 2.3: A resource-based approach to strategy analysis according to Grant
(1991)........................................................................................................ 42
Figure 2.4: A framework for the investigation of market entry strategies of
foreign banks and AFIs entering China..................................................... 105
Figure 4.1: Entry mode and asset size of the participating German banks........ 155
Figure 4.2: Entry mode and international experience of the participating
organisations......................................................................................... 156
Figure 4.3: Entry mode and number of Asian countries (other than mainland
China) with a presence........................................................................ 158
Figure 5.1: Structure of Chapter 5 with regard to individual research questions.... 198
List of tables

<table>
<thead>
<tr>
<th>Table 1.1:</th>
<th>China’s WTO commitment in Banking ........................................... 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1.2:</td>
<td>Comparison of several aspects of foreign bank branches and locally-incorporated foreign banks under the New Regulations ............. 21</td>
</tr>
<tr>
<td>Table 2.1:</td>
<td>Theories, models and frameworks applied to internationalisation and foreign market entry ......................................................... 33</td>
</tr>
<tr>
<td>Table 2.2:</td>
<td>Share of bank assets held by foreign banks ........................................... 64</td>
</tr>
<tr>
<td>Table 2.3:</td>
<td>Strategic investments of foreign banks in Chinese banks .................. 74</td>
</tr>
<tr>
<td>Table 2.4:</td>
<td>Market segments in China based on customer type and currency of services ............................................................................ 93</td>
</tr>
<tr>
<td>Table 2.5:</td>
<td>Economic freedom indices of selected countries .............................. 97</td>
</tr>
<tr>
<td>Table 3.1:</td>
<td>Criteria used to establish validity and reliability in this research ........ 119</td>
</tr>
<tr>
<td>Table 3.2:</td>
<td>Selected sampling strategies for case selection .................................. 123</td>
</tr>
<tr>
<td>Table 3.3:</td>
<td>Sources of evidence and their relative strengths and weaknesses .......... 127</td>
</tr>
<tr>
<td>Table 3.4:</td>
<td>Research issues and the corresponding predetermined interview questions .................................................................................. 129</td>
</tr>
<tr>
<td>Table 4.1:</td>
<td>Product/service range of participating financial services providers .... 138</td>
</tr>
<tr>
<td>Table 4.2:</td>
<td>Client segments served by the participating financial service providers ................................................................. 139</td>
</tr>
<tr>
<td>Table 4.3:</td>
<td>Size of participating financial services providers (in total assets) ....... 139</td>
</tr>
<tr>
<td>Table 4.4:</td>
<td>Number of offices, branches or subsidiary companies of the participating financial service providers in Asian countries (including Hong Kong and Taiwan) other than mainland China .... 139</td>
</tr>
<tr>
<td>Table 4.5:</td>
<td>Number of countries being served by the participating financial services providers (with an office, branch, or subsidiary company) .... 140</td>
</tr>
<tr>
<td>Table 4.6:</td>
<td>Motives of the participating German banks to enter the Chinese market (multiples are possible) ...................................................... 141</td>
</tr>
<tr>
<td>Table 4.7:</td>
<td>Motives of the participating AFIs to enter the Chinese market (multiples are possible) ................................................................. 141</td>
</tr>
<tr>
<td>Table 4.8:</td>
<td>Market entry modes applied by the participating financial services providers ........................................................................ 153</td>
</tr>
<tr>
<td>Table 4.9:</td>
<td>Customer segments served by the participating financial service providers ................................................................................... 160</td>
</tr>
<tr>
<td>Table 4.10:</td>
<td>Currency of products and services being offered by the participating financial service providers in China ................................. 161</td>
</tr>
<tr>
<td>Table 4.11:</td>
<td>Nationality of clients served by the participating organisations ........ 162</td>
</tr>
</tbody>
</table>
List of tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.12</td>
<td>Geographic focus of the participating German banks in China</td>
<td>163</td>
</tr>
<tr>
<td>4.13</td>
<td>Geographic reach/focus of the participating AFIs in China</td>
<td>163</td>
</tr>
<tr>
<td>4.14</td>
<td>Product/service scope of the participating financial service providers</td>
<td>164</td>
</tr>
<tr>
<td>4.15a</td>
<td>Factors influencing the choice of entry mode and market strategy/activities (part 1)</td>
<td>165</td>
</tr>
<tr>
<td>4.16</td>
<td>Arguments for the choice of market entry mode by the participating AFIs</td>
<td>179</td>
</tr>
<tr>
<td>4.17a</td>
<td>Challenges of German banks and AFIs in China (part 1)</td>
<td>180</td>
</tr>
</tbody>
</table>
List of appendices

Appendix A- Information sheet for interviewees ......................................................... 249
Appendix B - Standard interview protocol (German) .................................................. 250
Appendix C - Informed consent form ........................................................................ 251
List of abbreviations

ABC Agricultural Bank of China
AFI Automotive Financial Institution
ATM Automated Teller Machine
BOC The Bank of China
BVR Bundesverband der Deutschen Volksbanken und Raiffeisenbanken
CA Contingency Approach
CBRC China Banking Regulatory Commission
CCB China Construction Bank
CEE Central and Eastern Europe
CEO Chief Executive Officer
CEPA Closer Economic Partnership Arrangement
CIRC China Insurance Regulatory Commission
CPC Central Committee of the Communist Party of China
DBRS Dominion Bond Rating Service
DSGV Deutscher Sparkassen- und Giroverband
EME Emerging Market Economies
EU European Union
EUR Euro
FDI Foreign Direct Investment
FSFDI Financial Services Foreign Direct Investment
GDP Gross Domestic Product
GNP Gross National Product
HSBC Hongkong and Shanghai Banking Corporation
ICBC Industrial and Commercial Bank of China
JV banks Joint Venture Banks
JV partner Joint Venture Partner
List of abbreviations

M&A  Mergers and Acquisitions
MNE  Multinational Enterprise
MoF  Ministry of Finance
NPL  Nonperforming Loans
OCA  Organisational Capability Approach
OECD Organisation for Economic Co-operation and Development
OEM  Original-Equipment-Manufacturer
PBC  People’s Bank of China
PCBC  People’s Construction Bank of China
PRC  People’s Republic of China
PWC  Pricewaterhouse Coopers
QDII  Qualified Domestic Institutional Investors
RBV  Resource-Based View
RMB  Renminbi
ROA  Return on Assets
ROE  Return on Equity
SAFE State Administration of Foreign Exchange
SAT  China’s State Administration of Taxation
SME  Small and Medium Enterprises
SOE  State-Owned Enterprises
TCA  Transaction Cost Approach
UK  United Kingdom
US  United States of America
USD  US Dollars
WFOE  Wholly Foreign Owned Enterprise
WTO  World Trade Organisation
1 Introduction

This dissertation investigates market entry strategies of German financial services providers in China. This first chapter of the thesis provides an introduction to the research. The remainder of this chapter is organised as follows. First, the background of this research and its context is briefly described (Section 1.1). This is followed by the presentation of the research problem in general as well as the five specific research questions to be investigated in this study (Section 1.2). After this, the research is justified (Section 1.3) and the methodology used is briefly described (Section 1.4). The following section, Section 1.5, then outlines the structure of the whole thesis. This is followed by the discussion and justification of the delimitations of the scope and key assumptions of this study (Section 1.6). The chapter concludes with an overview of the situational context of this study, the opening and ongoing reform of the Chinese financial services market and the German banking industry (Section 1.7).

1.1 Background to the research

While not a new phenomenon, especially since the early 1980s, the internationalisation and entry of banks into foreign markets has increased significantly (Slager 2004; Choi 1997). At the same time, China has been undergoing a historic economic and cultural transformation as it emerges as one of the largest economies in the world. Since the inception of the open-door policy in 1978, a gradual and carefully sequenced reform program, China has attracted thousands of firms wishing not only to make use of low production costs, but also to locate there to gain access to the country’s large and growing market. However, China’s financial service market remained heavily restricted until the country finally joined the World Trade Organisation (WTO) after years of negotiations at the end of 2001 (KPMG 2007; Reid and Walsh 2003).

Since China joined the WTO, the Chinese government has begun to encourage foreign banks to enter the country’s financial services market and to invest in local financial institutions, while gradually expanding the range of products and services that foreign financial services providers are allowed to offer and the clientele they are allowed to serve. From December 2006 foreign banks were formally granted full competitive ac-
Introduction

Access to the Chinese market. Despite numerous remaining administrative and legal restrictions that make it difficult to compete, since then many foreign financial services providers have embraced this liberalisation and have started to increase their presence in China in various forms (Metcalfe 2007; Worthington 2005).

The phenomena of firm internationalisation and foreign market entry have been intensively researched and discussed in literature in the last few decades, across several academic disciplines and from various different viewpoints (e.g. international marketing, strategic management, organisation theory, economics). A firm’s decisions with regard to internationalisation and especially concerning its choice of entry mode have been regarded as a “frontier issue” and as one of the most critical strategic decisions of internationally operating enterprises (Fu 2004; Root 1994; Agarwal and Ramaswami 1992).

In broad terms, this research seeks to contribute to the body of knowledge and to address gaps in the existing literature with regard to the market entry strategies of foreign financial services providers in transition economies. In particular, this study focuses on German banks and Automotive Financial Institutions (AFIs) active in China. The research problem, the specific research questions, as well as the contributions of this study, will be detailed further in the next section.

1.2 Research problem, research issues and contributions

The present study aims to contribute to the knowledge and understanding of market entry strategies of German financial services providers in the dynamic financial services market of China. Based on a review of the extant theoretical and empirical literature regarding internationalisation and the entry of financial services firms into foreign markets, five topics have been identified as “core issues” for the investigation at hand.

The first issue is a financial services firm’s initial decision to enter a foreign market. It can be assumed that typically, the decision to enter a foreign market will come from the results of an initial feasibility study which may involve a comprehensive analysis of market size and growth rate, competition, entry barriers, available resources, the economic and political climate of the host country and other possible risks (Gunaratne and Emerson 1999). Thus, the first issue investigated in this study are the motives of financial services companies to enter a foreign market. Here, the two main themes previous research has identified are “following the customer” based on the pre-existing bank-
client relationship and the search for market opportunities based on the size or characteristics of the host market (“market seeking”). Consequently, the first research question is:

Research Question 1: What are the motives of German banks and AFIs to enter the Chinese market?

The second and third core issues of bank internationalisation identified in the literature review are the choice of entry mode or institutional arrangement a firm chooses when entering a foreign market and the activities it chooses to engage in, which include the clients and regions being served, and the scope of products and services being offered in the host market. In this research, this bundle of dimensions describing the foreign banks’ activities will also be referred to as the market strategy of the participating organisation, while the combination of entry mode and market strategy can be seen as the actual market entry strategy. Thus, the second and third research questions are:

Research Question 2: Which entry modes are being used by German banks and AFIs in China (including the choice of a possible local partner)?

Research Question 3: What are the market strategies or activities of German banks and AFIs in China (that is, which clients and geographic regions are being served, and which products and services are being offered by German banks and AFIs in China)?

The analysis of the factors or determinants, both internal and external to the firms, which influence the choice of entry mode and market strategy, or which are being considered by the participating organisations in the above choices, constitute the fourth core issue of this research. Investigating these factors is essentially analysing “why” the participating financial services providers are using the entry modes and market strategies of their choice. The research on entry modes has shown that the choice of entry modes depends on different types of factors, often distinguished as firm-specific, industry-specific, and country specific factors (Pan and Tse 2000; Sarkar and Cavusgil 1996). Consequently, the fourth research question is:

Research Question 4: What factors influence German banks and AFIs with regard to their choices of entry mode and market strategy in China?

Finally, the fifth core issue identified in the literature review are the challenges foreign financial service providers are facing in the Chinese market. While this is an issue
which is usually not at the centre of academic research, but rather a “by-product”, it appears to be of strong interest in more applied research that attempts to draw conclusions for policy and management practice (e.g. Metcalfe 2009; 2008).

Research Question 5: What are the challenges that German banks and AFIs are facing in the Chinese market?

1.3 Justification for the research

While the phenomena of firm internationalisation and foreign market entry have been intensively researched, the body of literature shows several imbalances with regard to the attention that the various themes and sub-themes have been receiving.

Focus on manufacturing vs. services. The services industries are already responsible for the largest part of gross domestic production in developed economies and international trade (Belke, Burger and Seidel 2009). However, while the internationalisation of services has been experiencing increasing attention in literature in the last two decades, the majority of previous research has focused on manufacturing firms (Javalgi, Griffith and White 2003; Grönroos 1999; Erramilli and Rao 1993).

Focus on Central and Eastern Europe and Latin America vs. Asia. International business research appears to have paid disproportionately less attention to emerging markets in comparison to developed markets (Peng 2001). Of the existing research on the internationalisation and the entry of financial service firms into the world’s three major developing regions of Latin America, Central and Eastern Europe and greater Asia, Asia appears to have received considerably less attention than the first two. This imbalance in academic research may well reflect the difference in development in these three developing regions. While the share of banking assets held by foreign-controlled banks rose in the 1990s in Latin America, Central and Eastern Europe (CEE), and Asia, the increase was significantly higher in the first two regions. For instance, in Argentina, Chile, Hungary, and Poland, the share of banking assets held by foreign-controlled banks rose from less than 20 per cent in 1994 to more than 50 per cent in 1999. In contrast, in East Asia the average share only rose from 3 to 7 per cent in the same period (Clarke, Cull, Martinez Peria and Sánchez 2003). These differences in development can partly be explained by the differences in market liberalisation. The banking crises in several countries in Latin America led local governments to speed up the liberalisation
of local banking markets in order to recapitalise and consolidate their banking systems in the second half of the 1990s. The CEE countries opened their banking markets for foreign banks in the 1990s when privatisation of the banking system and preparations for EU membership took place. In contrast, large-scale FDI in the banking sector is still a relatively recent phenomenon in emerging markets in Asia (Domanski 2005).

**Focus on pre-WTO entry China vs. post-WTO entry China.** To date only very few studies have investigated the entry of foreign banks into China. Moreover, most of these studies have been conducted either before China’s accession into the WTO at the end of 2001 (e.g. Popp 1996; Leung 1997), or in the years from 2002 to 2006 when China was in the process of gradually opening its market to foreign banks according to the country’s WTO-commitment (e.g. Leung and Young 2002; He and Fan 2004; Metcalfe 2005).

In addition, there are several gaps in the body of literature with regard to various topics which are addressed in this research. For instance, the motive of banks for entering foreign markets needs further research. One major issue is that the often examined positive correlation between foreign direct investment (FDI) by banks and FDI by other firms in a given foreign market does not necessarily mean that the foreign banks operating in this market followed their clients or that they mostly serve clients from their home countries (Clarke, Cull, Martinez Peria & Sanchez 2003). The present study addresses this gap in the literature by specifically investigating the motives of German financial service providers who have entered the Chinese market.

**Bank size.** Most studies on foreign banks in China have focused on larger international banks, presumably because larger banks are more likely to have entered the Chinese market and tend to choose entry modes which require a higher commitment of resources (e.g. Metcalfe 2010, 2009). The majority of the banks participating in this study are relatively small in comparison. Again, this study addresses a gap in the literature by investigating the market entry strategies of smaller banks which typically lack the resources of large multinational banks like Standard Chartered or Citibank.

**Ownership structure.** Besides being small in comparison to other internationally active banks, many of the participating German banks are also unique with regard to their ownership structure. Several of the participating banks are owned by large groups of small regional savings or cooperative banks in Germany, some of them are also essen-
tially state-owned, which strongly influences their internationalisation strategies. Here the present study addresses a gap in the literature by documenting, how the interests of these shareholders affect the market entry strategies of these banks in China.

**Implications for policy and practice.** Finally, this study’s results have implications not only for academic research, but also for policy and practice. With regard to policy and the regulatory environment in China, implications of this research especially concern:

- the needs of smaller foreign banks active in China,
- the shortage of qualified, English-speaking employees,
- the issue of refinancing or funding of foreign financial services providers, and
- the requirements foreign banks need to fulfil to locally incorporate in China.

The managerial implications drawn from this study again reflect characteristics of some of the sample organisations. They mainly concern:

- the **business model** applied by smaller foreign banks in China,
- how to deal with the shortage of qualified, English-speaking Chinese employees, and
- the value of **prior experience** in geographically and culturally similar markets.

Finally, research on a market like China can assist managers from Germany and other Western countries to cope with the difficulties arising from the cultural and geographical distance between China and their country, as well as the existing differences in the social, political and economic systems (Zhao 2005).

### 1.4 Research methodology

This section will provide a brief overview of the research methodology applied in this study. A more detailed description and justification of the research methodology used in this study will be provided below in Chapter 3. In addition, Chapter 3 will discuss data collection and analysis procedures as well as ethical considerations of this study.

This research is both descriptive and exploratory in its investigation of market entry strategies. It is descriptive in its investigation of motives for entering the Chinese market, the entry modes used, and the market strategies followed by the participating organisations. It is exploratory in its investigations of factors influencing the choices of entry
Introduction

modes and market strategies applied and challenges encountered by the organisations taking part in this research.

With regard to the choice of a suitable research methodology, this study follows the idea that the choice of research methods should mainly be based on a thorough assessment of which methods are best suited to answer a given research question (Ticehurst and Veal 2000). This research uses case study as its research method. Yin (2003) defines case study as a comprehensive research strategy including the logic of design, data collection techniques and specific approaches to data analysis which relies on multiple sources of evidence and which can be used to investigate a contemporary phenomenon within its real-life context (Yin 2003). A similar definition is suggested by Feagin, Orum and Sjoberg (1991, p. 2), who define case study as an “in-depth, multifaceted investigation” of a “single social phenomenon”, which is conducted in “great detail” and often relies on the use of “several data sources”.

Case study is considered to be able to provide a more holistic view of complex settings and processes (Sjoberg, Williams, Vaughn, and Sjoberg 1991). It can provide insight into the complexities of real-life situations, which may not be captured by other research methods (Zainal 2007). To investigate why foreign financial services providers enter the Chinese market, which market entry strategies they choose and which factors influence their choice appears to require a holistic approach to capture the full complexity of the market entry process. In addition, case study research is flexible and often develops as it proceeds, which is especially helpful when dealing with complex and dynamic research subjects like the ones under investigation (Nykiel 2007), as it does not require a design that is as detailed and pre-structured as the designs required for some other research methods like experiments or surveys. In addition, case study works well when conducted within the context of its subject of analysis. It therefore permits the observations to take place in “natural settings” “at close hand” (Orum et. al. 1991, p. 6; Yin 2003). This was another argument for using case study in this research, since it allowed for special consideration of the situational context of this research, especially the characteristics of the host market China, but also the home-market characteristics of the participating organisations.

Based on the purpose of this research, the complexity of the phenomenon under investigation, the situational context, considerations of “depth vs. width”, and the available time and resources, it was decided to investigate 12 cases of financial service providers
and their entry into the Chinese market. This is on the upper end of the usual number of cases (Carson, Gilmore, Perry, and Gronhaug 2001; Perry 1998). The services providers included nine German banks and three Automotive Financial Institutions (AFIs) active in China.

Each of the 12 participating organisations was considered as a separate case study. The interviews with key employees of these organisations were the most important sources of information. A standard interview protocol was developed for this research and used in all interviews conducted. Additional sources of information included documents provided by the participating organisations (e.g. reports, memoranda, presentations), as well as documents provided by external sources, including research firms, universities, and government organisations. The results of the data analysis procedures, which included within-case analysis as well as cross-case analysis, are detailed in Chapter 4.

A more detailed description and justification of the main research methodology and the specific research method used in this study will be provided in Chapter 3. In addition, Chapter 3 will discuss data collection and analysis procedures as well as ethical considerations of this study.

1.5 Outline of the thesis

This thesis is organised into five chapters. Chapter 1 introduces the background, main theme, structure and justification of this research. It also briefly describes the research methodology, delimitations, and key assumptions of the study. In addition, Chapter 1 provides an overview of the situational context of this research, the development of the Chinese banking market and major laws and regulations affecting the entry of foreign financial services providers into the country as well as a brief overview of the types of German banks participating in this research.

Chapter 2 presents a comprehensive review of the extant theoretical and empirical literature with regard to the research problem: the market entry strategies of (German) financial services providers in China. Based on this two-part review, gaps in the literature and issues which are worth researching are identified and a conceptual framework is developed to guide the process of data collection and analysis, and to structure the findings of this study and put them into perspective with regard to existing theories and models as well as the findings of other studies on similar or closely related issues.
**Chapter 3** presents a description and justification of the research methodology applied in this study. In addition, it provides an outline of the research process including the procedures used for data collection and analysis, and a brief discussion of ethical considerations of the study.

**Chapter 4** presents the data collected for this study and an analysis of the data collected with regard to all five research questions of the study developed in Chapter 2. In addition, Chapter 4 provides an overview of the characteristics of the sample organisations that took part in this research.

The final chapter, **Chapter 5**, discusses the conclusions and implications of the findings of this study with regard to each research question and within the context of the body of literature reviewed in Chapter 2. In addition, the contributions, implications, and limitations of the research are discussed, and opportunities for further research are proposed.

The basic outline of this thesis is shown in Figure 1.1.

**Figure 1.1: Outline of this thesis**

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Chapter 1: Introduction
Chapter 2: Literature Review
Chapter 3: Research Methodology
Chapter 4: Data Analysis
Chapter 5: Conclusions and Implications
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Source: Developed for this research

### 1.6 Delimitations of the scope of this study

This study examines the market entry strategies of German financial service providers in China. As such, the scope of this study can be defined by several dimensions.

For instance, the present study’s analysis focuses on the level of the individual firm and the considerations and choices they make, rather than an industry-analysis, country-analysis, network-analysis, or transaction-analysis. As such, it does not include a macroeconomic perspective, such as the macroeconomic factors attracting foreign banks to
Introduction

China. The **concepts** under investigation are the motives for entering the Chinese market, and the entry modes and market strategies applied by the participating organisations as well as the challenges they face in the foreign market. This study does not examine which entry modes or market strategies are the best suited; thus it does not examine the effect of the above choices on the performance of the participating organisations.

All participating organisations belong to the **financial services industry**. German banks make up the majority of the sample organisations, which enables this research to take into account some key characteristics of the German banking industry. However, foreign banks are still heavily restricted when it comes to doing business with Chinese individuals in the local currency renminbi (RMB). Thus, two German AFIs were added to the sample, because being considered non-banks financial institutions under the WTO regulations in China, AFIs are less restricted than foreign banks in their dealings with Chinese individuals in foreign currency and have been especially active in consumer financing in China. As such, unlike most of the banks, they offered the opportunity to examine a market strategy in China which includes a classic retail banking service.

As described above, with regard to the home country of the participating organisations, the focus of this study is on financial services providers from **Germany**. However, in order to add depth and breadth to the investigation in a particular area, an additional third AFI from another Western country was added to the sample. The reason for this is that this particular company chose a different entry mode than its two German competitors and also offered ample access to study its entry strategy. Further information on the selection of participants for this study is provided in Chapter 3.

### 1.7 Situational context

This two-part section describes the situational context of this research to enhance the understanding and interpretation of the findings of this study. The first part (Section 1.7.1) describes the development and deregulation of the Chinese banking sector and the conditions for foreign banks in China. The second part (Section 1.7.2) provides a brief overview of the German banking industry and the different types of German banks.
1.7.1 Development and deregulation of the Chinese banking sector and the conditions for foreign banks in China

In December 1978 the Third Plenum of the Eleventh Central Committee of the Communist Party of China (CPC) decided to shift the focus of the Party’s work to socialist modernisation by implementing the open-door policy, a gradual and carefully sequenced reform program to move the country from a “planned economy supplemented with some market elements” to a “socialist market economy” (Okazaki 2007).

Since the inception of the open-door policy, which also includes bank reform and securities market development (Brean 2007), the Chinese banking industry has been in a constant phase of transformation. However it is only since China’s accession into the World Trade Organization (WTO) in 2001 that the Chinese banking market has been substantially liberalised and foreign banks have gradually received full access to customers in China (KPMG 2007; Leung and Young 2002).

The development of banking-sector reform and the opening-up of the banking-market in China can be viewed as a four-stage process. Before the inception of the open-door policy in 1978, China had a Soviet-style mono-banking system, which dated back to the Cultural Revolution (1966–1976), during which most Chinese financial institutions were shut down or incorporated into the People’s Bank of China (PBC) or the Ministry of Finance (MoF) (Okazaki 2007). The PBC was the only repository of deposits as well as the only lending institution, which distributed industrial and commercial credit in the form of government directed loans. There was no capital market; instead long-term investments were channelled through the budget, and the working capital of state-owned enterprises was determined administratively (Chiu and Lewis 2006).

The goals of the first stage (1978–1993) of the banking-sector reform can be summarised as changing the mono-banking system into a plural-banking system with a central bank and various other financial institutions, increasing the inflow of foreign funds, and improving the environment for foreign investment by facilitating better financial services for foreign business corporations in China (Okazaki 2007; CBRC 2007).

From 1978 to 1984, four state-owned specialised banks (the “big four”) were established and assigned with a special function within the economy to take over the commercial banking business from the PBC (Okazaki 2007; Chiu and Lewis 2006). These banks are:
- The **Agricultural Bank of China (ABC)** which was the first commercial bank to be established after 1978 for financing the rural and agricultural sectors, because agriculture development was seen as a priority by the Chinese government.

- The **Bank of China (BOC)** which was separated from the PBC in March 1979 to finance foreign trade and investment.

- The **China Construction Bank (CCB)** (called the People’s Construction Bank of China (PCBC) until March 1996) which was separated from the PBC in 1983 to undertake construction financing and fixed-asset investment.

- The **Industrial and Commercial Bank of China (ICBC)** which was set up in 1984, mainly to finance the business activities of the Chinese state-owned enterprises (SOE).

The business restrictions on these institutions were later loosened in the mid-1980s and today none of the specialised banks is still restricted to their initially designated business activities. The PBC was assigned the role of a national central bank (1983/84), its functions included such activities as carrying out monetary policy, monitoring financial markets, and issuing bank notes. However it did not become independent of the government, but remains part of the State Council in China (Leung and Young 2002; Okazaki 2007; Chiu and Lewis 2006).

In addition to the establishment of state-owned banks, China also started to partially open its market for foreign-funded banks. Japan Import and Export Bank was the first in 1979/80 to establish a representative office in Beijing, and in 1981 Nanyang Commercial Bank from Hong Kong established a branch in Shenzhen, becoming the first foreign-funded bank doing business in China since 1949. China gradually lifted geographic restrictions by allowing foreign-funded banks to expand from the initially opened four special economic zones in Shenzhen, Zhuhai, Shantou, and Xiamen (Bo’ao Asien Forum 2006) into coastal regions and major cities of the country (CBRC 2007; Okazaki 2007).

According to the China Banking Regulatory Commission (CBRC), by the end of the first stage of banking sector reform in 1993, foreign banks with combined assets of US$ 8.9 billion had established 76 operational entities in 13 cities (CBRC 2007).
The **second stage** (1993–2001) of banking-market reform was defined by the introduction of various economic reform measures, based on the concept of a “socialist market economy”, formally introduced at the 14th National congress of the CPC in 1992 (Okazaki 2007).

In December 1993, the State Council issued the Resolution on Financial System Reform, which defined the targets of China’s financial system reform. These targets included (Okazaki 2007):

- the establishment of an independent macro economic control mechanism by the PBC (independent from local governments, but under the direction of the State Council),
- the establishment of policy banks,
- the transformation of state-owned specialised banks to actual commercial banks,
- the establishment of unified, open, well-ordered, competitive, and well-managed financial markets,
- the reform of foreign-exchange controls,
- the issuance of appropriate guidance for the development of non-bank financial institutions, and
- the development of a financial-service infrastructure and the establishment of a modern financial-management system.

Several arrangements were made by the government to implement these new policy objectives.

Three **policy banks** (China Development Bank, Export and Import Bank of China, Agricultural Development Bank of China) were set up by the government in 1994 to separate policy lending from commercial lending and to enhance the independence of the four existing state-owned commercial banks. However, since these commercial banks still had to provide financing to the largely inefficient SOEs, they accumulated large volumes of **non-performing loans** (NPLs), which remain a major challenge for the Chinese banking system (Okazaki 2007).

In 1994 the first comprehensive law governing the nationwide activities of foreign-funded banks in China, (Regulations of the PRC on the Administration of Foreign-
funded Financial Institutions) was introduced, to provide legislative guidance for the market entry and supervision of foreign-funded banks (CBRC 2007).

The geographical restrictions on the business activities of foreign banks were further lifted, making it possible for these institutions to establish branches nationwide in all Chinese cities. In 1996, the Provisional Regulations on Foreign Financial Institutions’ RMB Business were introduced on a trial basis in the Shanghai Pudong area, which was later followed by Shenzhen as the second pilot city, allowing foreign banks to conduct RMB business for foreign enterprises and overseas residents, further boosting the development of foreign banks in China. In 2001, just before China’s accession into the WTO, the number of foreign-funded banks in China had reached 190 (CBRC 2007).

China joined the WTO on December 11th, 2001, with the financial services sector being one of the most intensely discussed areas in the preceding negotiations between the WTO and China (He and Fan 2004). While China tried to protect its fragile and immature financial services sector, it also acknowledged the advantages, for example the experience and international standards, which foreign financial services providers could bring to the country. China’s major WTO commitments in the financial services sector can be seen in Table 1.1
### Introduction

The WTO accession agreement gave China a transition period of five years to further open up its market for foreign banks, especially to allow foreign banks to conduct business in the local currency renminbi (RMB) without restrictions by 2007 (Brean 2007). Thus, the third stage (2002–2006) of banking-sector reform was characterised by further liberalisation of the market for financial services in China, mostly based on China’s WTO commitments, but partly also independent of and in addition to these commitments made in the WTO agreement (CBRC 2007).

The customer restrictions on the foreign exchange business of foreign-funded banks were immediately removed after China’s WTO accession. In the following years, the RMB business activities of foreign-funded banks were gradually expanded from the four major cities of Shanghai, Shenzhen, Tianjin and Dalian to the entire country, and foreign-funded banks were allowed to expand their RMB business clients from foreign enterprises and individuals to domestic corporations and residents. The restriction which

#### Table 1.1: China’s WTO commitment in Banking

<table>
<thead>
<tr>
<th>Activities Subject to Restriction</th>
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<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
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<td>Acceptance of deposits and other repayable funds from the public</td>
<td>Lending of all types including consumer credit, mortgaging, factoring, financing of commercial transactions</td>
<td>Financial leasing</td>
<td>All payment and money transmission services including credit, charge and debit cards, traveler’s cheques</td>
<td>Guarantees and commitments</td>
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<td>Geographic Coverage</td>
<td>Shanghai</td>
<td>Guangzhou</td>
<td>Jinan Fu-zhou</td>
<td>Kunming</td>
<td>Shantou</td>
<td>No geographical restriction</td>
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<td>Shenzhen</td>
<td>Qingdao</td>
<td>Chongqing</td>
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<td>Client Coverage</td>
<td>On accession no limitation on foreign currency business</td>
<td>Local currency business to Chinese enterprises only</td>
<td>No client restrictions</td>
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<tr>
<td>Company Licensing</td>
<td>Total assets more than US$10 billion to establish subsidiary or joint venture</td>
<td>Total assets more than US$20 billion to establish a branch</td>
<td>No establishment restrictions</td>
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<td>Further licensing requirements to engage in local currency business are 3 years business operations in China, being profit making for 2 consecutive years prior to the applications</td>
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<tr>
<td>Activities Allowed without Exception</td>
<td>Auto financing by non-bank financial institutions</td>
<td>Provision and transfer to financial information/software</td>
<td>No establishment restrictions</td>
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<td></td>
<td>Advisory, intermediary services including credit reference and analysis, investment M&amp;A, and portfolio research</td>
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Source: Bonin and Huang (2002), p. 1079
required that RMB liabilities of foreign-funded banks did not exceed 50 per cent of their foreign currency liabilities was removed and the limit on the proportion of foreign currency deposits accepted domestically by foreign-funded banks was relaxed (CBRC 2007).

In order to encourage the foreign banks to establish a presence in the non-coastal areas, especially the central, western, and north-eastern regions of China, a number of cities including Xi’an, Shenyang, Harbin, Changchun, Lanzhou, and Xining were opened to RMB business of foreign funded banks ahead of the WTO schedule, while foreign banks applying to set up new establishments and open new businesses in these regions were entitled to expedited review and approval procedures. In addition, the minimum requirement on foreign-funded banks’ operating capital was lowered, and foreign-funded banks were allowed to engage like local banks in the trading of financial derivatives, qualified domestic institutional investor (QDII) investments, offshore wealth management and custodian business, and insurance agency business (CBRC 2007).

In April of 2003, the **China Banking Regulatory Commission (CBRC)** was established as a regulatory body to oversee the reform agenda and to fill the need for the regulation of the increasingly complex Chinese banking system, replacing the PBC in this role which was now to focus on monetary policy (Okazaki 2007; Chiu and Lewis 2006).

After first being very cautious about allowing foreign investors to buy shares of domestic banks, the Chinese government acknowledged the positive effects foreign direct investment had had in other sectors of the economy and finally allowed foreign direct investment into the banking sector. In December 2003, a new regulation was introduced with regard to foreign equity investment in Chinese financial institutions, raising the limit on equity shares held by a foreign investor in a Chinese financial institution to 20 per cent (from previous 15 per cent) for a single investor, or to 25 per cent for more than one foreign investor. Since then the Chinese government has been encouraging Chinese banks to invite qualified overseas financial services providers to act as strategic investors in accordance with each institution’s individual plan for structural reform. The term “strategic” implies that the government does not only seek to sell shares of Chinese banks, but that strategic foreign investors are expected to infuse new long-term capital, to transfer knowledge and new management systems, and to help to improve the overall corporate governance of commercial banking in China (Okazaki 2007).
In January 2004, the **Closer Economic Partnership Arrangement (CEPA)**, a free trade agreement between Hong Kong and mainland China, came into effect, establishing preferential access to China’s market for Hong Kong. Under the CEPA provisions, China opened its market to Hong Kong-based services providers in 18 service sectors, including banking (Hong Kong Trade Development Council 2004). The CEPA offers preferential treatment to Hong Kong banks, including Hong Kong-registered foreign banks, when they are establishing branches or opening new businesses on the mainland. The CEPA favours Hong Kong banks by:

- reducing the asset requirement of Hong Kong banks seeking to enter the mainland market from US$20 billion to US$6 billion,

- reducing the minimum operations time on the mainland from three to two years, after which Hong Kong-registered banks were permitted to accept deposits from the public as well as provide other RMB-denominated banking services (and after undergoing a profitability assessment),

- allowing Hong Kong banks to have their profitability assessment being based on their combined branch network, rather than the profitability of their individual branches.

These regulations were designed to give Hong Kong banks, particularly small and mid-sized ones, a head start by accelerating their access to the China retail banking market (CBRE 2006).

According to the CBRC (2007), at the end of 2006, there were 14 locally incorporated wholly foreign-funded banks and Chinese-foreign joint venture banks in China, which had opened 19 branches and sub-branches. In addition, 74 foreign-funded banks from 22 different countries and regions established 200 branches and 79 sub-branches in 25 Chinese cities. Finally, 186 foreign-funded banks from 42 countries and regions established 242 representative offices in 24 Chinese cities. Of all those operational entities, 168 were established by Asian banks (54% of the total), including 102 from Hong Kong, 19 from Japan, and 17 from Singapore. Seventy-seven (25% of the total) operational entities were established by European banks, including 21 from the UK and 15 from France. Thirty-two (10% of the total) operational entities were established by North American banks, including 26 from the USA and six from Canada (CBRC 2007).
Geographically, the opening up of the Chinese banking system has revolved around three major areas, covering the Yangtze River Delta, the Pearl River Delta and the Bohai Economic Zone. At the end of 2006, 100 operational entities of foreign-funded banks were located in Shanghai (32% of the total number), 40 (13%) operational entities were located in Shenzhen, 37 (12%) in Beijing, 28 (9%) in Guangzhou, 17 (5%) in Tianjing, and 16 (5%) in Xiamen, with the remaining 34% of operational entities having located in other cities around the country (CBRC 2007).

The *Regulations on the Administration of Foreign Invested Banks* (the “New Regulation”) were passed by the State council on November 11th, 2006 and became effective on December 11th, 2006 (Pinsent Masons 2006). With this New regulations, China entered yet another stage of banking sector reform and formally fulfilled its WTO commitment with regards to the banking market. It did so by lifting the remaining geographic restrictions as well as all the non-prudential restrictions on banking services provided by foreign banks, giving foreign financial service providers the right to engage in business with foreign and domestic enterprises as well as individuals in all Chinese regions, provided they complied with a new set of requirements (Brean 2007; Asia Pacific Foundation of Canada 2006). The CBRC (2007) gave the following explanation of the New Regulations:

In order to promote the all-around development of foreign-funded banks, protect the interests of Chinese depositors and follow the international banking trends, China encourages foreign banks to set up locally incorporated subsidiaries or convert their existing branches into subsidiaries. These locally incorporated entities of foreign banks are allowed to offer full foreign currency and RMB services to all customers, enjoy the identical treatment with the Chinese banks in terms of registered capital and working capital, and are subject to the same regulations as domestic banks when determining the interest rates for deposits and loans, the rates of service fees, depositing required reserves and drawing loan loss provisions. These subsidiaries shall also meet the same requirements as the Chinese banks in their asset-liability management activities, including capital adequacy and large exposure requirements, and connected lending activities (Report on the opening-up of the Chinese banking sector by the CBRC, January 25, 2007).
However, substantial regulatory barriers still remain, with some industry observers suggesting that the future pace of deregulation will largely be dependent on the degree of competitiveness of the domestic banks (Achhorner, Chng, Michaelis and Tang 2006).

The New Regulations apply to the following four forms of foreign invested banks established in China (Mallesons Stephen Jaques 2006a; 2006b):

- **wholly foreign-owned banks** (WFOE banks), wholly-owned by one foreign bank or jointly owned by several foreign banks,

- **joint venture banks** (JV banks), jointly funded by a foreign financial institution and one or more Chinese companies,

- **foreign bank branches** (branches of a foreign-incorporated bank),

- **representative offices of foreign banks** (Rep. offices).

Wholly foreign-owned banks, joint venture banks, and foreign bank branches are collectively treated as operational foreign invested banks. As opposed to the old regulations, the New Regulations no longer apply to foreign-invested finance companies and instead apply only to representative offices of foreign banks (superseding the Administrative Measures of Foreign-Invested Financial Institution's Representative Offices in China promulgated on 27 June 2002). The New Regulations further distinguish foreign invested bank branches from foreign bank branches, to which different rules now apply (Pinsent Masons 2006).

**Differences between locally and foreign incorporated foreign banks.** By increasing the capital requirements and limiting the business scope of foreign-incorporated bank branches in comparison to locally incorporated banks, the New Regulation encourages foreign banks to incorporate in China,

While WFOE banks and JV banks are now entitled to conduct wholesale and retail RMB business with all customers in all regions, foreign bank branches are limited in their business scope and may conduct only “large-volume” RMB business with Chinese citizens with a minimum deposit of RMB 1 million, thereby limiting their business to very affluent Chinese customers and keeping a large portion of the population out of the reach of foreign banks’ local branches. In addition, foreign bank branches are not allowed to engage in “bank card” business (KPMG 2008a; Pinsent Masons 2006; Mallesons Stephen Jaques 2006a; 2006b). All foreign banks (including foreign bank
branches) can engage in conversions and sales of foreign exchange subject to the approval by the People's Bank of China (Pinsent Masons 2006).

With the above limitations on the business scope of foreign banks branches in place, some industry observers (e.g. Lexsina 2007; Mallesons Stephen Jaques 2006a) predict that foreign banks targeting the mass market of Chinese individuals will have no choice but to incorporate in China as a WFOE or JV bank to fully exploit the growing market for retail banking services in China.

While the New Regulations have abolished the limitation that foreign currency deposits taken by a competent foreign invested bank should not exceed 70% of its total foreign currency assets held in the People’s Republic of China (PRC), the minimum registered capital for WFOE banks and JV banks has been significantly increased from (freely convertible currencies valuing at) RMB 300 million to RMB 1 billion or freely convertible currencies of the equivalent value (Pinsent Masons 2006). The minimum operational fund or working capital foreign bank branches should receive from their headquarters has been increased from freely convertible foreign currencies valued at RMB 100 million to RMB 200 million or freely convertible currencies of the equivalent value; and for branches of WFOE banks and JV banks, to RMB 100 million or equivalent. In addition, the aggregate operational funds used by a foreign invested bank to set up these branches should not exceed 60% of its total capital funds (KPMG 2008b, 2007; Pinsent Masons 2006). Table 1.2 compares several aspects of foreign bank branches and locally incorporated foreign banks in China.
Table 1.2: Comparison of several aspects of foreign bank branches and locally-incorporated foreign banks under the New Regulations

<table>
<thead>
<tr>
<th></th>
<th>Foreign bank branches</th>
<th>Locally-incorporated foreign banks (WFOE or Joint venture)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business scope</strong></td>
<td>Can only take fixed deposits of more than RMB 1 million from domestic PRC residents.</td>
<td>Can conduct full-scope business including credit cards business.</td>
</tr>
<tr>
<td><strong>Branch’s application for local currency business</strong></td>
<td>A branch needs to satisfy the “three years after commencement, two consecutive profitable years” requirement and other requirements as stipulated by State Council, and must apply individually.</td>
<td>Branches are qualified for full-scope local currency business as long as its Head Office has obtained local currency business license.</td>
</tr>
<tr>
<td><strong>Organisational structure</strong></td>
<td>Foreign Banks which have 2 or more branches in China are required to designate a management branch (similar to head office) responsible for managing and monitoring their business operations in China. Other non-designated branches are required to report to this branch.</td>
<td>All existing foreign bank branches will be restructured to form under a local head office with the permission to keep one other branch under overseas parent due to credit rating considerations for conducting wholesale foreign currency transactions.</td>
</tr>
<tr>
<td><strong>Regulatory ratios</strong></td>
<td>Not subject to the same regulatory requirement as Chinese domestic banks.</td>
<td>Subject to the same regulatory requirements as Chinese domestic banks with the grace period up to 31 December 2011 for loan to deposit ratio and 31 December 2009 for loan concentration requirement.</td>
</tr>
</tbody>
</table>
| **Registered capital/operating funds** | Minimum operating fund of RMB 200 million | • Minimum registered capital: RMB 1 billion  
• Minimum operating fund per branch: RMB 100 million |
| **Capital adequacy ratio** | Capital adequacy ratio for RMB business is calculated and regulated at branch level. | Capital adequacy ratio is calculated and regulated at the Head Office level. |

Source: Deloitte (2006); KPMG (2008b)

There have been complaints that the increased capitalisation requirements with regard to foreign banks’ operations and the impact on their business development are inconsistent with WTO regulations and with China’s commitment upon its accession into the WTO. However, China has justified these rules on the grounds of financial system security and prudential supervision and sees them as fully compatible with WTO rules (Lexsina 2007).

Operational foreign invested banks established prior to the enactment of the New Regulations are not required to meet the new requirements on registered capital and working capital provided that their client bases and business scopes remain unchanged. The New Regulations expressly require that the foreign investor of a WFOE bank and the key foreign investors of a JV bank must be commercial banks, whereas the Old Regula-
tions merely require the foreign investor to be a financial institution (Pinsent Masons 2006).

In addition, all foreign banks incorporated in China, like Chinese banks, have to fulfil certain requirements of the PRC Commercial Banking Law. These requirements include:

- Commercial banks must limit their loan-to-deposit ratios to 75 per cent or less. Foreign banks incorporated in China must meet this loan-to-deposit ratio by the end of December 2011.

- Foreign-invested banks should not lend more than 10 per cent of their capital to any single lender. Foreign-invested banks however enjoy a three-year grace period with regard to this requirement. In this grace period, foreign-invested banks are allowed to lend up to 25 per cent of their total capital to a single customer and its affiliated companies (Pinsent Masons 2006).

In addition, foreign-invested banks have two years to ensure that their computer systems comply with administrative regulations.

**Obtaining a banking licence in China.** In order to be able to engage in RMB business, WFOE banks, JV banks, and branches of foreign incorporated banks need to obtain the approval of the banking regulatory authorities of the State Council by satisfying several conditions, including (Wei 2007):

- having operated within China for at least three years prior to lodging the application, and

- having been profitable for two consecutive years prior to lodging the application.

Other requirements include an international track record, effective internal policies and procedures, including anti-money laundering measures, as well as approvals from home country regulators (KPMG 2007).

As an alternative to starting a new Chinese corporation from scratch, foreign banks can, provided they fulfill certain criteria, convert their standing branches into independent WFOE banks (Pinsent Masons 2006). Under the New Regulations the Chinese government will decide within a period of six months on whether it accepts or rejects the preliminary application for a WFOE bank. If the application is rejected, a formal explana-
tion for the decision will be given. If the application is accepted, the formal approval from the CBRC should then take an additional two months following the submission of all formal application materials. Once the formal approval for the establishment of a WFOE bank has been granted, the CBRC will issue a licence to the bank. Upon issuance of the licence, a public announcement of the commencement of the WFOE bank will need to be made in a newspapers designated by CBRC. The application process for setting up a JV bank typically entails a similar length of time for CBRC approval. However, unlike the conversion from branch to WFOE, there is no need to give a specific notice for the conversion under the joint venture process (KPMG 2007).

WFOE Banks and JV banks are no longer allowed to establish new representative offices in China. However, a foreign bank that converts its branches into a locally incorporated bank may keep its current representative offices (Mallesons Stephen Jaques 2006a; 2006b; Pinsent Masons 2006).

### 1.7.2 Characteristics of the German banking industry

This section provides a brief overview of the characteristics of the German banking industry as part of the situational context of this study.

The German banking system has some unique characteristics which sets it apart from other developed banking markets, such as the US or Australia. Among these characteristics are the following which will be briefly discussed below (Tolckmitt 2007; Cai 2006):

- The dominance of “universal banks”
- The “three-pillar-system”
- A high level of fragmentation
- A high level of state ownership
- The “House bank” principle.

**The dominance of “universal banks”**. Germany’s banking sector has traditionally been dominated by “universal banks”; which account for approximately 75% of the industry’s total business volume (Association of German Banks 2005; Grill, Perczynski, Grill 2007). The majority of German banks are typically active in the full range of banking activities including retail, wholesale and investment banking rather than specialising or being legally restricted to performing only certain activities. The existing regulations
require separate legal entities only for some types of business, such as life insurance companies, building societies and unit trust funds. However, the respective products can still be sold through the parent company’s branch network (Tolckmitt 2007; Association of German Banks 2005; Grill, Perczynski, Grill 2007).

**The three-pillar-system.** The German banking industry is often characterised by its traditional three-pillar system (Cai 2006; Hackethal and Schmidt 2005), which includes

- the group of private commercial banks
- the savings bank group and
- the cooperative bank group.

The three-pillar system distinguishes between the German banks based mainly on their legal and ownership structure, however other characteristics apply as well (Tolckmitt 2007; Brunner, Decressin, Hardy, and Kudela 2004).

The first group are the so called “private commercial banks” (Association of German Banks 2005; Grill, Perczynski, Grill 2007), which refers to the fact that these institutions are privately or publicly owned (as public limited companies) by individuals or other companies. According to the Association of German Banks (German: Bundesverband deutscher Banken), this includes both big and small banks, institutions which are operating worldwide and those with a regional focus, universal banks and banks specialising in individual lines of business (Association of German Banks 2005; Grill, Perczynski, Grill 2007).

The second group, the **savings bank group** (German: Sparkassen-Finanzgruppe) consist of regular savings banks (German: Sparkassen), the central savings banks which are called *Landesbanks* (German: Landesbanken) and other associated companies. The group comprises approximately 620 companies employing some 366,500 people, with a combined business volume of EUR 3,410 billion (DSGV 2010, 2009a; 2009b).

Most of the 431 municipal savings banks (as of December 2009) are owned by groups of municipalities. They offer universal banking services on a local or regional level with a focus on savings and lending products and enjoy leading market positions across a wide range of financial services provided to retail customers and SMEs in Germany. (Tolckmitt 2007; DBRS 2010). According to the German Savings Banks Association’s (German: Deutscher Sparkassen- und Giroverband or DSGV) website, “the savings banks are full-service banks, providing comprehensive banking services for personal,
corporate (especially SMEs and small traders), municipal and institutional customers” (DSGV 2009a).

The *Landesbanks* act as “central banks” to groups of savings banks and as bankers to the German state in which they are headquartered. Seven of the eleven German Landesbanks are jointly owned by regional groups of savings banks (via a savings banks association) and one or more German states, in which they operate (reflecting their origin as state banks). The other four *Landesbanks* are owned by other *Landesbanks* (Tolckmitt 2007; DSGV 2009b, 2010).

The *Landesbanks* are mostly active in wholesale banking. They are important lenders to SMEs and public-sector entities in their domestic regions. The *Landesbanks* are also significant participants in international loan syndication, securitisation, money markets, and asset-based financing. However, the recent financial crisis has forced several *Landesbanks* to undergo severe restructuring which will significantly change their profiles. As the rating agency DBRS points out, “the franchises of the Landesbanks vary. Some Landesbanks have successfully developed more diverse franchises; however, in aggregate the Landesbanks are more vulnerable to market dislocations than the savings banks” (DBRS 2010, p. 6).

The regional savings banks work together with their associated *Landesbanks* in a *division-of-labour* process, an arrangement in which the savings banks usually cater for retail clients and SMEs, while the *Landesbanks* focus on larger corporations, providing more complex and international services. In addition, they function as product specialists for the clients of their shareholding savings banks (DSGV 2009b).

According to the German Savings Banks Association’s website, *Landesbanks*

perform public functions and offer a wide range of services. Acting as central banks for the savings banks, they forge the link between savings banks and national and international banking systems by providing know-how in more complex products, joint ventures, efficient payment systems and liquidity management. They contribute to the cost efficiency of the savings banks by handling operations such as securities business and foreign payment transactions centrally (DSGV 2009b).

The regional savings banks usually don’t compete for the same clients because they are subject to the “regional principle” (German: Regionalprinzip), which confines them to serving the region of their shareholding municipalities. The competition with the
Landesbanks is also limited because of the division-of-labour cooperation between the savings banks and the Landesbanks (Krahnen 2005; DSGV 2009a, 2009b).

The ownership structure of savings banks and Landesbanks has some significant consequences for these institutions. The owners of the savings banks and Landesbanks, German municipalities in the former, and states and the savings banks themselves in the latter case, usually lack the resources to provide their savings banks or Landesbanks with additional equity which forces both types of institutions to seek other sources of funding (Schrooten 2009). The savings banks can usually rely on their strong deposit-gathering ability for funding. However, the Landesbanks with their largely wholesale business models, rely heavily on market funding, which makes them especially vulnerable to rising interest rates and market disruptions (DBRS 2010).

The savings bank group enjoys a strong combined position in the German banking market. This is demonstrated by their market share in core products, with a combined 43% share in retail customer deposits as well as in business lending at year-end 2009 (DBRS 2010). However, the recent financial crisis has strongly affected the savings bank group, with most losses occurring on the Landesbank-level. According to the rating agency DBRS, in 2008 the group recorded an overall net loss of EUR 5.4 billion. While the savings banks have remained profitable throughout the cycle and even recorded improved net profits of EUR 2.3 billion in 2009, the Landesbanks recorded a net loss of EUR 6.7 billion in 2008. While aggregated data for the Landesbanks is not yet available for 2009, based on the announcements of individual Landesbanks, all Landesbanks combined may post another aggregate loss for 2009, although some Landesbanks will probably remain profitable (DBRS 2010).

The third group, the cooperative banking group consists of regional cooperative banks (German: Volksbanken and Raiffeisenbanken), “central” cooperative banks and other associated companies. In 2008, the consolidated total assets of the cooperative banking group grew slightly by Euro 12.5 billion to Euro 1,024.8 billion. About 54.1 percent of the group's total assets are attributable to the regional cooperative banks (BVR 2009).

Like the savings banks, the regional cooperative banks are universal banks focusing on providing banking service to retail clients and SMEs. Like savings banks, they are usually only active in their own regions and as such don’t compete with each other. According to the German Association of Cooperative banks (German: Bundsverband der
Deutschen Volksbanken und Raiffeisenbanken, BVR), cooperative banks in Germany serve around 30 million customers (BVR 2010). Cooperative banks are usually owned by a larger number of “members” who in most cases are private individuals who are usually also customers of their respective banks (Tolckmitt 2007).

Similar to the savings banks, the regional cooperative banks work closely together with two central cooperative banks in a division-of-labour process, an arrangement in which the regional cooperative banks usually cater for retail clients and small and medium enterprises (SMEs), while the central cooperative banks focus on larger corporations, and provide more complex and international services, which the smaller cooperative banks would not be able to provide by themselves. In addition, they function as product specialists for the clients of the regional cooperative banks. Both central cooperative banks in Germany are majority-owned by groups of regional cooperative banks (Tolckmitt 2007; Grill, Perczynski, Grill 2007).

**A high level of fragmentation in the German banking industry.** One issue closely related to the three-pillar system and especially to the large groups of savings banks and cooperative banks is the high fragmentation of the German banking industry. In comparison to other developed banking markets, the German market is still one of most fragmented. At the end of 2006 it had more than 2,000 independent banks with over 46,000 branches. As a result, the German banking market has often been described as being “overbanked” and “overbranched”. However, in recent years there has been a clear trend towards reducing the number of independent banks via the mergers of banks within the three pillars (Tolckmitt 2007; Krahnen 2005).

**A high level of state ownership.** Another characteristic of the German banking industry is the relatively high degree of state ownership, due to the ownership structure of the savings banks, which are owned by municipalities, and the ownership structure of the *Landesbanks*, which are jointly owned by regional savings banks and one or more of the sixteen German states. One significant consequence of this high level of state ownership is that savings banks and *Landesbanks* are not strictly profit-maximising entities (Conglu 2006; Tolckmitt 2007). Instead, they are expected by their state owners to serve additional objectives. This “public mandate” includes serving the local business community by providing sufficient loans and payment transactions, or by providing basic banking services to low income households (Auerbach 2009).
The “house bank” principle. The house bank principle (German: Hausbankprinzip) refers to the close business relationship that many German corporations have traditionally forged with a single bank, with which they do most of their banking business. However, as Tolckmitt (2007) points out, recent research suggests that these close and almost exclusive relationships are beginning to dissolve and more and more German corporations have started to work closely with not just one but a number of different banks. Increasing competition from foreign banks approaching German clients appears to be one important factor in this development (Tolckmitt 2007).

1.8 Conclusion

This chapter laid the foundations for the thesis. It provided an overview of the research problem and introduced the specific research questions to be investigated. In addition, this chapter presented justifications for this research and briefly described and justified the choice of research methodology. Finally, this chapter discussed the delimitations of this study and outlined the structure of this thesis. Chapter 2 will now present a review of the extant literature with regard to the research problem.
2 Literature Review

2.1 Introduction

Chapter 1 introduced the main theme, structure and justification of this research. It also briefly described the methodology, delimitations, and key assumptions of this study. In addition, Chapter 1 provided information regarding the context of this study. This included an overview the development of the Chinese banking market and major laws and regulations affecting the entry and operating conditions of foreign financial services providers in the country as well as a brief overview of the German banking industry.

Chapter Two now provides a comprehensive review of the extant literature with regard to the research problem: market entry strategies of (German) financial services providers in China. This literature review has three main sections:

(1) Theoretical background

(2) Empirical research

(3) Framework development

Theoretical background. In the first section (2.2), a theoretical foundation for this study is built by reviewing (and synthesising) major theories, models, and frameworks which have been applied to the investigation, analysis, and explanation of firms’ internationalisation and their entry strategies into foreign markets. This theory review includes those theories or models (like the stage model or the OLI model) which have been developed specifically to explain firm internationalisation and foreign market entry, as well as “classic” economic theories and models from a wide range of research areas (like the transaction cost theory or the resource-based view) which were not initially developed to explain internationalisation and foreign market entry, but have been used to explain these phenomena.

Empirical research. The second section (2.3) of this literature review focuses on empirical research covering several major issues with regard to the internationalisation of banks and their entry into foreign markets. This includes the motives of banks to internationalise, their choice of entry mode, their choice of activities (which products and
services they offer and which regions and customers they serve) in foreign markets, and the challenges they face in their foreign ventures.

**Development of a conceptual framework.** Based on this two-part review of the extant theoretical and empirical literature, gaps in the literature and issues which are worth further research will be identified. In addition, a conceptual framework will be developed to guide the process of data collection and analysis and to structure the findings of this study and put them into perspective with regard to existing theories and models as well as the findings of other empirical studies that deal with similar or closely related issues. The structure of Chapter 2 is shown in Figure 2.1.
Figure 2.1: Structure of Chapter 2 (Literature review)

2. Literature Review

2.1 Introduction

2.2 Internationalisation and foreign market entry – a review of theories, models, and frameworks

2.2.1 Introduction

2.2.2 “Economic” approaches

2.2.2.1 The Transaction Cost approach

2.2.2.2 The Resource Based View

2.2.2.3 The Eclectic Framework

2.2.3 Selected “Process” approaches

2.2.3.1 Stage & Learning models and the Network approach

2.2.3.2 Contingency approach

2.3 Internationalisation and foreign market entry of banks – a review of empirical research

2.3.1 Introduction

2.3.2 Deregulation and Banking sector reform as a major background for the activities of foreign banks in China

2.3.3 Competition and Performance of foreign and Chinese banks in China

2.3.4 “Strategic Investors” and Chinese banks

2.3.5 Motives of reasons of foreign banks to enter the Chinese market

2.3.6 Entry mode (organisational form) of foreign banks (in China)

2.3.7 Activities (Market strategies) of foreign banks (in China)

2.3.8 Challenges for foreign banks (in China)

2.4 Development of a conceptual framework for the investigation of market entry strategies of financial services providers

2.5 Conclusion

Source: Developed for this research
2.2 Internationalisation and foreign market entry – a review of theories, models and frameworks

2.2.1 Introduction

The phenomena of firm internationalisation and foreign market entry have been extensively discussed in literature across several academic disciplines and from various different viewpoints (e.g. international marketing, strategic management, organisation theory, economics) in the last few decades. Studies connected with internationalisation and foreign market entry have been conducted on a wide range of related issues. Internationalisation research has even been criticised by some on the grounds that it is mainly being phenomenon-driven by scattered and only remotely connected topics (Peng 2001). The following themes, which are not mutually exclusive and sometimes overlap, appear to have attracted the most attention (Cumberland 2006; Ruzzier, Hisrich & Antoncic 2006; Zhao & Decker 2004; Fletcher 2001; Sarkar and Cavusgil 1996; Erramilli & Rao 1993):

- the factors or determinants causing internationalisation (on a macroeconomic level as well as on a firm level of analysis)
- the motives of firms to increasingly get involved in international activities (firm level of analysis),
- the process of internationalisation,
- the firms’ choice of foreign market entry mode,
- the firms’ activities and strategies in the foreign market, and
- the effects of foreign market entry on the host country.

Presumably because of the complexity and interrelations of these core topics and surrounding themes and subthemes, the literature does not provide a generally accepted theoretical model that could be applied to all of the above issues. Instead, a wide range of theories, models and frameworks has been applied and developed to understand and explain the core problems and the surrounding phenomena (Cumberland 2006; Fletcher and Brown 2005; Zhao & Decker 2004; Whitelock 2002; Coviello and McAuley).

Table 2.1 presents an overview of selected authors and their selection and classification of approaches for the topics of internationalisation and foreign market entry:
Table 2.1: Theories, models and frameworks applied to internationalisation and foreign market entry

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Theories and Approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Otto Andersen (1997)</td>
<td>- Chain of establishment model&lt;br&gt;- Transaction cost approach&lt;br&gt;- Eclectic framework&lt;br&gt;- Organisational capability perspective</td>
</tr>
<tr>
<td>Pan and Tse (2000)</td>
<td>- Gradual involvement model&lt;br&gt;- Transaction costs perspective&lt;br&gt;- Dunning’s eclectic paradigm</td>
</tr>
<tr>
<td>Whitelock (2002)</td>
<td>- Eclectic paradigm&lt;br&gt;- Transaction cost analysis&lt;br&gt;- Industrial network approach&lt;br&gt;- Business strategy approach</td>
</tr>
<tr>
<td>Zhao and Decker (2004)</td>
<td>- Stage of development model&lt;br&gt;- Transaction cost analysis&lt;br&gt;- Eclectic theory (OLI model)&lt;br&gt;- Organisational capacity model&lt;br&gt;- Decision making process model</td>
</tr>
<tr>
<td>Fletcher and Brown (2005)</td>
<td>- Dunning’s eclectic paradigm&lt;br&gt;- Transaction cost approach&lt;br&gt;- Stage approaches &amp; learning approaches&lt;br&gt;- Contingency approaches&lt;br&gt;- Network approaches</td>
</tr>
<tr>
<td>Ruzzier, Hisrich, and Antoncic (2006)</td>
<td>- Internalisation theory &amp; transaction cost approach&lt;br&gt;- Eclectic framework&lt;br&gt;- Monopolistic advantage theory&lt;br&gt;- Stage models of internationalisation&lt;br&gt;- Network approach&lt;br&gt;- Resource-based approach&lt;br&gt;- International entrepreneurship</td>
</tr>
<tr>
<td>Cumberland (2005)</td>
<td>- Internalisation theory &amp; transaction cost theory&lt;br&gt;- Eclectic paradigm&lt;br&gt;- Resource-based theory&lt;br&gt;- Stage models&lt;br&gt;- Contingency approach&lt;br&gt;- Network approach</td>
</tr>
<tr>
<td>Morschett (2006)</td>
<td>- Transaction cost approach&lt;br&gt;- Resource-based theory&lt;br&gt;- Stage models of internationalisation</td>
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Source: Developed for this research

Trend towards eclectic, integrating approaches. While various theories and models have been applied to the issues of internationalisation and foreign market entry, the trend has been to take a more eclectic approach and try to develop more contingent and
integrated frameworks which take into account classic economic, efficiency, and resource-based perspectives, as well as additional aspects, such as strategic, behavioural and other non-economic considerations (Sanchez-Peinado, Pla-Barber and Hébert 2007; Uiboupin 2005; Peng 2001; Coviello and McAuley 1999; Sarkar and Cavusgil 1996). At the same time, while the majority of studies have concentrated on examining simple bivariate relationships, more and more studies appear to be moving towards examining internationalisation and foreign market entry with a more multidimensional and holistic approach (Fletcher 2001; Sarkar and Cavusgil 1996).

Theoretical background. In this first section of the literature review, a theoretical foundation for this study is built by reviewing major theoretical models and frameworks which have been applied to the investigation and explanation of firms’ internationalisation and their entry strategies into foreign markets. As a starting point, this study will follow considerations by Cumberland (2005), Decker and Zhao (2004), and Benito and Welch (1994) in their approaches and divide the theories and models in question into two basic groups of economic approaches and process approaches (Figure 2.2).

Figure 2.2: Theories, models, and frameworks of internationalisation and foreign market entry reviewed in this research

The first group, the economic approaches are “classic economic theories” (Cumberland 2005, p. 5) of which two (the transaction cost approach and the resource-based view) were not developed specifically to address issues with regard to internationalisation and foreign market entry. However all have been considered to have some power to contribute to an explanation of the issues in question (Cumberland 2005).
The economic approaches usually discuss internationalisation and foreign markets in terms of a firm’s strategic choice of foreign market entry mode, location, and activities. Explanations proposed by economic approaches tend to emphasise rational and strategic decision-making criteria such as the involved costs, risks, and control ability. They also seem to implicitly assume that internationalisation and foreign market entry decisions basically consist of discrete alternative options, and occur at specific points in time (Jones and Coviello 2002). In addition, economic approaches are primarily “content-oriented” (Decker and Zhao 2004, p. 182) and focus on the identification of factors which influence firms’ choices with regard to internationalisation and foreign market entry decisions (Decker and Zhao 2004).

The second group, the process approaches focus on the process of firm internationalisation and foreign market entry. They tend to suggest a gradual development of internationalisation and often emphasise behavioural factors as driving forces behind a firm’s internationalisation and entry into a foreign market (Cumberland 2005; Decker and Zhao 2004; Jones and Coviello 2002). Thus, Coviello and McAuley (1999) also speak of an economics school and a behavioural school of internationalisation research.

2.2.2 Economic approaches

The first two approaches discussed below, the transaction cost approach (TCA) and Dunning’s eclectic framework basically consider firms as efficiency-seeking entities, which choose organisational forms that minimise costs, based on the idea of imperfect markets which leads to the integration of economic transaction in organisational structures (Cumberland 2005).

2.2.2.1 The transaction cost approach (TCA) and extensions

Within the last two decades the transaction cost theory (first developed by Williamson 1975 and 1985) has been applied regularly to the phenomena of internationalisation and foreign market entry (Anderson and Gatingnon 1986; Gatingnon & Anderson 1988; Hennart 1991; Erramilli & Rao 1993; Delios & Beamish 1999; Brouthers and Brouthers 2003; Brouthers and Nakos 2004).

The level of analysis of the TCA is the transaction and its related cost. The TCA suggests that asset specificity, behavioural uncertainties, and environmental uncertainties create two main types of costs for a firm, market transaction costs and control costs.
The TCA assumes that the objective of minimising the cost of a transaction (e.g. the cost of finding and selecting a transaction partner or the cost of contract negotiation, monitoring and enforcement) determines the governance mode or operation mode of a transaction. Firms will therefore try to internalise operations when doing so will mean that the costs of arranging and organising business transactions will be lower than the costs of market transactions (Morschett 2006; Ruzzier, Hisrich & Antoncic 2006). Bounded rationality and opportunistic behaviour of transaction partners are basic assumptions of the TCA (Williamson 1985). When applied to internationalisation and foreign market entry, the entry strategy is seen as a cost-minimising choice from among different forms of governance, covering the full continuum from market contracts, such as exporting or other non-equity modes, to establishing equity-based hierarchal structures like wholly owned subsidiaries in the foreign market (Cumberland 2005; Brouthers and Nakos 2004; Sarkar and Cavusgil 1996; Klossek and Nippa 2005).

According to the TCA, the core dimensions of the transaction are:

- **specificity** of the assets involved, for example specialised physical or human investments, that have little value outside the specific transactional relationship (Brouthers et.al. 2003),

- the **frequency** of the transaction. However, in entry mode studies, transactions are usually considered to be continuous, which makes the separate measurement of the frequency of the transactions unnecessary (Brouthers et. al. 2003; Erramilli & Rao 1993),

- **external uncertainty**, which refers to the risks associated with a foreign market; for example, uncertainty regarding the ability to enforce contracts or control other types of political and legal risks due to economic and political factors in the host country (Fletcher and Brown 2005),

- **internal uncertainty**, usually related to the level of control over the agent in the foreign market and his ability to exploit (free-riding potential) the relationship with the firm (Fletcher and Brown 2005; Brouthers and Nakos 2004).

These characteristics of the transaction usually represent the independent variables in the application of the TCA to internationalisation and the market entry problem (Cumberland 2005). The dependent variable, the mode of entry, has usually been defined by
the entrant’s level of control, based on the assumption that the concepts of control and organisational integration are closely related (Andersen 1993; Erramilli & Rao 1993).

According to the TCA, the benefits of higher control (higher organisational integration and lower market transaction cost) must be compared with the cost of higher integration, which requires a higher commitment of resources and higher internal control cost (Whitelock 2002). Based on the above assumptions, the TCA suggests that high-control modes of entry (e.g. wholly owned subsidiaries) should be chosen:

- when asset specificity is high, as the assets have limited other use and the firm needs to protect the advantages (e.g. proprietary knowledge or technology) those assets offer in the transaction in question (Whitelock 2002; Brouthers and Nakos 2004),
- when external uncertainty is low, as such conditions expose the resources committed by the investing firm to a lower risk and therefore allow equity-based, high-investment entry modes (Anderson and Gatingnon 1986; Erramilli and Rao 1993; Brouthers and Nakos 2004),
- when the free-riding potential of agents is high, for example when the number of potential partners in the foreign market is limited, which reduces competition between them and increases the risk of exploitation by the agent and as such increases the cost for stringent negotiation and supervision of contractual agreements (Whitelock 2002).

Conversely, lower-control modes (e.g. exporting, licensing, joint-venture) should be chosen when the market transaction costs are lower than the costs associated with organisational integration or when the involved level of risk does not justify the resource commitment of a high-control mode. According to the TCA, this should usually be the case:

- in markets with a low free-riding potential for agents due to high competition among potential partners, which forces them to perform efficiently because of the threat of replacement (Anderson and Gatingnon 1986; Whitelock 2002),
- when asset specificity is low, which reduces the costs of protecting the firm’s specific investment from competitors, because the knowledge required is less specific and widely available (Anderson and Gatingnon 1986; Brouthers and Nakos 2004) and in addition because lower asset specificity reduces the switch-
ing costs that accrue when the investing enterprise needs to change agents or modes of entry in a foreign market (Erramilli and Rao 1993; Brouthers and Nakos 2004), and

- when external uncertainty is high, since when committing additional resources by using a wholly owned subsidiary, a firm increases its exposure to external environmental risks, while when using a low-resource commitment strategy in an uncertain market, a firm can retain flexibility and, if necessary, switch partners or exit the market altogether, without losing too much (Anderson and Gatignon 1986; Erramilli and Rao 1993; Brouthers and Nakos 2004).

Many studies applying the TCA to internationalisation and foreign market entry have modified or extended the framework (Erramilli and Rao 1993; Andersen 1997; Zhao and Decker 2004). These modifications and extensions include, for example, the integration of both environmental and strategic factors into the TCA (Hill, Hwang and Kim 1990; Zhao and Decker 2004) and particularly a modification of the TCA to be applicable to the services industry (Erramilli and Rao 1993; Brouthers and Brouthers 2003).

Several studies reviewed by Erramilli and Rao (1993) find that asset specificity is indeed positively related to high control entry modes, which confirms the predictions of the TCA, which proposes that in the case of valuable transaction-specific assets, firms prefer high control entry modes to avoid being locked into a relationship in which they might be vulnerable to the opportunism of an external partner (Anderson and Gatignon 1986).

**Criticism of the TCA.** Despite being one of the major frameworks used in research with regard to internationalisation and market entry (Morschett 2006), researchers have repeatedly criticised the TCA for a number of shortcomings and limitations (Cumberland 2005; Zhao and Decker 2004; Andersen 1993). The concept of transaction cost is considered to be ambiguous and the costs themselves are difficult to measure (Zhao and Decker 2004; Cumberland 2006) and they usually cannot accurately be calculated until after the international operation has already been established (Andersen 1993). As such, a TCA-based analysis can only reveal limited implications for managers (Zhao and Decker 2004). Similarly, the variables of the TCA are not well defined and are difficult to measure in practice and therefore often have to be measured indirectly (Cumberland 2005; Andersen 1993). Other criticisms of the TCA include:
• The TCA seems to be more applicable to the clear alternative of using either the market or the organisational hierarchy as alternative mechanisms to coordinate economic transactions. It does not distinguish well between different degrees of partnerships with regard to the entry mode (Gatingnon and Anderson 1988; Andersen 1993) and has been less useful in explaining more complex multinomial choices among entry strategies (Erramilli and Rao 1993; Andersen 1993).

• The TCA does not consider government regulations, which usually limit and define the available modes of market entry in a foreign country (Gatingnon and Anderson 1988, Zhao and Decker 2004). As Erramilli and Rao (1993) point out, most studies applying the TCA to the entry decisions implicitly assume that the actual entry mode chosen by a firm reflects its desired level of control. However, restrictions imposed by the foreign market often effectively limit the entry modes available to the entering firm, causing significant differences in the desired and actually achieved levels of control.

• Finally, the TCA is criticised for not taking into account non-transaction benefits (Gatingnon and Anderson 1988; Zhao and Decker 2004).

2.2.2.2 The resource-based view and the organisational capability perspective

Resource-based view. The resource-based view (resource-based theory, RBV) is mainly based on Penrose’s theory (1959) on the growth of enterprises (Cumberland 2006). The RBV has been intensively discussed, especially in the strategic management literature. It has been further developed since the mid 1980s and especially in the 1990s (e.g. Wernerfeldt 1984; Barney 1991; Madhok 1997) and has emerged as an influential theoretical perspective in recent international business research (Peng 2001).

From an RBV perspective, the firm, rather than the industry or the transaction, is the focus of the analysis. Firms are viewed as complex organisational systems which develop competitive advantages based on individual bundles of specific resources and capabilities (Vernon-Wortzel and Wortzel 1997). According to the RBV, sustainable competitive advantages can materialise in the form of a cost advantage, a location advantage or a differentiation advantage. These advantages are based on the ownership or control over specific resources which enable the company to execute certain functions more efficiently or better than the competition (Grant 1991; Barney 1991) which in turn allows the achievement of above-normal returns in terms of market-based performance (e.g.}
market share) or financial-based performance (e.g. return on investment, creation of shareholder wealth) (Fahy and Smithee 1999; Wernerfelt 1984).

The RBV makes two basic assumptions concerning the allocation and transferability of resources (Barney 1991):

- Resources are heterogeneously allocated across firms, which is explained by differing firm histories or imperfect markets for resources (Fladmoe-Lindquist and Tallman 1997; Barney 1991). This leads to the observable level of heterogeneity and difference in performance among firms within the same industry (Cutcher and Wailes 2006).

- Resources cannot be transferred from one organisation to another without cost (imperfect resource mobility) (Barney 1991).

Based on these assumptions of resource allocation and transferability, the RBV makes two major arguments:

- Resources which are (1) rare and (2) valuable can produce a competitive advantage.

- If the same resources cannot be replicated easily by competitors (the resources are not imitable), cannot be substituted with other resources (the resources are not substitutable) and cannot be transferred (the resources are not available on the resource market), then these resources can produce a competitive advantage that can be sustained by the firm over time (Priem and Butler 2001; Barney 1991).

As a result, rarity and value of resources each represent a necessary but not sufficient condition for the creation of a competitive advantage, while non-imitability, non-substitutability, and non-transferability each represent necessary but not sufficient conditions for the sustainability of a competitive advantage (Priem and Butler 2001).

The literature offers several extensions and variations of the above list of characteristics that resources need to possess in order to act as the basis for competitive advantage. Grant (1991) identifies four determinants of the sustainability of competitive advantage: durability, transparency, transferability and replicability. Aiming to help managers to identify and evaluate their companies’ resources objectively, Collis and Montgomery (1995) add appropriability, substitutability and competitive superiority to this group. Amit and Schoemaker (1993, p. 38) list the eight desired characteristics of a firm’s stra-
tactic resources as complementarity, scarcity, low tradability, inimitability, limited substitutability, appropriability, durability and overlap with strategic industry factors. However, even if a resource is valuable, rare, and costly to imitate, it can only be the source of a sustainable competitive advantage if there is no strategically equivalent substitute which itself is not rare or costly to imitate (Barney, Write and Ketchen 2001; Fahy and Smithee 1999).

The literature also offers several ways to classify a firm’s resources. Grant’s (1991) classification differentiates between financial resources, physical resources, human resources, technological resources and reputation. Barney (1991) classifies resources into physical capital, human capital, and organisational capital. Fladmoe-Lindquist and Tallman (1997) add financial and political resources to this list to extend the approach from a more domestic focus to an international level.

According to the RBV, physical resources (e.g. plants, equipment, physical technologies) are seldom the basis for sustainable competitive advantages because they are easier to be copied or substituted. More likely sources of sustainable competitive advantages can be found among intangible resources. These include (besides rights or patents) especially the skills, knowledge and decision-making ability of the firms’ human capital and which form the basis for the firms’ capabilities (Fladmoe-Lindquist and Tallman 1997; Grant 1991).

The RBV emphasises the importance of organisational routines and experience in the creation of capabilities or skills and, in turn, competitive advantage (Ekeledo and Sivakumar 2004; Fahy and Smithee 1999). According to Grant, capabilities are based on “complex patterns of coordination between people and between people and other resources”. They are developed over time and sustained through experience (Grant 1991, p. 122).

The RBV considers the firm’s resources as the drivers of the firm’s business strategy (Ekeledo and Sivakumar 2004; Grant 1991). It assumes that firms cannot always pursue those strategies that are likely to offer the highest return for them but instead that they have to pursue strategies which can be supported by their pool of resources and capabilities. According to Grant (1991), firms develop their strategy based on a five-step process which includes (1) the identification and classification of the firm’s resources and (2) the identification and classification of the firm’s capabilities, (3) the analysis of
the profit-earning potential of those resources and capabilities, (4) the selection of a strategy that best exploits the firm’s resources and capabilities with regard to the existing external opportunities and (5) the identification of the firm’s base of resources and capabilities and the extension and upgrading in case of possible gaps in that base (see Figure 2.3).

Figure 2.3: A resource-based approach to strategy analysis according to Grant (1991)

1. Identify and classify the firm’s resources. Appraise strengths and weaknesses relative to competitors. Identify opportunities for better utilization of resources.

2. Identify the firm’s capabilities: What can the firm do more effectively than its rivals? Identify the resources inputs to each capabilities, and the complexity of each capability.

3. Appraise the rent-generating potential of resources and capabilities in terms of:
   a) their potential for sustainable competitive advantage, and
   b) appropriability of their returns.

4. Select a strategy which best exploits the firm’s resources and capabilities relative to external opportunities.

5. Identify resource gaps which need to be filled
   Invest in replenishing, augmenting and upgrading the firm’s resource base.

Source: Grant, 1991, p. 115

The RBV has also become an influential perspective in research on internationalisation and foreign market entry (Morschett 2006; Cumberland 2006; Zhao and Decker 2004; Ekeledo and Sivakumar 2004; Peng 2001; Fladmoe-Lindquist and Tallman 1997; Madhok 1997). In the RBV perspective, entry into a foreign market will be strongly influenced by the optimal use of the firm’s existing resources, the opportunity to extend the firm’s existing resource base, and the possibility of accessing the complementary resources of the firm’s partners (Morschett 2006).

Organisational capability approach. The organisational capability approach (OCA) is largely rooted in the RBV (Andersen 1997; Madhok 1997). It focuses primarily on the
capabilities or skills of the firm and explains internationalisation and foreign market entry based on the availability of knowledge and the ability to efficiently transfer capabilities and knowledge into the foreign market (Morschett 2006).

Market entry according to the RBV/OCA can be seen as a function of firm-specific resources and capabilities, home country and host country factors, the nature of the product and the degree of control sought by the firm, which both direct and limit the strategic choice of market entry mode (Ekeledo and Sivakumar 2004; Madhok, 1997).

According to the RBV/OCA, organisational routines as the basis of capabilities are not perfectly transferable across firm boundaries. Imitation of capabilities and skills is especially difficult, partly because they are difficult to articulate or teach, but also because the complementary organisational support structure can never be fully copied because of differing firm histories. Thus, the firms’ tacit know-how, which is mostly lodged in the firms’ employees, loses part of its value as a source of competitive advantages when it is transferred across firm boundaries to another business entity (Ekeledo and Sivakumar 2004; Madhok 1997).

Based on the above assumptions, the RBV/OCA suggests that a high-control mode of entry (e.g. wholly owned subsidiaries) should be chosen if the firm possesses a lot of tacit know-how, because the know-how has more value to the original owner which also possesses the complementary supporting capabilities in contrast to a potential licensee who would first need to replicate those complementary organisational capabilities (Madhok 1997). Other conditions which should lead to a high-control mode of market entry according to the RBV/OCA are the possession of firm-specific assets or capabilities which itself are the basis for strong competitive advantage. The need to protect an asset or capability to preserve a competitive advantage would discourage the possessing firm from using a collaborative entry mode (e.g. joint venture or licensing). Possible assets and capabilities which could be the source of a competitive advantage are proprietary technology, extensive geographic experience, specialised assets in the form of physical or human investments that only have value in a narrow range of uses, a special organisational culture, or a reputation for superior products, management or technology (Ekeledo and Sivakumar 2004).

In contrast, the RBV/OCA predicts a collaborative mode of entry (e.g. joint venture, licensing/franchising) if it improves the firm’s access to complementary resources or ca-
abilities such as target market specific knowledge, distribution channels, or easy access to local authorities, which can enhance the use of an existing resource or capability of the firm as a source of a competitive advantage (Ekeledo and Sivakumar 2004; Zacharakis 1997).

The RBV/OCA has also been applied to the foreign market entry of services firms which offer non-separable services that require simultaneity of production and consumption (Ekeledo and Sivakumar 2004; Erramilli and Rao 1993). Since it usually requires a higher investment to make a service available at multiple sites, according to the RBV, service firms are more likely than manufacturing firms to combine an entry mode of sole ownership or joint venture with licensing or franchising, because the licensee/franchisee then carries part of the investment (Ekeledo and Sivakumar 2004). Another example is local market knowledge or the lack of it. Since the marketing of services requires special knowledge of the target market, services firms that lack this resource are more likely than manufacturing firms to choose a collaborative entry mode as a way to gain access to local knowledge (Ekeledo and Sivakumar 2004).

The RBV/OCA has emerged as an influential framework within the research on internationalisation and foreign market entry. For example, the RBV/OCA has helped to increase understanding of the nature of the resources required to deal with the liability of “foreignness” (Barney, Wrigth and Ketchen 2001) or the role of top managers’ significant international experience as a valuable, unique resource that represents a firm-specific advantage which is difficult to imitate (Peng 2001). Since entering a foreign market successfully usually requires particular experience or knowledge, firms without that knowledge or experience are typically expected to be reluctant to enter foreign markets (Coviello and McAuley 1999). However, knowledge-based resources critical for foreign market entries do not necessarily have to reside within the boundaries of the firm – they can also be “rented” from specialised agents such as consulting firms acting as intermediaries in the process of internationalisation (Peng and Ilinitch 1998; Chi 1994). With regard to alliances in emerging economies between foreign and local firms, the RBV/OCA has helped to better understand the perspective of local partners, their motives to acquire certain capabilities from their foreign partners, and their criteria when selecting these partners (Peng 2001).

**Weaknesses and criticism of the RBV.** Despite its popularity in recent years, several limitations and shortcomings of the RBV have been pointed out in the literature (Cum-
berland 2006; Priem and Butler 2001; Fahy and Smithee 1999; Andersen 1997). For instance, a major criticism refers to the definition and measurement of the central concepts of the RBV. Fahy and Smithee (1999) criticise a certain level of ambiguity caused by weak taxonomies and the inconsistent and conflicting use of terminology. Capabilities and intangible resources are difficult to measure (Cumberland 2006; Barney, Wright and Ketchen 2001; Andersen 1997), and so is the identification of the exact source of a competitive advantage (Fahy and Smithee 1999). Thus the term “resource” may lose its explanatory value because everything that could be the possible source of an advantage becomes a resource (Cumberland, 2006, Priem and Butler, 2001). As a result, the RBV may offer only limited managerial guidance to CEOs and managers who want to enhance or manipulate the firm’s pool of resources based on an RBV analysis (Priem and Butler 2001).

The RBV has also been criticised for providing a static view of what is essentially a dynamic process, especially since a major concept of the RBV is the “sustainability” of a competitive advantage – the ability of the organisation to keep its advantage over a long time period (Priem and Butler, 2001; Fahy and Smithee, 1999).

Moreover, Fahy and Smithee (1999) point to the imbalance of conceptual work and empirical validation with regard to the development of the RBV. While most of the work that has been done on the RBV is conceptual, Fahy and Smithee (1999) emphasise the need for more studies to test the empirical validity of the RBV. However, since the idea of building sustained competitive advantages implies a long-term perspective and as such may require longitudinal analysis. Barney, Wright and Ketchen (2001) point out that this poses a real challenge for researchers.

The next approach being discussed, Dunning’s eclectic framework, is partly based on the RBV as well as the TCA.

### 2.2.2.3 The eclectic framework

The eclectic framework (also called Dunning’s eclectic framework, the ownership, location and internalisation model, OLI model), was introduced by Dunning (1977) and further developed by Dunning himself (1980, 1988, 1995, 1997, 2000) and other scholars who apply the model in their research (e.g. Hill, Hawang and Kim 1990; Kim and Hwang, 1992).
The eclectic framework, as indicated by the term “eclectic”, is the attempt to combine and integrate elements and concepts of various theories into one general framework to identify and analyse the factors influencing both the initial act of foreign market entry and the growth of foreign production (Cumberland 2006; Dunning 1988). Thus, the eclectic framework can be considered a synthesis of other theoretical models, incorporating elements of the economic theory of the firm, industrial organisation theory, international trade theory, the transaction cost approach, and the resource-based view as its main base (Zhao 2005; Axinn and Matthyssens 2002; Andersen 1997).

The eclectic framework makes two basic assumptions about factor endowment and market failure (Fletcher and Brown 2005):

- Different countries are endowed with different combinations of the various factors of production which can be mobile or immobile across national boundaries. This is seen as a major reason for internationalisation, as the more uneven the allocation of production factors across countries, the greater the likelihood of firms locating production in different countries.

- Different countries offer different political and economical conditions, which can lead to structural (e.g. market entry barriers) and transactional (e.g. economies of scale) market failure. This is seen as another reason for firms to locate production in different countries.

Both conditions are seen to be changing over time. The eclectic framework suggests that the market entry decisions of firms are based on the composition of three types of advantages, which are ownership advantages, location advantages and internalisation advantages (also referred to as OLI factors), as perceived by the firms:

- **Ownership advantages (O)**: In order to overcome the advantages of the domestic firms in the target market and to be able to compete with them, the investing firm needs to possess ownership advantages which are defined as assets or skills that are specific to the nature and the nationality of the owner (e.g. international experience, the ability to develop differentiated products) (Andersen 1997; Fletcher and Brown 2005).

- **Location advantages (L)**: Location advantages are defined as advantages that are specific to the country in question (the potential target market of the investment). Location advantages are usually more broadly defined and can include
the market potential or investment risk of the recipient country (Root 1994), its culture, its infrastructure or lower production cost (Andersen 1997), or the wide availability of a production factor that is essential to the activities of the investing firm (Cumberland 2006).

- **Internalisation advantages (I)**: A firm possesses internalisation advantages when it is more efficient for the firm to maintain the activity internally (to choose a hierarchical mode of operation) rather than to use the market mechanism (e.g. in the form of a licensing arrangements) when targeting a foreign market (Fletcher and Brown 2005; Cumberland 2006).

Thus, according to the eclectic framework, ownership advantages and location advantages represent necessary but not sufficient conditions for a firm to invest in a foreign operation. Only if the firm also possesses an internalisation advantage, which means it is more efficient for the firm to maintain the activity internally, should it invest in a foreign operation (Uiboupin and Sõrg 2006; Andersen 1997; Dunning 1988). Applied to the entry mode choice, the eclectic framework suggests that a firm will only choose an equity-based entry mode (e.g. a wholly owned subsidiary or joint venture) if all three conditions can be met (Braun 1988).

**Application of the OLI model to foreign bank entry.** The OLI model has been widely applied to investigate foreign direct investment and entry mode decisions and according to Zhao and Decker (2004) its basic assumptions have been supported by several studies. Although the model has mainly been used to analyse the foreign direct investment decisions of multinational enterprises (MNEs), it has also been applied to small and medium enterprises (SMEs), in the services sector (Javalgi, Griffith and White 2003; Brouters, Brouters and Werner 1996; Agarwahl and Ramaswami 1992) and also to the entry of foreign banks into emerging markets (Uiboupin and Sõrg 2006; Leung and Young 2005; Mutinelli & Piscitello 2001; Leung 1997).

For instance, based on an analysis of foreign bank entries into several Central and Eastern European countries (CEE countries), Uiboupin and Sõrg 2006 find that financial liberalisation in transition economies creates additional ownership and location-specific advantages that are additional pull factors for foreign banks. The authors suggest that during a banking crisis in a transition economy, when investors are moving their capital away from riskier investments towards safer investments, certain ownership advantages of foreign banks such as more advanced risk management, a better reputation, stronger
financial resources, and aid from parent banks, help foreign banks to gain market share in developing economies by benefiting from this “flight to quality” (Uiboupin and Sörg 2006, p. 11).

Another example of the application of the eclectic framework to the market entry of foreign banks into emerging markets is Leung (1997), who conducted an empirical analysis of factors contributing to the attraction of foreign banks to China in the pre-WTO period of 1980 to 1993, a time when access to the Chinese market was still highly restricted for foreign players. “Follow the customer” was the highest rated motive of foreign banks to enter China. The ownership advantages of asset size, international experience (measured by the number of countries in which a bank has branches and subsidiaries), and financial soundness (measured in the banks’ capital asset ratio) were found to significantly increase the likelihood of a foreign bank having established a presence in China. On the other hand, the location-specific advantages of the Chinese market (a potentially large retail market, financial incentives offered to the banks, and a rising security market) were not rated highly by the participating banks. In addition, the lack of well established regulations, the restrictions on capital movement, and political uncertainty were reported as the most important reasons keeping foreign banks from entering the Chinese market (Leung 1997).

Criticisms and shortcomings of the eclectic framework. In spite of being so widely applied, the eclectic framework has also been repeatedly criticised and the literature provides a lists of shortcomings and limitations (e.g. Cumberland 2005; Zhao and Decker 2004; Andersen 1997). Some authors have criticised the model for only offering very limited predictive ability, which is blamed on its lack of operational if-then relationships (Braun 1988), its large number of possible explaining variables (Andersen 1997), and its neglect of the relationships and interdependencies among the different factors influencing the market entry decisions (Andersen 1997; Macharzina and Engelhard 1991). In particular in comparison with the transaction cost approach, studies using the eclectic framework seem to be less specific and theoretically grounded (Andersen 1997). Other criticism of the eclectic framework include:

- In spite of the framework’s intention to integrate all important factors influencing market entry decisions, the eclectic model neglects the impact of competition and strategic factors (Zhao and Decker 2004) such as foreign direct investment...
in the form of the acquisition of a foreign competitor to reduce international competition (Braun 1988).

- The eclectic framework is solely a static model (Zhao and Decker 2004). Although it allows for the OLI factors to change over time (Braun 1988), these changes are merely seen as exogenous changes which can lead to a new equilibrium that can be compared to the previous status, but which does not truly reflect the dynamic process of foreign direct investment (Braun 1988).

- In its analysis of market entry decisions, the eclectic framework contains a bias toward the assumption of a strictly rational acting decider, or “homo economicus” and neglects behavioural aspects and situational contingencies surrounding the decision maker (Zhao and Decker 2004; Macharzina and Engelhard 1991).

As a result of its shortcomings and limitations, some authors consider the eclectic framework in its current form not to be a full theory, but merely a catalogue of factors of, and conditions for, foreign direct investment (Braun 1988), or an abstract analytical framework (Cumberland 2005).

### 2.2.3 Selected process approaches

The **process approaches** are the second category of theories and frameworks that have been regularly applied to the phenomena of internationalisation and foreign market entry.

Process approaches focus on the **processes** of internationalisation and foreign market entry. In contrast to the economic approaches which generally explain internationalisation as being based on rational economic analysis, process approaches often emphasise behavioural factors as driving forces behind a firm’s internationalisation and entry into a foreign market (Cumberland 2005; Zhao and Decker 2004). As such, Coviello and McAuley (1999) also speak of a behavioural school of internationalisation research.

#### 2.2.3.1 Stage and learning models, network approach

**Stage and learning models.** The various stage models (chain of establishment models, learning models) which can be found in the literature primarily date back to the “Uppsala model” based on the work of Johanson and Vahlne (1977) and Johanson and Wiedersheim-Paul (1975), which itself is partly based on the product life-cycle theory (Vernon 1966) and Penrose theory (1959) on the growth of enterprises. Newer elements
of the stage models can be traced to the resource-based view and the eclectic framework (Andersen 1997).

Generally, stage models propose a slow, incremental process of internationalisation with increasing levels of resource commitment, obligations and risk in each stage. Behavioural factors are considered to be a driving force behind the move from one stage to the next (Cumberland 2005). Johanson and Vahlne (1977) suggest that firms usually go through an internationalisation process of four stages: (1) no exporting, (2) exporting via an agent, (3) exporting through a sales subsidiary, and (4) manufacturing/production in the host country. Major underlying assumptions of the stage models include:

- The approach attempts to conceptualise “psychic distance” as a way to measure the cultural distance between countries or markets (Buckley and Casson 1998). Johanson and Vahlne (1977) define “psychic distance” as possible factors preventing the flow of information from one market to another, for instance different languages or differences in education, culture, business practices or economic development.

- Firms usually start their internationalisation with the entry mode that requires the least commitment of resources (Fletcher 2001) and first enter those foreign markets which are geographically or “psychically” closer to their home market, in order to avoid uncertainty and minimise risk (Johanson and Vahlne 1977; Araujo and Rezende 2004).

- Stage models differentiate between objective knowledge that can be taught and experiential knowledge which can only be learned through personal experience (Johanson and Vahlne 1977).

- The model assumes a continuous interplay between market knowledge and commitment to a particular foreign market. Increasing market knowledge leads to increased commitment which again increases the experiential knowledge. The result is a self-reinforcing mechanism of market knowledge development of the firm’s management. (Araujo and Rezende 2004). International involvement of the firm can therefore be seen as a function of increasing market knowledge and commitment.

Applied to internationalisation and the entry into foreign markets, stage models attempt to predict a firm’s entry mode based on the firm’s international involvement and in par-
A number of studies find strong support for basic assumptions of the stage model. For example, Langston and Teas (1976) find that the exporting behaviour of smaller US manufacturing firms correlates with their management’s foreign language skills and experience of living abroad, thus supporting the notion that “psychic distance” between home country and target market plays a role in the internationalisation behaviour of the firm. Other studies find support for the assumption that many firms follow a gradual and sequential process of internationalisation (e.g. Camino & Cazorla 1998; Juul and Walters 1987) and the idea that experience or experiential knowledge plays an important role in the internationalisation of firms (e.g. Chang and Rosenzweig 2001; Jiang and Beamish 2004).

The stage model approach has been credited in the literature for several accomplishments. Stage models focus on process or the path taken by firms in their internationalisation rather than a combination of variables which lead to a particular outcome (Araujo and Rezende 2004). Thus they are generally seen to be more dynamic than the “economic approaches” (Klossek and Nippa 2005). Secondly, besides economic considerations, stage models also take into account behavioural factors with regard to internationalisation and market entry decisions (Coviello and McAuley 1999). Finally, when it was developed in the 1970s, the stage model approach drew attention to the issues of learning and knowledge management which are currently “at the top of the research agenda of international business” (Araujo and Rezende 2004, p. 6).

**Criticism of the stage model approach.** On the other hand, several authors have criticised the stage model approach and have questioned its assumptions and explanatory power (Cumberland 2005; Andersen 1997):

- Stage models have been criticised for being deterministic by assuming that a specific stage of development is always the basis for the next stage, while management’s ability to make a different strategic choice when entering a foreign market is ignored (Andersen 1997; Root 1994). For example Johanson and Vahlne (1977) ignore the possibility of cooperative entry modes (e.g. joint ventures) in their chain of establishments (Cumberland 2005).
The main explanatory variable of the stage model approach, experiential knowledge, is not considered to be sufficient enough by itself to explain the market entry choice of a firm, which could also be influenced by other factors (Petersen and Pedersen 1997; Andersen 1997). In addition, firms could increase their critical knowledge not only by experience and learning, but also by imitation or acquisition of other firms (Forsgren 2002).

The original stage model suggested that experiential knowledge is developed as a result of the relationships between the firm’s subsidiary unit in the host country and external players such as buyers and suppliers located in this market (Johanson and Vahlne 1977). It did not consider that a firm would also have the option to gain knowledge through its sister subsidiaries and external actors in other markets which then could be used in the host market in question (Araujo and Rezende 2004). Johanson and Vahlne (1990) later expanded their model and included multilateral relations and especially inter-firm relationships as a source for management’s knowledge development.

Since stage models suggest a slow, incremental process of internationalisation, they don’t appear to be well suited to explain more direct and rapid forms of internationalisation among firms (“born globals”), which operate in international markets from the earliest days of their establishment and enter foreign markets with joint ventures or wholly owned subsidiaries rather than exports (Ruzzier et al. 2006; Zhao and Decker 2004).

Some scholars suggest that stage models made more sense in the 1970s when they were first developed and in the early 1980s when international business did not play as big a role as it does today. Thus, stage models are less applicable in today’s globalised world with its easy access to methods of internationalisation. In addition, the concept of “psychic distance” is also being questioned because of an increasing cultural homogeneity in many countries (Leonidou and Katsikeas 1996; Bell 1995).

In addition, the results of several studies could not provide empirical support for the stage model approach. Some studies argue that stage models do not seem to be valid for services industries (Blomstermo, Sharma and Sallis 2006; Johanson and Vahlne 1990; Erramilli 1990). As Erramilli (1990) points out, many services are being performed and consumed simultaneously at the same location, requiring some physical “brick and mor-
tar” facilities, which makes the export of these services impossible. Blomstermo, Sharma, and Sallis (2006) support this argument. The authors find that some service firms are more likely to choose high control entry modes than others. They suggest that a stronger foreign presence allows these service firms to become familiar with the requirements of foreign buyers, to better manage buyer-seller interactions, as well as to better adapt their services to meet buyers’ requirements. Johanson and Vahlne (1990) themselves suggest that the inherent differences between manufacturing and service firms mean that a context-specific approach is needed to explain service firms’ internationalisation and foreign market entry.

Other critics suggest that the model is geographically limited and very closely connected to the Swedish/Nordic context and region where it was initially developed and therefore less applicable to explain the internationalisation behaviour and market entry choice of firms which are based in other countries (Araujo and Rezende 2004).

**Network approach.** Evolving from the stage model perspective and also partly as a result of the above criticism of stage models, the network approach has recently emerged as another popular perspective for investigating internationalisation and foreign market entry, particularly with regard to SMEs (Ruzzier, Hisrich and Antoncic 2006; Johanson and Mattsson 1993). Besides some similarities with the stage model perspective, the network approach also draws on concepts of the RBV. Among the assumptions of the network approach is the dependence of the individual firm on resources controlled by others. By entering a network and establishing a position in that network, firms can gain access to resources which are in the possession of other network members (Cumberland 2005). Other important preconditions for networks to evolve include a certain level of complementarity between the long-term goals of the parties involved (Easton 1992).

According to the network approach, internationalisation and foreign market entry is a process that takes place through networks of relationships with other players, such as clients, suppliers, competitors, and consultants, but also family and friends. Thus, the network incorporates both formal business relationships and informal social relationships (Coviello and McAuley 1999). As such, network relationships are considered to be more important in the process of internationalisation and the entry into foreign markets than strategic decisions (Johanson and Vahlne 1992). From the network perspective, internationalisation of the firm can be achieved through extension by creating relationships in foreign country networks which are new to the firm, through penetration by
developing relationships and by increasing resource commitments in those networks in
which the firm already has a position, or by connecting the existing networks in differ-
ent countries (Johanson and Mattson 1988).

Literature has recognised that the network approach offers a new perspective on various
issues. For instance, the network approach can explain how the resources necessary for
internationalisation can be acquired through network relationships (Vissak 2004). As
such it sheds light on the internationalisation of SMEs, which lack the resources usually
considered to be necessary to successfully enter foreign markets (Ruzzier et. al. 2006).
The same can be said with regard to the phenomenon of rapid internationalisation by
firms with no, or very little, prior international experience, which can also be explained
by the access to resources offered by a firm’s network (Loane and Bell 2006). In addi-
tion, the network approach has been credited for going beyond the analysis of dyadic re-
lationships by emphasising the relevance and contributions of other internal and exter-
nal actors within the network in the internationalisation process of a firm. As such, the
network approach also draws attention to the often neglected implementation of interna-
tionalisation decisions (Sydow, Windeler and Wirth 2003; Vissak 2004).

Several empirical studies confirm the importance of networks in the internationalisation
process. For example, Rutashoby and Jaensson (2004) investigate the internationalisa-
tion of small firms in Tanzania, which traditionally lack resources and relevant interna-
tional experience. The authors find that the small firms investigated strongly benefited
from their network relations, especially with regard to access to foreign market inform-
ation, training, and financial resources in the form of loans. The authors also empha-
sise the need for developing countries’ governments to facilitate the development of
networks as a way to support their countries’ struggling economies (Rutashoby and
Jaensson 2004). Investigating entrepreneurial firms from Australia, Canada, Ireland and
New Zealand, Loane and Bell (2006) find that a large number of firms either actively
use already existing networks or build new networks to develop their knowledge of in-
ternational markets and improve their international competitiveness.

Criticism and limitations. The criticisms of and limitations attributed to the network
approach include the following: It has been argued that the network approach is descript-
tive and possesses only vague predictive power. It has also been claimed that several
aspects of networks are not sufficiently covered. For instance, the network approach
does not explain how to create relationships, or how a network position is established

54
and developed over time. In addition, other important factors like the decision maker or other firm characteristics which influence the internationalisation and foreign market entry are neglected (Vissak 2004; Cumberland 2005). Other criticisms of the network approach concern the definition and operational measurement of concepts of the network approach, for example the strength of the bond between two network organisations (Easton 1992). Finally, the network approach appears to underestimate the issue of opportunism which will almost inevitably arise in collaborations among potentially competing firms (Duschek 2004; Cumberland 2005).

2.2.3.2 Contingency approach

The contingency approach (CA) has become a major theoretical model for analysing complex organisations in dynamic environments (Lemak and Wiboon 1997) and especially for explaining the success or failure of organisations (Donaldson 2001). The CA can be traced back to the works of several scholars (e.g. Burns and Stalker 1961; Lawrence and Lorsch 1967; Thompson 1967) and its emergence and development can partly be seen as a reaction to and criticism of other organisational theories dominant in the 1950s (e.g. Taylor 1947; Brech 1957) which assume that there is “one-best-way” for a company to organise itself in a given industry environment to reach maximum returns (Jennings, Rajaratnam & Lawrence 2003; Zeithaml, Varadarajan and Zeithaml 1988).

The basic assumption of the CA is that the economic performance of an organisation is mainly influenced by a “fit” between organisational characteristics, such as its structure, and contingencies which reflect the situation of the organisation and which may include environmental factors as well as the organisation’s size and its strategy (Donaldson 2001). Thus, research based on a CA has been trying to show that organisations which accomplish a high degree of “fit” with these contingencies perform significantly better than those which do not (Klaas 2004). Over the years several studies, covering a wide range of different contingencies on which performance at the organisational and the sub-organisational level are thought to be dependent, have substantially supported the CA (Donaldson 2001; Klaas 2004).

The CA assumes that for each situation that requires a decision, there is not one universal “right choice” but several appropriate options based on situational contingencies. As a result, one can observe wide variations in effectives, for instance concerning the way to organise effectively, to lead effectively, or to enter a foreign market effectively.
Literature Review

(Zeithaml et. al. 1988). Thus the CA abandons the goal of being a theory with universal validity, but tries to make more operational predictions at a mid-range level of abstraction concerning the relationship of context, strategy and performance. Specifically, the CA tries to:

- identify the relevant contingency factors for a given decision situation,
- analyse the alternative options for action, and
- among those alternatives, choose the option which provides the best performance under the given circumstances (Olavarria 2001; Staehle 1976; Zeithaml et. al. 1988).

The CA is often applied using a framework which includes the following set of variables (e.g. Jenner 1994; Lehner 1990; Setzer 2001):

- **Context variables** (also called contingency variables) describe the external and internal environment of the organisation, which usually cannot be influenced or controlled by the organization (at least not in the short run). Management literature often classifies the PESTLE factors (Political, Economic, Socio-cultural, Technological, Legal, and Environmental) as contingency variables in strategy development (e.g. Armstrong 2006; Johnson and Scholes 1999). In addition, some organisational variables such as product differentiability, asset mix or cost structure which can be relatively fixed and therefore difficult for the organisation to change in the short run, can also be considered context variables (Hambrick and Lei 1985). Context variables are usually the independent variables in a contingency framework (Olavarria 2001; Setzer 2001).

- **Design variables** (also called response variables) represent or model the different options for action (e.g. organisational or managerial actions) available to the organisation, which have to be evaluated and decided on by the organisation. Depending on the actual research question, design variables can be independent or dependent variables (Olavarria 2001; Zeithaml et. al. 1988).

- **Performance variables** measure the performance of the chosen and implemented management options, using economic measures (e.g. return on investment, return on assets) or non-economic measures (e.g. market share, customer satisfaction) (Jennings et al. 2003; Klaas 2004) which are appropriate to evaluate the “fit” between context variables and design variables for the situation under con-
sideration. Performance variables usually represent the dependent variables in a CA framework (Setzer 2001; Zeithaml et. al. 1988).

- **Intervening variables** are sometimes included in contingency frameworks to represent subjective factors like the decision makers’ preferences, goals and expectations, which allows adding a behavioural science perspective to the CA analysis (Setzer 2001; Lehner 1990; Kumar & Subramaniam 1997).

The goal of a CA study is usually to come to the following conclusion: in a given contextual situation X (rather than situation Y), a course of action A (rather than action B) is best suited to accomplish goal Z. In order to reach such a conclusion, usually several groups of hypotheses are proposed. First, the presumed relations between certain courses of action (design variables) and the relevant context variables are explored. In this first step, the design variables are the dependent variables. Then, in a second step, the relations between the alternative courses of action and the performance variables are explored, with the design variables this time being the independent variables. Finally, a combination of all three types of variables is used to analyse which courses of action achieve a certain performance in a given situation (Olavarria 2001; Jeschke 1993; Jenner 1994).

Applied to internationalisation and the entry into foreign markets, the CA suggests that an organisation will choose the market entry strategy which it assumes to be the most suited to reach its goals (e.g. profitability, market share) by offering the best “fit” with the firm’s internal resources and capabilities (Gao 2004; Davidson 1980; Erramilli 1991; Root 1994), its strategic goals and objectives (Hill, Hwang & Kim 1990) and several external environmental factors (Ekeledo and Sivakumar 1998; Erramilli and Rao 1993).

The CA is more a descriptive than a normative approach, because its focus is not on the mechanism used to select the entry strategy, but on which design variables provide the best “fit” with the contingency factors. Therefore, various studies that use other (more normative) theories or frameworks to explain the entry strategy choice can also be considered to be using a contingency perspective, because they define the choice of entry strategy as a function of various internal or external factors (e.g. Ekeledo & Sivakumar 1998, pp. 276–277). Thus, Hofer (1975) suggests that previous research implies that “any theory of business (corporate) strategy must be a contingency theory” (Hofer,
1975, p. 786), because business strategy always depends on an organisation’s resources and the environmental circumstances.

When applied to the market entry strategies of services firms, Ekeledo and Sivakumar (1998) propose a contingency framework which, besides internal and external factors, also incorporates product classification to differentiate between hard and soft services. Jack, As-Saber, Edwards, and Buckley (2008) stress that many offerings are actually compositions of product and service elements and suggest that the degree of separability and the embeddedness of the service elements have to be taken into account as additional contingencies for the choice of market entry strategy.

**Criticism and weaknesses.** Several aspects of the CA have been controversially discussed in the literature. A major point of criticism is that of determinism (Olavarria 2001; Donaldson 2001; Staehle 1989; Schreyoegg 1980) in the sense that according to the contingency perspective, the organisation is left without choice and its actions are determined by its environmental contingencies because of the need to achieve “fit” and performance (Donaldson 2001). Defenders of the CA argue that by including behavioural factors in the form of intervening variables like the perceptions, preferences and goals of the decision maker, the effects of contingencies are limited, and managerial decision-making intervenes between the objective situation and the structure chosen by the organisation (Donaldson 2001; Olavarria 2001).

In addition, research based on the CA has been criticised for not being clear about applied research designs and their validation (Klaas 2004). While considerable effort has been directed towards the identification of the relevant context variables within the different sub-themes of management, the selection of an inevitably limited number of potentially relevant context variables remains a major problem in studies based on the contingency approach, which when being flawed may lead to flawed managerial implications being drawn from that research. The same can be said about the selection and measurement of performance variables. Since organisational effectiveness can be measured in various ways (e.g. return on investment, productivity, profit or customer satisfaction), the choice of performance variables may strongly influence the outcome of a study based on the contingency approach (Olavarria 2001; Zeithaml et. al. 1988).

Some researchers have pointed out that the core concept of the CA, the “fit” between characteristics of the organisation, its strategy and other contingency factors is not
equally important in every industry and every development stage of an industry, which limits the useful application of the CA (e.g. Barth 2003). Porter (1980) for example argues that “rapid growth tends to mask strategic errors” which allows companies in misfit to “survive and even to prosper financially” (Porter 1980, p. 241). In contrast, in mature industries, a competitive strategy is usually much more based on a sound knowledge and understanding of the external conditions (e.g. customers, competitors and suppliers) and internal conditions (e.g. resources and capabilities, procedures and costs) of the firm’s environment (Barth 2003), which makes the CA more applicable to mature industries.

This first part of Chapter 2 reviewed major theories, theoretical models, and paradigms which have been applied to the investigation and explanation of firms’ internationalisation and their entry strategies into foreign markets. The second part of the literature review will now focus on empirical research covering several major issues with regard to the internationalisation of banks and their entry into foreign markets in general and China in particular.

2.3 Internationalisation and foreign market entry of banks – a review of empirical research

2.3.1 Introduction

In the first section (2.1) of Chapter 2, a theoretical foundation for this study was built by reviewing and discussing major theories, models, and frameworks which have been applied to the investigation and explanation of firms’ internationalisation and their entry strategies into foreign markets. This theory review included those theories or models (like the stage model or the OLI model) which have been developed specifically to explain firm internationalisation and foreign market entry, as well as other theories and models from a wide range of research areas (like the transaction cost theory or the resource-based view) which were not initially developed for applying to firm internationalisation and entry into foreign markets, but which have also been used to investigate and explain these phenomena.

This second part (2.2) of the literature review now focuses on empirical research covering several major issues with regard to the internationalisation of banks and their entry into foreign markets in general and China in particular. The entry of foreign banks into
China was preceded by, and is now accompanied by, major efforts by the Chinese authorities to **deregulate** and **reform** the country’s massive banking sectors. As such, these issues have received considerable attention in the literature (e.g. Kumbhakar and Wang 2007; Brean 2007; Farrell, Lund and Morin 2006; Garcia-Herrero, Gavila and Santabarbara 2006). In addition, several studies concerning the development and reform of the Chinese banking sector also touch on related topics like the **performance** and **competitiveness** of foreign and Chinese banks in China and the issue of foreign banks acting as “**strategic investors**” and taking minority ownership of Chinese banks and what that means for the organisations involved (e.g. Song 2009; Chen 2008; Xu and Nellis 2008; Hawes and Chiu 2007; Wu, Chen and Lin 2007; Berger, Hasan and Zhou 2009; Fu and Heffernan 2005; Leung, Young and Rigby 2003; Bonin and Huang 2002; Li, Liu, Liu and Whitmore 2001).

After this review of topics which provide the major background for the activities of foreign banks in China, the literature with regard to the **main research topics** of this study is reviewed. These topics include:

1. the **motives** of banks to internationalise and enter foreign markets,
2. their choice of **entry mode** form,
3. their choice of **market strategy** or **activities** (e.g. the products and services they offer and which regions or customers they serve) in foreign markets,
4. the **factors** which influence the choices of entry mode and activities, and
5. the **challenges** they face in their foreign ventures.

The existing research on the entry of foreign banks into China is still very limited. In order to provide a comprehensive overview of the above stated main research topics of this study, this review also draws on research focused on other regions, especially the world’s three major developing regions of Latin America, Central and Eastern Europe and greater Asia.

### 2.3.2 Deregulation and banking sector reform as a major background of the activities of foreign banks in China

The deregulation and reform of the Chinese banking sector and the growing entry of foreign banks into China are closely connected, as reform and deregulation can be seen as preconditions for the entry of foreign banks in China and they can also be seen as be-
ing further driven by the entry of these banks. Thus, it should be no surprise that various authors have focused on the nexus of banking sector reform and the entry of foreign banks into China.

Previous research has found that especially in transition economies, state ownership of banks often negatively effects economic growth, productivity, and financial development (e.g. Dobson and Kashyap 2006; Bonin, Hasan, Wachtel 2005; La Porta, Lopez de Silanes, and Shleifer 2002). In addition, the literature on economic growth in developing countries consistently finds that growth is strongly and positively related to efficient financial markets and legal systems, indicating for China that the high rates of economic growth the country has been enjoying for the last two decades may not continue indefinitely without major reform measures in the banking sector (Berger, Hasan, and Zhou 2009; Bonin and Huang 2002; Lardy 1998). Farrell and Lund (2006) estimate that the Chinese economy loses up to US$321 billion a year in GDP due to various deficiencies in its financial sector.

The ongoing reform process in the Chinese banking sector can be divided into three main areas (Garcia-Herrero, Gavila and Santabarbara 2006; Hawes and Chui 2007):

1. The restructuring of Chinese banks, through the cleaning-up of non-performing loans (NPLs), capital injections by the government, and the transfer of knowledge and expertise in several areas from foreign “strategic investors”,

2. Gradual financial liberalisation in terms of reducing price controls and opening up the banking market for foreign competition, and

3. Strengthened financial regulation and supervision in combination with efforts to improve corporate governance and transparency.

These reform measures have been widely discussed in the literature. While the efforts of the Chinese government to reform the country’s banking system are being acknowledged (e.g. Dobson and Kashyap 2006; Setser 2006), many scholars remain sceptical and strongly suggest additional and more far-reaching reforms to be undertaken (e.g. Dobson and Kashyap 2006; Setser 2006; Farrell, Lund and Morin 2006; Farrell and Lund 2006; Garcia-Herrero et. al. 2006; Bekier, Huang and Wilson 2005).

**Government influence.** Dobson and Kashyap (2006) for example, question China’s approach of a “gradual” banking reform, which has been undertaken by several former command economies in order to prevent widespread unemployment. Various authors
(e.g. Dobson et. al. 2006; Farrell, Lund and Morin 2006; Farrell and Lund 2006; Bekier et. al. 2005), are particularly critical of the still existing practice of “policy lending”, where lending decisions at Chinese banks are not based purely on the perceived creditworthiness of a potential borrower, but on policy objectives, political goals or personal connections. Moreover, many executives in Chinese banks are still, essentially, political appointees and owe their loyalties to the traditional powers in government and the communist party (Li et. al. 2001). As a result of their analysis, Dobson and Kashyap (2006) suggest that various government levels continue to influence local banks, thus sustaining the tension within these banks between management’s desire to make business decisions based on commercial considerations and the pressure to support political objectives like keeping high levels of employment by giving policy loans to loss-making SOEs. Flawed loan-pricing is aggravating this problem. Many Chinese banks still price their loans too low, encouraging over borrowing by many SOEs, which leads to excess capacity and inefficient investments in many industries (Farrell, Lund and Morin 2006). As a result, many Chinese banks have been turning into inefficient, low-margin, low-growth businesses, while creating a new generation of non-performing loans. Similar concerns are put forward by Garcia-Herrero et. al. (2006) and Bekier, Huang and Wilson (2005).

Setser (2006) compares China’s current situation with that of the South-East Asian booming economies in the mid 1990s and suggests that many recent loans will only continue to perform as long as China’s banks continue to lend, other firms continue to invest and the Chinese economy continues its strong growth. While China may not be vulnerable to a repeat of the Asian financial crisis of the 1990s, Setser fears trouble from a shock to China’s real economy, pointing out that investment growth will have to slow down at some point in the future. Moreover, as Setser (2006) points out, having fought against an often demanded appreciation of its currency, China would not be able to count on an RMB depreciation in the case on an economic downturn.

**Risk management and corporate governance.** Besides the continuing influence of the various government levels, several authors point to the lack of advanced risk management skills and fundamental components of good corporate governance in many Chinese banks (e.g. Bekier, Huang and Wilson 2005, Garcia-Herrero et. al. 2006). Examples of poor risk management skills include the assessment of creditworthiness, the audit of loan portfolios including the proper identification and reporting of non-
performing loans (NPLs), and the collection of collaterals (Bekier et. al. 2005). With regard to the introduction of better corporate governance, some of the measures adopted seem to have focused mostly on China’s largest banks which were scheduled to go public, leaving out hundreds of smaller regional banks and credit corporations, which still account for more than a third of all banking assets in China (Bekier et. al. 2005).

Besides the deregulation and reform of China’s banking sectors, other major topics with regard to the entry of foreign banks into the Chinese market discussed is the literature refer to the performance and competitiveness of foreign and Chinese banks and foreign banks acting as “strategic investors” and taking minority ownership of Chinese banks and what that means for the organisations involved.

2.3.3 Competition and performance of foreign and domestic banks in China

Foreign direct investment (FDI) in the financial sectors of emerging market economies (EME) has strongly expanded in the last 15 years (Domanski 2005). Previous research (e.g. Aysan and Ceyhan 2006; Moreno and Villar 2005; Cardenas, Graf, and O’Dogherty 2004) suggests that emerging market economies (EMEs) benefit from the entry of foreign banks in several ways, especially through the inflow of additional capital, advanced management techniques, (especially with regard to risk management), new technologies, and innovative products as well as through the benefits of increased competition. As a result, FDI into the financial sector of many EMEs has led to higher efficiency, better pricing and improved economic and financial stability in these countries (Domanski 2005; Moreno and Villar 2005).

However, from the perspective of a host country with a desire to protect its industry from too much foreign competition, some additional impacts of the entry of foreign banks may be considered less desirable. Some recent studies from developing countries suggest that foreign banks often enjoy higher interest rate margins and usually outperform their domestic rivals (Cardenas, Graf, and O’Dogherty 2004; Clarke, Cull, Peria and Sanchez 2003). While an increase in competition in general may still be welcomed, the governments of some developing economies may worry about the sustainability of the domestic banking industry in the face of aggressive foreign entrants (e.g. Boning and Huang 2002).
The degree of foreign bank penetration differs widely across developing regions (see Table 2.2). The privatisation of state-owned banks (especially in the Czech Republic, Hungry, Poland, Brazil and Peru) and the need for recapitalisation of the financial system (for example in Mexico and Korea) have been major driving forces of foreign bank penetration in the last 20 years in many Latin American countries and especially in Central and Eastern Europe (Moreno and Villar 2005; Domanski 2005), giving foreign banks in some of these countries control of 80% or more of total banking assets.

Table 2.2: Share of bank assets held by foreign banks

<table>
<thead>
<tr>
<th>Region</th>
<th>1990¹</th>
<th>2004²</th>
<th>Percentage of GDP</th>
<th>In billions of US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central and Eastern Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0</td>
<td>80</td>
<td>49</td>
<td>13</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>10</td>
<td>96</td>
<td>92</td>
<td>99</td>
</tr>
<tr>
<td>Estonia</td>
<td>97</td>
<td>89</td>
<td></td>
<td>11</td>
</tr>
<tr>
<td>Hungary</td>
<td>10</td>
<td>83</td>
<td>67</td>
<td>68</td>
</tr>
<tr>
<td>Poland</td>
<td>3</td>
<td>68</td>
<td>43</td>
<td>105</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>2</td>
<td>4</td>
<td>71</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>89</td>
<td>72</td>
<td>344</td>
<td>570</td>
</tr>
<tr>
<td>India</td>
<td>5</td>
<td>8</td>
<td>6</td>
<td>36</td>
</tr>
<tr>
<td>Korea</td>
<td>4</td>
<td>8</td>
<td>10</td>
<td>65</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td>18</td>
<td>27</td>
<td>32</td>
</tr>
<tr>
<td>Singapore</td>
<td>89</td>
<td>76</td>
<td>148</td>
<td>159</td>
</tr>
<tr>
<td>Thailand</td>
<td>5</td>
<td>18</td>
<td>20</td>
<td>32</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>10</td>
<td>48</td>
<td>20</td>
<td>31</td>
</tr>
<tr>
<td>Brazil</td>
<td>6</td>
<td>27</td>
<td>18</td>
<td>107</td>
</tr>
<tr>
<td>Chile</td>
<td>19</td>
<td>42</td>
<td>37</td>
<td>35</td>
</tr>
<tr>
<td>Mexico</td>
<td>2</td>
<td>82</td>
<td>51</td>
<td>342</td>
</tr>
<tr>
<td>Peru</td>
<td>4</td>
<td>46</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1</td>
<td>34</td>
<td>9</td>
<td>9</td>
</tr>
</tbody>
</table>

¹Percentage share of total bank assets

Source: Domanski 2005, p. 83

In light of these developments, the opening-up of the Chinese banking market leads various scholars to ask questions about how foreign and Chinese banks will perform in the changed environment and how their competition will play out (e.g. Wu, Chen, Lin 2007; Kumbhakar and Wang 2007; Leung and Chan 2006; Fu and Heffernan 2005; Jiang, Locke and Willette 2003; Leung, Young and Rigby 2003; Bonin and Huang 2002; Li, Liu, Liu and Whitmore 2001). Within this context, several authors also look at the effect that different forms of ownership (in the case of China especially foreign “strategic investors”) are having on the performance of their local partners (e.g. Wu,
2.3.3.1 Performance of domestic and foreign banks in China

To date, relatively little research has been conducted on the factors and/or attributes affecting the performance of Chinese banks and foreign banks in China. This may partly be due to the limited availability of data on the subject, particularly with regard to detailed financial information (Hope and Hu 2006). A study by Li, Liu, Liu and Whitmore (2001), examines the financial performance of Chinese banks before China’s WTO entry, using financial ratio analysis. The authors’ analysis shows that state-owned commercial banks had a lower profitability in terms of return on assets (ROA) and return on equity (ROE) than joint-stock banks, resulting from their higher ratio for non-interest expenses and lower interest margins. While data limitations prevented the authors from analysing the risk profiles of the banks in more detail, they find that Chinese banks in general achieve lower returns despite taking higher financial risks than banks in Western economies (Li et. al. 2001).

Another study based on pre-WTO entry figures was conducted by Leung, Young and Rigby (2003). The authors studied 33 foreign banks in Shanghai between 1990 and 2000 and examine internal and external factors influencing the time it took for branches of these banks in Shanghai to achieve a positive rate of return after entering the market. They find that particular bank characteristics (interpreted by the authors as ownership-specific advantages) including (1) having a large parent bank, (2) an early entry into the Shanghai market, which was first selectively opened to foreign banks in 1990, and (3) a high market penetration in China (measured in the number of additional branches the bank had in China) were found to reduce the time it took for a branch to become profitable. A strong Asian background (in terms of being headquartered in Asia or having a branch network in Hong Kong), as well as having a large potential home-country client base (measured in FDI in Shanghai from the bank’s home country) did not significantly affect the time taken to attain profitability. In addition, the authors looked at external factors or market conditions in Shanghai (interpreted by the authors as location-specific advantages), and found that both, rising total FDI in Shanghai, and declining foreign interest rates were reducing the time it took foreign bank branches in Shanghai to become profitable (Leung, Young and Rigby 2003).
The authors conclude that having an Asian background is not sufficient enough for a foreign bank to be successful in China. They suggest that foreign banks should work with local staff in order to replace expensive expatriate staff and reduce credit risk using the local staff’s personal relationships and knowledge of the local conditions. Since international interest rates have a strong impact on profits, Leung et al. argue that foreign banks should try to generate more revenue from fee-based products and services. In addition, foreign banks should not depend solely on clients from their home country but need to attract business of clients from other countries as well (Leung et al. 2003).

In a recent study on the performance of Chinese banks, Wu, Chen and Lin (2007) find that a bank’s age has a negative effect on its performance, measured in ROA. The authors suggest that accumulated “legacy problems” in terms of human resource management and fund utilisation are the main reasons, while “younger” banks appear to have less historical baggage to deal with. The study also finds that a higher ratio of non-interest revenue is also associated with a lower ROA, reflecting the lack of experience of Chinese banks in the fee-generating business, leading to a low profitability of such efforts. In addition, a bank’s asset size was found to have a significantly negative effect on ROA. Here the authors suggest that Chinese banks have tended to concentrate on asset growth and the scales of their operations, while neglecting asset quality, operational profitability, and loan collateral. Finally, a rising GDP per capita has a positive impact on the banks’ ROA, leading the authors to conclude that a continuously growing Chinese economy will help the domestic banks to eventually reach higher levels of ROA.

With the expansion of foreign direct investment (FDI) in the financial sectors of emerging market economies in the last 15 years (Domanski 2005), the competitive positions of the entering foreign banks and the host country banks has come into the focus of researchers (e.g. Berger, Hasan, and Zhou 2009; Boning and Huang 2002). This is the topic of the following section.

2.3.3.2 Competitive advantages and disadvantages of foreign and domestic banks in China

Foreign banks and domestic banks in China possess a number of advantages and disadvantages relative to one another (Berger, Hasan, and Zhou 2009). Especially since China’s entry into the WTO and the subsequent gradual opening up of the country’s banking market, the competitive positions of both foreign banks and domestic banks have
been discussed in the literature, with sentiments ranging from fear about the ability of the weak domestic banks to survive to questions about whether or not more than a handful of foreign banks can achieve profitability in a market which still poses a lot of regulatory challenges for new entries (e.g. Metcalfe 2009; Leung and Chan 2006; Bonin and Huang 2002). There appears to be some consensus however on the sources of potential competitive advantage and disadvantage for foreign and domestic banks.

**Competitive advantages of Chinese banks.** Despite the increasing usage of online-banking (e.g. Pikkarainen, Pikkarainen, Karjaluoto and Pahnila 2004) and other automated banking facilities and the developments banking technology, the existing extensive “bricks and mortar” branch network of many domestic banks in China (especially the “big four” and the city banks) is still seen as a major advantage for these banks (e.g. Hansakul 2007; Leung and Chan 2006; Podpiera and Leigh 2006; Bekier and Lam 2005, Jiang, Locke and Willette 2003). While the number of foreign banks’ branches increased from 192 in 2003 to almost 450 in 2007, the presence of foreign banks in terms of branches is still very small compared to local banks. The “big four” alone have more than 70,000 branches across the country (KPMG 2008a). Evidence from Central and Eastern Europe suggests that foreign banks find it easier to gain market share in the credit and loans business than in the area of deposits. Bonin and Huang (2002) argue that this can be partly accredited to the extensive branch network of many domestic banks, which still seems to offer an advantage in the collection of household deposits.

Another competitive advantage of Chinese banks pointed out by several scholars (e.g. Leung and Chan 2006; Jiang et. al. 2003; Bonin and Huang 2002) are their long-standing relationships with domestic customers, which have an average duration of nine years in small cities and 12 years in big cities (Bekier and Lam 2005). The long-standing relationships are also the basis for another advantage. Coupled with a better knowledge of the market conditions in China, and the lack of credit bureau data outside of Shanghai, these relationships improve the Chinese banks’ ability to better assess the risks associated with lending to local clients (von Emloh and Wang 2004; Jinag et. al. 2003).

In addition, as Jinag et. al. (2003) point out, while there is a cultural gap between foreign banks and Chinese customers, Chinese banks have an advantage because they share a cultural base with most of their customers. This is especially important in retail banking, which requires significant attention to culture and communication.
Finally, previous research from Central and Eastern Europe with regard to interest rates spreads suggests that foreign banks need to gain a threshold level of banking asset-ownership, before much competitive pricing pressure is felt by the domestic competition (Bonin and Huang 2002). However, the market share of foreign banks in China has remained at a rather low level of around 2% in recent years (Metcalfe 2009; 2007).

**Competitive disadvantages of Chinese banks.** The literature on the weaknesses of foreign banks to a great extent mirrors the issues raised in the literature on the current situation of China’s banking sector, discussed above. Despite improvement in recent years, many Chinese banks continue to suffer from several weaknesses. Underperforming loans still burden many institutions while flawed **lending practices** continue to exist and advanced **risk management** and fundamental components of good **corporate governance** are still missing in many banks (Hansakul 2007; Bekier, Huang and Wilson 2005; Fu and Heffernan 2005; The Boston Consulting Group 2002). With regard to **cost management** and **budgeting controls**, Fu and Heffernan (2005) find that many state-owned banks in China are characterised by rather lax cost controls and “soft” budget constraints. Similar deficiencies are found in a study by The Boston Consulting Group (BCG 2002), which reveals a lack of oversight and accountability in many Chinese banks as well as the absence of appropriate expense approval processes. As mentioned above, various levels of **government** continue to **influence** local banks within their reach, especially in lending decisions to state-owned enterprises (Dobson et. al. 2006; Farrell, Lund and Morin 2006), but also with regard to other areas, including the geographic area which the banks are expected to serve (e.g. some unprofitable rural areas) and the level of employment they are supposed to maintain (Jiang et. al. 2003; Li et. al. 2001), leading to higher costs and lower efficiency.

While domestic banks still serve the vast majority of retail clients (KPMG 2007), several authors suggest that they are in danger of losing the most profitable retail segments. While the number of affluent households is rapidly increasing, the wealth among individuals in China is still highly concentrated. In terms of the number of wealthy individuals, recent estimates say that about 2% of the Chinese population owns around 60% of the country’s privately held wealth, and very affluent customers only make up about 2% of retail customers of Chinese banks (KPMG 2008a; Achhornor, Chng, Michaelis, and Tang 2006). In terms of geographic location, three quarters of the very affluent individuals live in Beijing or in one of the major coastal cities like Shanghai and Guangzhou.
Foreign banks had already started to target this highly profitable segment before they were allowed to be involved in RMB business in China (von Emloh et. al. 2004). Now that foreign banks can become licensed to offer RMB products to Chinese individuals, and with their higher quality in customer service and greater experience of serving the affluent market, this niche segment is seen by many in the literature as a major target for foreign players (e.g. KPMG 2007; Achhorner et al. 2006; von Emloh et. al. 2004; Jiang et al. 2003).

Furthermore, many Chinese banks have not been able to serve the country’s broader middle class segment of retail customers efficiently. In turn, according to von Emloh and Wang (2004), about 80% of customers in the mass market segment are largely still unprofitable, because the banks lack risk-assessment skills in retail lending and a sales-and-service culture in their operations (BCG 2002). Moreover, Jiang et. al. (2003) finds that many Chinese banks often do not really know who their most profitable and unprofitable customers are, because they still lack advanced accounting systems, which can be used for profitability accounting, data mining or integrated channel management. As a result, many Chinese banks are not able to make full use of the profit potential of their customer base. These findings are supported by BCG (2002) and von Emloh et. al. (2004) with regard to retail banking in China, and by Beshouri (2003) with regard to corporate banking in Asia in general.

On the revenue side, most Chinese banks still rely heavily on income from interest, which typically yields lower risk-adjusted returns than fee-based products. In 2003, the non-interest or fee-based income of Chinese banks represented only about 11% of total revenue, compared with an average of 48% for the global banking market and up to 75% for US banks (Brennand, Tang and Beal 2005; Beshouri 2003; BCG 2002). The difficulties of Chinese banks in the area of fee-based products and services are confirmed by a recent study by Wu, Chen and Lin (2007). The study finds a higher ratio of non-interest revenue is associated with a lower ROA, thus, as suggested by the authors, reflecting the lack of experience of Chinese banks in fee-generating businesses.

The demand for traditional banking products like deposits and loans is expected to fall due to the development of more advanced capital markets in China in the near future (von Emloh et. al. 2004). Surveys conducted by Metcalfe in 2005 and 2007 among foreign banks in China find that fee-based products in particular are expected to grow in both retail banking as well as wholesale banking (Metcalfe 2007, 2005). In order to
make up for reduced income from interest, Chinese banks will have to work hard to expand their product portfolio beyond deposits and loans and find ways to increase their revenues from fee-based products and services such as cash management, trade finance or treasury (Bennand et. al. 2005; Beshouri 2003).

**Competitive advantages of foreign banks.** So far, relatively little research been done on the competitive situation of foreign banks in China. Again, a possible reason may be that the Chinese banking market was only recently opened up for foreign competition. Naturally, some of the advantages/disadvantages of foreign banks discussed in the literature mirror the discussion of the disadvantages/advantages of the domestic banks in China. The literature that deals with the competitive situation of foreign banks in China seems to give more attention to the disadvantages, with a focus on the challenges which foreign banks still face in the Chinese market. A possible explanation for this could be a widely held notion that foreign banks hold a natural advantage in many areas over their Chinese competitors; after all, it is also the major rationale for the encouragement (discussed below) of foreign banks by the Chinese government to become “strategic investors” in Chinese banks (Hawes and Chui 2007; Berger et. al. 2009). According to the literature, these areas of competitive advantage include for example access to capital (Berger, et. al. 2009), cost management and cost reduction (Leung et. al. 2006), risk management and pricing (Berger et. al. 2009; Leung et. al. 2006; Bekier et. al. 2005; Jiang et. al. 2003), customer service, segment tailored and integrated services (Metcalfe 2009; Bekier et. al. 2005; von Emloh et. al. 2004; Jiang et. al. 2003), fee-based products (Bekier et. al. 2005, Beshouri 2003; BCG 2002), product sophistication and innovation (Achhorner et. al. 2006; Bekier et. al. 2005; BCG 2002), corporate governance (Berger et. al. 2009; BCG 2002) foreign currency funding (BCG 2002), international networks (Jiang et. al. 2003; BCG, 2002), and technology (Berger et. al. 2009). In addition, foreign banks in China can often maintain their existing relationships with clients from their home countries, making it very difficult for Chinese banks to win foreign customer accounts (Jiang et. al. 2003).

**Competitive disadvantages of foreign banks.** Previous research with regard to the entry barriers and challenges which foreign banks are facing in the South-East Asian region suggest that these barriers and challenges can be classified into legal or regulatory, economic, and cultural. Among the legal and regulatory barriers, previous studies list certain regulations which restrict the activities of foreign banks, for example with regard
to local currency business, refinancing, geographic areas, and licences for specific forms of deposits and loans, as well as foreign exchange control laws (e.g. Metcalfe 2009; American Chamber of Commerce 2008; Metcalfe 2007; Soukhov 2001).

The greatest impetus of foreign banks’ activities in China so far has been the deregulation of the Chinese banking market. However, according to several scholars and foreign banks active in China, regulatory issues still remain the greatest challenges for foreign banks operating in China (Metcalfe 2008, 2007; Achhorner et. al. 2006). In particular, high capital requirements to operate branches which are allowed to serve Chinese customers in the local currency may discourage some foreign banks from entering the newly opened and highly anticipated RMB market for Chinese individuals (KPMG 2007; Leung and Chan 2006, Leung and Young 2005).

The availability and cost of RMB funds poses another obstacle for foreign banks to participate in this market by constraining their operational capabilities. The amount of local currency foreign banks can loan to their customers is restricted and that restriction is connected to the amount of deposits collected. Since most foreign banks lack a big branch network to collect larger amounts of deposits, they depend on outside sources of funds. Because of the absence of RMB convertibility on capital accounts, foreign banks rely for access to local currency on the tightly controlled Chinese inter-bank market which is dominated by the “big four” banks. This situation makes it especially difficult for foreign banks to use pricing as a competitive tool, particularly in the loan market (Bonin and Huang 2002; Leung and Chan 2006; Leung and Young 2005). Another example of regulatory issues concerns the continuing need for foreign banks to engage in lengthy negotiating processes with the CBRC before being able to launch new products (Leung and Chan 2006).

The importance of regulation and currency controls is confirmed in a recent survey (Metcalfe 2008) by executives of 42 foreign banks in China when they are asked about their major concerns of the Chinese banking system. Moreover, the regulatory environment was also seen as the most difficult aspect of banking in China, followed by finding and keeping good personnel. Another major issue for foreign banks in China according to the literature is the lack of a nationwide comprehensive system of credit records, making it extremely difficult for foreign banks to assess a potential borrower’s financial credibility outside of Shanghai, especially in the retail banking market (Qi 2010; Xu and Liu 2006; Chan, Fung and Liu 2007; Metcalfe 2007).
Examples of cultural barriers for foreign banks discussed in the literature are the bank managers’ relative lack of personal relationships or guanxi (Soukhov 2001; Graham and Lam 2004; Guthrie 1998), as well as their inexperience in dealing with different levels of the Chinese government bureaucracy (Ambler and Witzel 2004, Blackman 2001).

A more competitive environment has been one of the major objectives of China’s reform efforts ever since the inception of the open-door policy in 1978. The competition in the Chinese banking market is fuelled even more by the introduction of foreign investors as one of the possible ways for China to effectively restructure its banking sector and improve the competitiveness of its banks (Hope, Laurenceson, and Qin 2008). The impact of foreign “strategic investors” on Chinese banks is discussed in the following section.

2.3.4 “Strategic investors” and the performance of Chinese banks

As mentioned above, some theoretical research as well as previous empirical research suggest that FDI into the financial sector of an emerging market economy (EME) has a positive effect on that country’s financial sector efficiency (e.g. Hope, Laurenceson and Qin 2008; Domanski 2005; Moreno and Villar 2005). As part of its efforts to reform the banking sector in China and strengthen the local banks, the Chinese government in 2003 updated regulations to encourage foreign banks to become “strategic investors” in Chinese banks, without the local bank surrendering majority control to the foreign shareholders. In January 2004, the cap for a single foreign owner of a domestic bank was lifted from 15% to 20% and from 20% to 25% for all foreign investors combined. In addition, in order to act as new sources of capital, foreign investors are also expected to provide and transfer specific skills, management expertise, professional ethics and technology to their Chinese partners (Hawes and Chui 2007; Berger et. al. 2009; Hansakul 2007).

So far, relatively little research has been done on the ownership-performance nexus with regard to the Chinese banking industry, and in particular with regard to the effect that “strategic investors” have on the efficiency or performance of the Chinese banks they become shareholders of. Some recent studies appear to support the rationale of the Chinese government’s policy, however there are also some contradicting results.

In their study on the effects of different ownership types on the cost efficiency of four state-owned banks and ten joint stock banks in the period of 1985–2002, Fu and Heffer-
nan (2005) find that joint-stock banks are more efficient than state-owned banks. The authors suggest that the differences in efficiency can be partly explained by the proportionately greater cost incurred by state-owned banks when they update their technology, due to the much greater number of branches and sub-branches in state-owned banks in comparison with joint-stock banks. In 2002 there were just under 100,000 branches and sub-branches of state-owned banks in contrast to 5,068 for joint-stock banks. In addition, the authors suggest that state-owned banks are likely to be less cost effective because they are expected to support certain political objectives and are subject to “soft” budget constraints. By contrast, even though the central and local governments remain key shareholders in the joint-stock banks, these banks have been subject to relatively “hard” budget constraints (Fu and Heffernan 2005).

Similar results are presented by Kumbhakar and Wang (2007) in their examination of factors impacting the technical efficiency and total factor productivity changes of 14 national banks in China over the period 1993–2002. They found that private ownership in joint-equity banks improved technical efficiency, with these banks being, on average, 43% more efficient than wholly state-owned banks.

Berger et. al. (2009) examine data of 38 Chinese banks with different ownership-structures for the period of 1994–2003. For both profit and cost efficiency, foreign minority ownership by foreign banks of Chinese banks was found to be associated with significantly improved efficiency. The results also suggest that the efficiency improved after the foreign investor became a shareholder, rather than just because banks which were already more efficient were selected for investment. According to the authors, anecdotal evidence suggests that skill transfers via the training of banking staff and the influence of the foreign owners via board membership are possible mechanisms for foreign minority shareholders to achieve efficiency improvements (Berger et. al. 2009).

A study conducted by Wu, Chen and Lin (2007) does not, however confirm the above results with regard to the positive effect of foreign investors. Based on a sample of 14 Chinese banks in the period of 1996–2004, the authors examine the impact of foreign banks’ ownership on the operational performance (measured in return on assets) of Chinese banks. Controlling for bank age, bank size, share of non-interest income and some macroeconomic factors, the study finds that the ROA for Chinese banks with foreign shareholders was lower than the ROA of Chinese banks without foreign shareholders. As possible explanations for their results, the authors suggest that the minority-
stakeholder limits of 20% for a single foreign investor and 25% for all foreign investors combined make it difficult for foreign banks to exert significant influence over the operational management of Chinese banks. In addition, they speculate that foreign banks may not necessarily always invest in already high-performing Chinese banks.

A recent study by Hope, Laurenceson and Qin (2008) offers some explanations for the above inconsistent results with regard to the impact of direct investments of foreign banks in China. The authors find that while Chinese banks may benefit from foreign strategic investors in the long run, the acquisition of shares in a local banks initially leads to a culture shock which together with other lingering factors may impede the transfer of management knowledge into the Chinese banks and delay the generation of synergies (Hope et. al. 2008).

A list of selected significant investments of foreign banks in Chinese banks can be found in Table 2.3.

Table 2.3: Strategic investments of foreign banks in Chinese banks

<table>
<thead>
<tr>
<th>Chinese bank</th>
<th>Foreign investor</th>
<th>Stake (as %)</th>
<th>USD (million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Everbright Bank</td>
<td>Asian Development Bank</td>
<td>3</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>IFC</td>
<td>4.9</td>
<td>19</td>
</tr>
<tr>
<td>Bank of Shanghai</td>
<td>HSBC</td>
<td>8</td>
<td>63</td>
</tr>
<tr>
<td></td>
<td>IFC</td>
<td>7</td>
<td>47</td>
</tr>
<tr>
<td>Nanjing City Commercial Bank</td>
<td>IFC (will be reduced)</td>
<td>15</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>BNP Paribas</td>
<td>19.2</td>
<td>87</td>
</tr>
<tr>
<td>Shanghai Pudong Development Bank</td>
<td>Citigroup (may increase to 19.9)</td>
<td>4.6</td>
<td>67</td>
</tr>
<tr>
<td>Quingdao International Bank</td>
<td>Hana Bank</td>
<td>72.3</td>
<td>25</td>
</tr>
<tr>
<td>Ping An Bank</td>
<td>HSBC</td>
<td>27</td>
<td>N/A</td>
</tr>
<tr>
<td>Bank of Communications</td>
<td>HSBC</td>
<td>19.9</td>
<td>1747</td>
</tr>
<tr>
<td>Minsheng Bank</td>
<td>IFC</td>
<td>1.6</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>Temasek Holdings</td>
<td>4.6</td>
<td>110</td>
</tr>
<tr>
<td>Industrial Bank</td>
<td>Hang Seng Bank</td>
<td>15.9</td>
<td>208</td>
</tr>
<tr>
<td></td>
<td>IFC</td>
<td>4</td>
<td>52</td>
</tr>
<tr>
<td></td>
<td>GIC Special Investments of Singapore</td>
<td>5</td>
<td>65</td>
</tr>
<tr>
<td>Shenzhen Development Bank</td>
<td>Newbridge Capital (will drop)</td>
<td>18</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>GE Capital (pending)</td>
<td>7.3</td>
<td>100</td>
</tr>
<tr>
<td>Jinan City Commercial Bank</td>
<td>Commonwealth Bank of Australia</td>
<td>11</td>
<td>17</td>
</tr>
<tr>
<td>Xian City Commercial Bank</td>
<td>IFC</td>
<td>12.5</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Bank of Nova Scotia</td>
<td>12.4</td>
<td>N/A</td>
</tr>
<tr>
<td>Tianjin Bohai Bank</td>
<td>Standard Chartered</td>
<td>19.9</td>
<td>123</td>
</tr>
<tr>
<td>Bank Name</td>
<td>Strategic Investors</td>
<td>Equity Investment</td>
<td>Number of Branches</td>
</tr>
<tr>
<td>---------------------------------------------</td>
<td>----------------------------------------------------------</td>
<td>-------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>China Construction Bank</td>
<td>Bank of America, Temasek Holdings</td>
<td>9.1, 5.1</td>
<td>2500, 1460</td>
</tr>
<tr>
<td>Bank of China</td>
<td>Royal Bank of Scotland, Merrill Lynch, Li Ka-Shing, Tamasek Holdings, UBS, Asian Development Bank</td>
<td>10, 5, 5, 1.6, 0.2</td>
<td>3100, 1500, 1500, 500, 75</td>
</tr>
<tr>
<td>Bank of Beijing</td>
<td>ING Group, IFC</td>
<td>19.9, 4.9</td>
<td>215, 54</td>
</tr>
<tr>
<td>Hangzhou City Commercial Bank</td>
<td>Commonwealth Bank of Australia, Asian Development Bank</td>
<td>19.9, 4.9</td>
<td>78, 30</td>
</tr>
<tr>
<td>Nanchong City Commercial Bank</td>
<td>German Investment and Development Bank (DEG)</td>
<td>10, 3.3</td>
<td>4, 1.5</td>
</tr>
<tr>
<td>Tianjin City Commercial Bank</td>
<td>ANZ Bank</td>
<td>19.9, 3.3</td>
<td>120, 89</td>
</tr>
<tr>
<td>CITIC Bank</td>
<td>Banco Bilbao Vizcay Argentinia</td>
<td>5, 0.2</td>
<td>648, 54</td>
</tr>
<tr>
<td>Nan Tung Bank</td>
<td>Morgan Stanley</td>
<td>100</td>
<td>N/A</td>
</tr>
<tr>
<td>Chongqing Commercial Bank</td>
<td>Carlyle Group, Dah Sing Bank</td>
<td>8, 10</td>
<td>N/A, 31</td>
</tr>
<tr>
<td>United Rural Cooperative Bank of Hangzhou</td>
<td>Rabobank, IFC</td>
<td>10, 5</td>
<td>89</td>
</tr>
<tr>
<td>Industrial &amp; Commercial Bank of China</td>
<td>Goldman Sachs, American Express and Allianz Group</td>
<td>8.5, 4.1</td>
<td>3800, N/A</td>
</tr>
<tr>
<td>Huaxia Bank</td>
<td>Deutsche Bank, Sal Oppenheim</td>
<td>9.9, 4.1</td>
<td>327, N/A</td>
</tr>
<tr>
<td>Guangdong Development Bank</td>
<td>Citigroup, IBM</td>
<td>20, 4.7</td>
<td>697, 165</td>
</tr>
<tr>
<td>Ningbo City Commercial Bank</td>
<td>Oversea-Chinese Banking Corp.</td>
<td>12.2</td>
<td>70</td>
</tr>
<tr>
<td>Xiamen Commercial Bank</td>
<td>Fubon Financial Holding</td>
<td>20</td>
<td>62</td>
</tr>
<tr>
<td>Shanghai Rural Commercial Bank</td>
<td>ANZ Bank</td>
<td>19.9, 3.3</td>
<td>252, 120</td>
</tr>
</tbody>
</table>

1. This bank is a joint venture between Hana Bank and ICBC, which is why Hana Bank has a controlling stake.
2. Total investment in Nanjing City Commercial bank still remains below 25% as IFC’s stake was reduced upon BNP Pariba’s purchase.
3. Morgan Stanley was able to acquire this bank because Nan Tung is a foreign-funded bank formerly owned by Bank of China’s Macao subsidiary.

Source: KPMG 2008b; Hope, Laurenceson and Qin 2008; Wu, Chen and Lin 2007; publicly available information.

The deregulation of the Chinese market for financial services, the competitive advantages and disadvantages of Chinese and foreign banks in China and the impact of foreign strategic investors are major factors shaping the environment for foreign banks entering the Chinese market. However, as discussed above, previous research on the above issues does not appear to paint a clear picture on what the conditions will mean for foreign banks entering the Chinese market and their market entry strategies:
• While the reform measures undertaken by the Chinese authorities are being acknowledged, they are seen as not going far enough and as not being sufficiently far-reaching.

• The existing evidence on the competitive situation of foreign and Chinese banks appears to be conflicting and inconsistent. The domestic banks possess several “home field advantages” like existing client relationships, local market knowledge, and extensive “bricks and mortar” branch networks, but they are also burdened with a legacy of non-performing loans and flawed lending and risk management practices. In these areas they are outperformed by the more innovative, skilled and experienced foreign banks. However, the complex regulatory environment, together with issues like RMB-funding and capital controls remain an impediment for growth and pose a looming threat to foreign banks’ activities in China.

• The long-term impact of foreign “strategic investments” into Chinese banks also does not seem to be clear yet for all parties involved, including the particular Chinese bank, the foreign investor, and the Chinese government which is seeking to further increase the competitiveness of the country’s banking sector. The period considered by recent studies may have simply been too short to capture the long-lasting impacts of these transactions.

After this discussion of the issues which provide the major background for the activities of foreign banks in China, the literature relevant to the main research topics of this study will now be reviewed. These are: (1) the motives of banks to internationalise and enter foreign markets, (2) their choice of entry mode, (3) their choice of market strategy or activities (e.g. the products and services they offer and which regions or customers they serve) in foreign markets, (4) the factors which influence the choice of entry mode and activities, and finally (5) the challenges they face in their foreign ventures.

2.3.5 Motives for the entry of foreign banks into the Chinese market

Various previous studies (for example Wetzel 2004; Buch 1999; Yamori 1998) on the motives for banks to engage in foreign markets have found a positive and significant correlation between the internationalisation of banks and the extent of economic integration (for example measured in FDI or trade flows) between the banks’ home country and the banks’ host country. These results are frequently used to support the suggestion that
foreign banks follow their customers abroad, which has almost become the “conventional wisdom” with regard to bank internationalisation (Nolle and Seth 1996; Clarke, Cull, Martinez Peria & Sanchez 2003; Song 2009).

From a theoretical point of view, “following the customer” can be explained as the internalisation of a pre-existing bank-client relationship which represents an “internalisation advantage” within the framework of Dunning’s eclectic paradigm (Dunning 1977, 1980; Mutinelli & Piscitello 2001, see Section 2.2.2.3). Indeed several studies on bank internationalisation refer to the eclectic paradigm as a valid theoretical explanation of banks entering foreign markets (e.g. Xu and Nellis 2008; Uiboupin and Sörg 2006; Leung and Young 2005; Mutinelli & Piscitello 2001; Leung 1997).

Several studies on the motives of banks to engage in foreign markets have focused on German banks. For example, while investigating the factors influencing the location decisions of multinational German banks in selected emerging markets of Central and Eastern Europe, Latin America and Asia between 1994 and 2001, Wetzel (2004) identifies the desire to “follow the customer” as a major motive for German banks to enter these markets. These results confirm older findings by Buch (1999), who investigates the determinants of foreign activities of German banks for the years of 1981–1998.

Similar findings suggesting that banks follow their customers abroad have also been found for Italian banks (Di Antonio, Mariotti & Piscitello 2002; Mutinelli and Piscitello 2001), Japanese banks (Qian & Delios 2008; Yamori 1998), Spanish banks (Blandon 1998), foreign banks in Greece (Hondroyiannis & Papapetrou 1996), foreign banks in China (Xu and Nellis 2008; Song 2009), and foreign banks entering Central and Eastern European countries after these countries opened their market in the 1990s (Badulescu & Badulescu 2008; Konopielko 1999).

However, as Clarke, Cull, Martinez Peria & Sanchez (2003) point out, in these studies the causal relationship of economic integration and the internationalisation of banks remains unproven, and the positive correlation between FDI by banks and FDI by other firms does not necessarily mean that the foreign banks operating abroad mostly serve clients from their home countries. For example, a study by Seth, Nolle and Mohanty (1998) analysing the lending patterns of foreign banks from six different countries in the US finds that the banks from four out of the six countries were also lending to clients which were not from the banks’ home countries, suggesting that the motivation to “fol-
low the customer” is not the sole reason for entering the foreign market. Similar infer-
ences can be drawn from Clarke, Cull, Martinez Peria and Sanchez (2003) who investi-
gate the lending behaviour of foreign banks in Latin America. They find that although
(as a share of total lending) foreign banks generally lend less to small businesses than
private domestic banks do, the difference is primarily due to the behaviour of small for-

gain banks. The difference in lending behaviour was considerably smaller for large and
medium-sized banks. Finally, the authors suggest that in some Latin American countries
large foreign banks might actually lend slightly more to small domestic businesses (as a
share of total lending) than large domestic banks (Clarke et. al. 2003).

Indeed, several studies suggest that banks internationalise in order to exploit local busi-
neness opportunities in the foreign markets they enter (“market seeking”). For example,
investigating the entry of foreign banks into the Central and Eastern European (CEE)
markets, Uiboupin and Sõrg (2006) find that the predominant entry motive of foreign
banks has been the search for new business opportunities in these markets. A study by
Buch (2000) finds that variables capturing the size of a foreign market such as total
GNP, GNP per capita, and population size are highly correlated with foreign bank entry
into these markets. Based on a study on nearly 2,500 banks from OECD countries, Fo-
carelli and Pozzolo (2000) conclude that the need to follow home-country clients oper-
ating abroad is not the major motive for banks to enter foreign markets. Instead, the au-
thors suggest that local market opportunities are the main determinant of foreign banks’
decisions to go abroad. However, the question of what is the “right” way to correctly
measure the “market potential” or “market opportunities” of a host country is a contro-
versial topic in the literature. While several studies on international banking use proxies
like GNP, GNP per capita, or population size (e.g. Buch 2000; Yamori 1998), Focarelli
and Pozzolo (2000) suggest that banks prefer to expand to countries where the banking
system is on average less efficient, and to poorer countries where the expected rate of
economic growth is higher.

Changing motives. Some authors suggest that their research indicates a change in the
motives driving bank internationalisation in recent years. For example, Moreno and Vil-
lar (2005) suggest that there has been a strategic shift by foreign banks away from pur-
suing internationally active corporate clients towards the exploration of business oppor-
tunities in foreign markets. Focusing on emerging market economies (EMEs), Do-
manski (2005) finds that while traditionally, foreign banks focused primarily on the
provision of financial services to their international corporate clients, since the 1990s banks’ foreign investments have increasingly been driven by more general profit opportunities in local markets, turning foreign direct investment of financial services providers (FSFDI) from “a rather passive response to changing demand on the part of existing clients to the proactive exploration of new markets in host countries” (Domanski 2005, p. 73). Investigating the lending behaviour of foreign banks in the US, Seth, Nolle and Mohanty (1998) suggest that the “follow the customer” hypothesis may be more limited in its applicability than previously supposed. They find that several foreign banks in the US have started to allocate a growing proportion of their loans to host-country firms.

Evidence in China. To date, relatively little research been conducted on the motives of foreign banks to enter the Chinese market. This may be reflective of the relatively short time that has passed since the Chinese market was fully opened to foreign banks at the end of 2006.

Using the perspective of Dunning’s eclectic framework (Section 2.2.2.3), Leung (1997) conducted an empirical analysis of factors contributing to the attraction of foreign banks to China in the pre-WTO period of 1980 to 1993, a time when access to the Chinese market was still highly restricted for foreign players. “Follow the customer” was the highest rated motive of foreign banks entering China. In addition, (a) size, (b) international experience (measured in the number of countries a bank has branches and subsidiaries), and (c) financial soundness (measured in the banks’ capital asset ratio), all interpreted by the study’s author as ownership advantages, were found to significantly increase the likelihood of a foreign bank establishing a presence in China. On the other hand, the location-specific advantages of the Chinese market (a potentially large retail market, financial incentives offered to the banks, and a rising security market) were not rated highly by the participating banks. As a possible explanation for these results, the author cites the lack of full RMB convertibility, existing structural problems in the development of the retail banking market as well as the securities market, and the assumption that offered incentives (e.g. reduced taxes) were not as attractive as they first appeared. In addition, the lack of well established regulations, the restrictions on capital movement, and political uncertainty were reported as the most important reasons for keeping foreign banks from entering the Chinese market (Leung 1997).

Leung and Young (2005), also using an eclectic framework-perspective, confirm some of the above results in their analysis of factors influencing the decision and the timing of
foreign banks establishing a branch in China’s financial centre of Shanghai. Based on data ranging from 1990, when foreign banks were first allowed to establish branches in Shanghai, until 2001, the authors differentiate between ownership-specific factors and location-specific factors. Their duration analysis of the entry decision found, that the ownership-specific advantages, (1) region of origin, (2) parent bank size, (3) international experience (measured in the number of international branches) and (4) specifically China experience (measured in the number of already existing branches in China), had a significant (reducing) impact on the time of entry. With regard to the region of origin, the results of the study suggest that a foreign bank from an Asian country had a conditional probability of entry into Shanghai which was 2.4 times higher than that of a non-Asian bank, indicating that geographical and cultural proximity play an important role in the decision to enter the Chinese financial services market – possibly, the authors suggest, by reducing the banks’ transaction costs for negotiation and monitoring. In addition, Leung and Young find that having other branches in China increased the likelihood of a bank’s entry into Shanghai by a factor of 1.75, pointing to the advantage provided by already having some banking experience in China (Leung and Young 2005). The study’s findings also seem to confirm the importance of an existing or potential customer base from a bank’s home country and thus the motivation to “follow the customer”. When looking at location-specific advantages of Shanghai, the study found that a larger bank’s home-country share of the total FDI in Shanghai significantly reduced the time it took for a bank of that country to open a branch in Shanghai.

The findings of Leung (1997) and Leung and Young (2005) with regard to the importance of proximity to China, an existing customer base, and a bank’s size are also supported by a study by The Boston Consulting Group (Achhorner, Chng, Michaelis and Tang 2006). The authors identify several sources of competitive advantage among foreign banks in China, including a “leading global position” with “ample financial and human resources” (p. 24), a close proximity to China, an existing base of corporate customers in China, an expertise in special banking products that are in demand in China, and a high expertise in emerging markets, based on ample experience in other countries (Achhorner et. al. 2006).

To date, only very few studies are based on data collected after the WTO driven opening of the Chinese market at the end of 2006. Xu and Nellis (2008) also identify following their existing clients as the main motive of foreign banks to enter the Chinese mar-
ket. Song (2009), using data from 1991 to 2008 finds that there is a significant positive correlation between the growth of FDI in China as well as import and export trade and total assets of foreign banks in China. Using a multiple regression framework, Huaiyu (2010) identifies both “follow the client” (measured in FDI levels in China) as well as “market seeking” (measured in Chinese GDP growth) as the main motives for foreign banks to enter the Chinese market.

2.3.6 Entry modes of foreign banks

Depending on host-country regulations, foreign banks can usually adopt a range of entry modes or organisational forms when entering a host country (Clarke et. al. 2003).

The choice of ownership structure for a foreign subsidiary depends on a wide range of factors, which can be divided in two different, but interacting categories. One set of factors affects what kind of ownership structure the market entering bank prefers. These factors may include the capabilities of the firm, its strategic goals, its international experience, or the transaction costs of different ways of transferring capabilities. Another set of factors deals with what a firm can get, based on target market conditions, including regulations, and the goals and preferences of the local authorities. Especially in economies like China with a high level of government control, the ownership structure of foreign subsidiary will often be determined in a negotiation process between the foreign bank and various government authorities. In this process, the relative bargaining power of the negotiating parties also affects the outcome. As a result, the market entry mode will often reflect both what the market entering bank wants (ownership preferences) and what it can or cannot get (ownership concessions) based on the local conditions (Gomes-Casseres 1990; 1989; Pan 1996; Pan 2002).

The entry modes are also usually seen as a good indicator of the level of commitment by the bank in the host country, since to the investing firm, different entry modes represent varying levels of control, equity commitment, and risk, and as such they reflect the bank’s willingness to make a long-term and usually costly investment (Slager 2004; Blandon 1998; Tse, Pan, and Au 1997; Ursacki and Vertinsky 1992).

The following entry modes are available to foreign banks in China and are also the ones that are generally discussed in literature (Mallesons Stephen Jaques 2006a; Slager 2004; Blandon 1998; Ursacki and Vertinsky 1992):

- representative offices (rep. office),
• **foreign bank branches** (branches of a foreign-incorporated bank),

• **joint venture banks** (JV banks), jointly funded by a foreign financial institution and one or more host-country companies, and

• **wholly foreign-owned banks** (WFOE banks), wholly-owned by one foreign bank or jointly owned by several foreign banks (in the literature usually referred to as “subsidiaries”).

A **representative office** (rep. office) is the most limited but also most easily established entry mode or organisational form and it enables foreign banks to establish a presence in a host country at comparatively low cost (Uiboupin 2005; Clarke et. al. 2003). A rep. office does not engage in attracting deposits and extending loans, but usually acts as an intermediary between its parent bank and the bank’s customers without actually processing financial transactions. In addition, a rep. office can facilitate the generation of new business opportunities and channel information to and from the host-country where it is located. A rep. office is often in a better position to collect and interpret information needed by a domestic client or by its parent bank, because of its location and greater familiarity with the situation in the host country. Rep. offices are also often established to search out the possibility of further involvement in a host country. If the parent bank chooses to establish a branch or other form of presence in the host-country, an existing rep. office can be instrumental in supporting and managing the process (Naaborg 2007; Slager 2004; Clarke et. al. 2003).

A **foreign bank branch** regularly constitutes a higher level of commitment than a rep. office and is usually entitled to offer a wider range of services. In contrast to a subsidiary, a branch is not an independent legal entity, but an integral part and legal extension of its parent bank in the host market. This means it can usually draw on the parent’s capital base, and offers the parent bank maximum degree of control and supervision over its activities in the foreign market, but it also poses the risk for the parent bank of being held responsible for all commitments entered into by its branch in the host country (Naaborg 2007; Slager 2004; Clarke et. al. 2003). As Slager (2004) and Cerutti, Dell’Ariccia and Martínez Pería (2005) point out, as a legal extension of the parent bank, a branch signals that all the parent bank’s assets in the home country are put up as guarantee for its activities in a foreign market, a feature implying a direct and unlimited
liability of the parent bank for all commitments entered into by the branch in the host country.

**Joint venture banks** are usually jointly funded by one or more foreign financial institution and one or more host-country company and involve the sharing of assets, risks, profits, and participation in the ownership (i.e. equity) of the company. Often, personnel or parts of existing organisations within the founding banks can be brought into the joint venture (Slager 2004; Young 1989). In general, joint venture banks are equity sharing, independent legal entities incorporated under host-country law, over which control and supervision has to be shared by the joint venture partners (Julian 2005; Gutterman 2002). Firms enter into joint ventures for various reasons, for example to reduce their investment risks, to capture growing markets, or to facilitate the local operations of their joint venture partner (Tse, Pan, and Au 1997). The distribution of equity ownership in equity joint ventures is usually seen as the outcome of a negotiation process between the foreign and the local venture partners. As such foreign equity ownership in an equity joint venture reflects both what the foreign investor wants (ownership preferences) and what it can or cannot get (ownership concessions) from the local joint venture partner (Gomes-Casseres 1990, Pan 1996). In addition, macro-level economic environment variables in the foreign investor’s home country (for example exchange rate, the cost of borrowing, export capabilities, and management orientation) are also considered to affect a firm’s micro-level decisions on equity ownership (Pan 2002).

Foreign banks in the form of **subsidiaries** are independent local legal entities incorporated under host-country law in which the parent bank has a direct or indirect controlling and/or majority interest. Subsidiaries usually require the highest form of resource commitment by the founding parent organisation. Foreign banks in the form of subsidiaries are usually permitted to engage in a broader range of financial services activities. In many countries they can engage in the same activities as domestic banks and have to comply with the same regulatory requirements (Slager 2004; Clarke et. al. 2003). The alternative to setting up a subsidiary is often the acquisition of a local bank (Bădulescu and Bădulescu 2008). However, at this point in China, foreign banks can only become minority shareholders in Chinese banks, since the current regulation still limits foreign banks to a maximum of a 20% stake (for a single foreign bank) and 25% for a group of foreign banks in a Chinese bank (Deloitte 2006).
As pointed out by Cerutti, Dell’Ariccia and Martínez Pería (2005) and Blandon (1998), compared to other issues of bank internationalisation, the literature has paid little attention to the entry mode or organisational form that banks take when entering foreign markets. Various studies investigating the determinants of the internationalisation of banks do not distinguish between different modes of entry or organisational forms (e.g. Buch 1999) or only consider one or two different entry modes (for example, in their 2001 study, Focarelli and Pozzolo only consider merger and acquisition-based entries and Uiboupin’s (2005) study of foreign banks in CEE countries did not include foreign bank branches for some of the countries investigated). In addition, several studies which use secondary data to measure foreign banks’ activities do not consider representative offices at all, possibly because rep. offices do not engage in operational banking services and usually do not require registered equity. Finally, studies which do consider different types of entry mode (e.g. Ursacki and Vertinsky 1992) often look at the determinants of each type of organisational form in isolation and don’t take into account the bank’s decision to enter a given market (Cerutti, Dell’Ariccia and Martínez Pería 2005). However, since the entry mode or organisational form of a bank regularly determines the type of activities, and range of services that can be offered in the host market, the entry mode or organisational form is a major issue in bank internationalisation (Uiboupin 2005; Blandon 1998).

Factors influencing entry mode choice. The existing literature on the entry mode or organisational form that banks choose when entering foreign markets often distinguishes between parent bank-specific factors and host country-specific factors influencing the entry mode choices of foreign banks. A major study examining the factors influencing the organisational form under which foreign banks operate in foreign markets was conducted by Cerutti, Dell’Ariccia and Martínez Pería (2005) who examine the activities of a sample of the 100 biggest banks worldwide. With regard to the banks’ motives and client focus, the authors find that subsidiaries are the preferred entry modes by banks which enter the market to establish large and mostly retail operations, because they allow for easier penetration of the foreign market. Similar results are presented by Naaborg (2007) and Konopielko (1999), both of whom investigate foreign bank entry into Central and Eastern European countries (CEE countries). Konopielko (1999) notes that foreign banks in Poland, Hungary and the Czech Republic which are looking for host market opportunities seem to prefer subsidiaries to be able to build a
branch network in the host country. Naaborg (2007) finds that for foreign banks in 21 CEE-countries, the focus on retail clients is also related to using the subsidiary format. In contrast, as Di Antonio, Mariotti and Piscitello (2002) show that Italian banks, when following their customers abroad, typically adopt internal forms (i.e. branches and/or representative offices), which act on the basis of the parent’s capital and reputation.

**Bank size and international experience.** Other parent bank-specific factors influencing entry mode are the banks’ size and international experience. Both Blandon (1998), studying foreign banks in Spain, and Ursacki and Vertisky (1992), investigating foreign banks entering Japan and Korea, find that the banks’ size and their experience in other markets influence entry mode choice, with larger and more experienced banks tending to choose organisational forms which require a higher level of commitment. In contrast, branches are more likely when foreign operations are smaller (Cerutti, Dell’Ariccia & Martínez Pería 2005). For foreign banks in China, Leung and Young (2002) find that bank size and existing links to Asia increase the likelihood of banks engaging in the Chinese RMB market, which requires a stronger commitment in the country. For Italian banks going abroad, Di Antonio, Mariotti and Piscitello (2002) also find that larger and more internationally experienced firms are more likely to adopt higher levels of commitment.

**Regulatory constraints.** With regard to host country factors, various studies point to the importance of regulations as a major factor influencing entry mode choice by foreign banks (Bădulescu and Bădulescu 2008; Naaborg 2007; Cerutti, Dell’Ariccia and Martínez Pería 2005; Slager 2004; Konopielko 1999). Cerutti, Dell’Ariccia and Martínez Pería (2005) find that foreign banks are more likely to operate as branches in countries that have higher corporate taxes and in countries where they face lower regulatory restrictions on bank entry in general, and on foreign branches in particular. Stringent host-country bank entry requirements (a high number of procedures required to license a bank) have a negative effect on the establishment of branches but not on subsidiaries. The authors suspect that while branches are often new operations, banks can bypass entry requirements by setting up subsidiaries through the acquisition of local banks. General host-country restrictions on banking activities do not seem to have a significant effect on the entry modes chosen by foreign banks. The authors assume that one reason for this might be that these restrictions often apply not only to foreign-incorporated banks, but to locally-incorporated banks as well. In countries
with high corporate taxes, branches are the preferred entry mode because according to the authors they offer an advantage in shifting profits to the bank’s home country (Cerutti, Dell’Ariccia and Martínez Pería 2005).

For foreign banks entering Central and Eastern European countries, Bădulescu and Bădulescu (2008) find that host-country regulations can favour specific entry modes (e.g. liberal regulations towards foreign bank branches in the Czech Republic) which steer foreign banks toward one or the other organisational form. For the same region, Naaborg (2007) finds that local regulations influence whether foreign banks opt for a branch or a subsidiary. Investigating foreign banks’ entry into Poland, Hungary and the Czech Republic in the 1990s, Konopielko (1999) concludes that entry mode choices of foreign banks reflect existing opportunities and country-specific regulations on foreign bank entry. Based on a study of 44 banks from the US, the United Kingdom (UK), Japan, Germany, France, Spain, Switzerland, and the Netherlands, Slager (2004) finds that the legal and regulatory framework (for example differences in taxation, regulatory capital requirements and the desired legal liability structure) of both home and host country are a major factor influencing the entry mode choice of foreign banks in the host country. Di Antonio Mariotti, and Piscitello (2002) find that in countries which impose strong regulatory constraints on foreign banks, Italian banks establish only representative offices.

**Economic and political risk of the host country.** Cerutti, Dell’Ariccia and Martínez Pería (2005) suggest that, based on the parent banks’ responsibility for the liabilities of branches and subsidiaries in foreign markets, the host-country’s **economic** and **political risks** influence the banks choice of entry mode. The authors assume that in general, parent banks are fully liable for branches, but for subsidiaries their exposure is usually limited to the equity invested in the subsidiary. Thus, in countries with a relatively risky macroeconomic environment banks are more likely to operate subsidiaries, because they offer the advantage of limited liability, while banks prefer to operate as branches in host-countries with relatively low economic risk.

With regard to the risks associated with possible government intervention and other major political events (e.g. civil unrest or wars), Cerutti, Dell’Ariccia, and Martínez Pería (2005) find that parent banks are more likely to prefer branches, which are often protected against such events by “ring fencing provisions” that shield parent banks from the
liabilities of their foreign branches in events like civil wars, or actions by foreign governments (Cerutti, Dell’Ariccia & Martínez Pería 2005, p. 3).

**Market size and development of the host country.** Cerutti, Dell’Ariccia, and Martínez Pería (2005) find that foreign banks are less likely to use branches in relatively richer countries. The authors suggest two possible explanations for their findings. Firstly, they may in part reflect the fact that subsidiaries are often the result of crisis-related acquisitions which are more likely to occur in poorer countries. Secondly, it may be that foreign banks enter as subsidiaries in markets where they expect ample room for expansion, and these are typically poorer economies where the local banks are less developed and capitalised, and as such represent weaker competition (Cerutti, Dell’Ariccia & Martínez Pería 2005).

For the case of Italian banks, Di Antonio, Mariotti, and Piscitello (2002) find that when the foreign market is larger and more promising, Italian banks adopt greater levels of commitment in their entry modes. In contrast, in markets with less local business opportunities, Italian banks prefer to only establish (exploratory) rep. offices. In addition, cultural distance between home and host country decreases the probability that Italian banks will become heavily involved in foreign countries through acquisitions of local banks. Finally, summarising research covering the years 1983–1997, Slager (2004) reports that a larger market in the host country in relation to the market size of the home country tends to decrease the level of commitment by foreign banks.

**Other factors influencing entry mode choice.** Other factors found to influence the entry mode choice of foreign banks include the time of entry, the relative cost of conducting transactions from the head office compared to the cost of conducting transaction in the foreign country, strategic considerations, and the wealth of the banks’ home country (Naaborg 2007; Slager 2004).

### 2.3.7 Activities (market strategies) of foreign banks

When banks enter a foreign market, they usually have to make several major choices. Besides the above discussed choice of entry mode, foreign banks regularly have to make a choice with regard to the clients and regions they serve, and the products and services they offer (Slager 2004). As one would expect, these choices usually correspond with the initial motive of foreign banks to enter a foreign market and are often dependent on the bank’s choice of entry mode (Konopielko 1999; Badulescu and Badulescu 2008). In
this study, the choices with regard to the clients and regions served, and the products and services offered, is referred to as the “market strategy” of the participating financial services provider.

The number of studies focusing directly on the clients and regions served, and the products and services offered by foreign banks is limited. Most studies which also touch on the activities of foreign banks often don’t do so directly, but rather investigate the effects of foreign banks entry into a particular market (e.g. Cardenas, Graf and O’Dogherty 2004). Several of these studies also emphasise the need to distinguish between bank entry in developed and developing economies.

Foreign banks’ activities in developed economies. Existing studies on the activities of foreign banks in developed economies seem to suggest that foreign banks tend to focus on larger corporations and wholesale banking services, while more or less neglecting retail banking clients and services for SMEs (see for example Goldberg and Saunders 1981 and Damanpour 1991 for foreign banks in the US). Studies of other developed countries like Norway (Tschoegl 1997) and Italy (Magri, Mori and Rossi 2005) show similar results. The literature lists the strong competition by local banks which foreign banks face in developed economies as one possible explanation for this behaviour of foreign banks (Clarke, Cull, Martinez Peria and Sánchez 2003). With regard to retail banking, Slager (2004) points out that there is only a handful of large international banks which set out to offer retail banking in other developed markets like Belgium, The Netherlands, Germany, or the UK, partly based on the assumption that retail operations require a larger “minimum scale of operations” to compete effectively.

Several authors have suggest that foreign banks may behave differently in developing markets compared to when they operate in developed countries (for example Naaborg 2007; Herrero and Simón 2003; Lensink and Hermes 2004; Bonin and Ábel 2000). One concern is that foreign banks in developing markets might “cherry pick” the best borrowers and focus on the more transparent large national and international corporate clients, and more or less neglect other potential clients like the more opaque SMEs, leaving this market segment constrained (de Haas and Naaborg 2006; Clarke, Cull, Martinez Peria and Sánchez 2003). Furthermore, in transition economies foreign banks often face a lack of historical company data, such as income statements and balance sheets to access a potential client’s credit worthiness. In contrast, local banks seem to be better equipped to collect and interpret the “soft” information on potential clients, and espe-
cially the more opaque SMEs (Naaborg 2007). Thus it has been suggested in the literature that foreign banks operating in transition economies will focus on transparent segments, where “hard” information is readily available, which is more likely the case with large corporations, publicly listed companies, or foreign clients, leaving smaller or more opaque firms and mass retail clients to local banks (Maurer 2008; Berger, Klapper, Martinez Peria and Zaidi 2006).

The existing body of literature on the activities of foreign banks in developing or transition economies focuses more on the regions of Latin America and Central and Eastern Europe, and less on transition economies in Asia. This may reflect the difference in development in these markets. While the share of banking assets held by foreign-controlled banks rose in the 1990s in Latin America, Eastern Europe, and Asia, the increase was significantly higher in the first two regions. In Argentina, Chile, Hungary, and Poland, the share of banking assets held by foreign-controlled banks rose between 1994 and 1999 from less than 20 per cent to more than 50 per cent. In contrast, in the same period in East Asia the average share of foreign banks only rose from three to seven per cent (Clarke, Cull, Martinez Peria and Sánchez 2003). These differences in development between the three regions are partly explained by the differences in market liberalisation. The banking crises in several countries in Latin America led local governments to speed up the liberalisation of local banking markets in order to recapitalise and consolidate their banking systems in the second half of the 1990s. Many CEE countries opened their banking markets for foreign banks in the 1990s when privatisation of the banking system and preparations for EU membership took place. In contrast to these two regions, large-scale FDI in the banking sector is still a relatively recent phenomenon in emerging markets in Asia (Domanski 2005).

**Foreign banks’ activities in Central and Eastern European countries (CEE).** The most important investors in the financial sector in the CEE countries come from the neighbouring countries of Austria, Italy, Germany, and Belgian, while the big US and UK banks have only built relatively small presences in these markets (Naaborg 2007). Existing research with regard to the activities of foreign banks in CEE countries appears to show mixed results. Investigating the growing presence of foreign banks in CEE countries in the 1990s, Konopielko (1999) finds that foreign banks mainly focus on providing services for large corporations and trade-related services with corporate financing, foreign exchange trading, trade finance, and project financing being considered
the most important areas of activity by foreign banks – all of which, as Bădulescu and Bădulescu (2008) point out require relatively large levels of know-how but low staff levels in comparison to more standard banking services. In contrast, retail banking services for mass retail clients are ranked much lower by foreign banks in CEE countries (Konopielko 1999). According to the author, the low level of individual wealth in these countries and the high cost to establish retail banking operations might discourage foreign banks from entering the market for retail banking services.

Bădulescu and Bădulescu (2008) find similar results for the case of Romania. Corporate finance and trade-related services are the most preferred activities of foreign banks in Romania, while retail banking is significantly less interesting for foreign institutions. The authors suggest that the foreign banks’ comparative advantages with regard to the access to cheaper funding in foreign currency, as well as their know-how and experience influence their choices of client segments and services offered.

Similar results for Estonia and Romania are presented by Sõrg, Uiboupin, Varblane and Vensel (2004). In Estonia, the main target segments for foreign banks are large domestic corporations, home-country clients and large exporters. Accordingly, corporate financing is identified as the most important activity for foreign banks in the Baltic states. In Romania, the main target segments of foreign banks are international and home-country corporations, as well as large exporters, while mass retail clients are considered the least important client segment.

Somewhat more mixed results are presented by de Haas and Naaborg (2006). Their study of foreign banks in Central Europe and the Baltic states shows that while initially foreign banks focus almost exclusively on larger corporations, nearly all foreign banks have gradually increased their lending to local SMEs and retail clients, based on the improvement of lending technologies and competitive pressure. Similar results are presented for Poland and the Czech Republic. For Poland, a study by Farnoux, Lanteri and Schmidt (2004) does not find evidence that foreign banks are engaging in “cherry picking” in their lending practice by leaving the riskiest loans to local banks or by not lending to SMEs. Indeed, SMEs and high-income individuals represent the main target segments of foreign banks in Poland (Sõrg, Uiboupin, Varblane and Vensel 2004). In the Czech Republic, mass retail clients, high-income individuals, and SMEs make up the main target segments of foreign-controlled banks. Accordingly, retail banking services
are identified as the most important field of activity of foreign banks in the Czech Republic (Sörg et. al. 2004).

Finally, there are some CEE countries like Hungary (Bonin and Ábel 2000) and Estonia (Uiboupin 2001), where through the privatisation of local banks and de novo operations by foreign banks, foreign-controlled banks play a major role in wholesale banking as well as retail banking.

**Foreign banks’ activities in Latin America.** Similar to the activities of foreign banks in CEE countries, there is some evidence that initially foreign banks in Latin America focused their activities mainly on providing services to large corporate clients, but that they have since started to increase their services to SMEs and other market segments as well. For example, for Argentina, Berger, Klapper and Udell (2001) find that SMEs are less likely than large corporations to receive loans from foreign banks. Based on data from the late 1990s, Clarke, Cull, Martinez Peria, and Sánchez (2003) find that foreign banks in Argentina, Chile, Colombia, and Peru lent a smaller share of their portfolio to local SMEs than did similar domestic banks in these markets. However, for Argentina and Chile, with regard to lending to SMEs the authors also find some evidence that as foreign banks grow, the differences between foreign and domestic banks with regard to their loan portfolio might lessen over time.

For Brazil, Carvalho (2000) finds that after the liberalisation of the country’s banking market in the mid 1990s, wholesale and investment banking services were seen by foreign banks as the most attractive areas because these services required skilled labour, research capabilities, and special market connections, areas in which, according to the author, foreign banks had an advantage over domestic institutions. Initially, only a limited number of foreign banks also engaged into retail banking activities. However, since further liberalisation of the banking market, the number of foreign banks also serving retail clients started to increase at the end of the 1990s (Carvalho 2000).

The evidence for Mexico, a country with particularly high foreign bank penetration, is inconclusive. One study by Cárdenas (2003) does not find that foreign banks only focus on large corporations. However, another study by Beck and Martinez Peria (2008) finds evidence of “cherry picking” by foreign banks, which concentrate their activities on rich and urban areas of the country.
Foreign banks’ activities in Asia. The literature on the activities of foreign banks in
Asia, and in China in particular, is still limited. Again, the time since the complete
opening of the Chinese banking market may have been too short for major research pro-
jects on the activities of foreign banks in China. In addition, the number of foreign
banks in China is still relatively small, making it difficult to apply quantitative research
methodologies.

For the case of foreign banks in India, studies by Gormley (2010, 2006), find that for-
eign banks also focus their activities primarily on larger, listed, and foreign corporations. Similar results for the activities of foreign banks in Pakistan are presented by Mi-
an (2006).

Based on data from the time prior China’s inception into the WTO, Leung (1997) finds
that trade finance, and loans to joint ventures between foreign and Chinese corporations
were the main areas of activities for most foreign banks, while loans to solely Chinese
clients or the potentially large retail market were clearly less important.

He and Fan (2004) find that foreign banks substantially increased their activities after
the country joined the WTO. Nevertheless, the authors point out that the foreign banks’
share of total banking assets initially shrank from the beginning of 2002 to 2004 from
1.54% to 1.36%. Moreover, the foreign banks’ market share in terms of foreign curren-
cy lending fell from 15% in 2001 to 7.4% in 2002. With regard to products offered, and
clients served, the study shows that pre WTO, foreign banks in China focused on a very
limited scope of business such as trade-related services, with most banking transactions
being conducted in foreign currencies. Since China’s inception into the WTO, foreign
banks have extended their activities. According to He and Fan (2004), foreign banks in
China have been most active in the areas of corporate banking, private banking services,
and financial markets products. Their main clients are large international corporations,
and affluent individuals, while services to Chinese corporations have been very limited.
The authors conclude that foreign banks in China have tried to focus on “high-end cus-
tomers” and “quality clients” (He and Fan 2004, p. 8).

Two more recent studies by Metcalfe (2008, 2007) identify corporate banking and trade
financing as the most important activities of foreign banks in China, while retail bank-
ing plays a much lesser role. In comparison to 2007, wealth management services to af-
fluent individual clients moved up the ranks in 2008. In terms of revenue, corporate
banking, treasury/money market and trade finance were identified as the activities generating the highest revenues for foreign banks in China. In contrast, retail banking and SME lending only provide minor revenues. In the participating foreign banks’ loan portfolios, loans to international corporations and home-country clients outweigh loans to China-based corporations by over 50% (Metcalfe 2008).

Leung and Chan (2006), investigate the competitive prospects of foreign banks entering China and define market strategies for foreign banks in China in terms of (1) customer type (corporate and retail), (2) customer nationality (foreign and Chinese), and (3) currency business (local and foreign currency). Along the lines the authors define five market segments (Table 2.4).

<table>
<thead>
<tr>
<th>Market Segment</th>
<th>Customer Type</th>
<th>Currency denomination of business activities</th>
<th>Commencement date for operations by foreign banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Foreign firms and foreign individuals only</td>
<td>Foreign currency</td>
<td>1985</td>
</tr>
<tr>
<td>2</td>
<td>Foreign firms and foreign individuals only</td>
<td>Local currency (RMB)</td>
<td>December 1996</td>
</tr>
<tr>
<td>3</td>
<td>Chinese firms and individuals</td>
<td>Foreign currency</td>
<td>December 2001 (China’s WTO entry)</td>
</tr>
<tr>
<td>4</td>
<td>Chinese firms</td>
<td>Local currency (RMB)</td>
<td>December 2003</td>
</tr>
<tr>
<td>5</td>
<td>Chinese individuals</td>
<td>Local currency (RMB)</td>
<td>December 2006</td>
</tr>
</tbody>
</table>

Source: Adapted from Leung and Chan (2006)

Based on those three dimensions, Leung and Chan (2006) define three strategic options for foreign banks in China: (1) a market niche strategy, (2) a market challenging strategy and (3) a strategic alliance strategy. According to the authors, the choice of strategy greatly depends on a bank’s risk preference, as well as on its resource and competence profile.

According Leung and Chan (2006), a market niche strategy should be applied by banks with limited resources and little or no international experience, or when a distinct and potentially promising customer segment is under-served by existing major competitors. At the time of their study, the authors found 12 foreign banks in China focusing solely on conducting foreign currency business with foreign corporate and retail clients (market segment 1). Another 40 foreign banks were identified as pursuing a niche strategy by offering various kinds of foreign and local currency banking services to foreign clients, usually targeting clients from their home country or from countries neighbouring the home country (market segments 1 and 2). The study also finds that many of the
niche players focused on the Shanghai region in their operations. Thus, market nichers basically stick to the business segments which were already open to foreign banks before China joined the WTO at the end of 2001 (Leung and Chan 2006).

Foreign banks which also offer foreign currency business to Chinese corporations and individuals and RMB business to Chinese corporations are pursuing a market challenger strategy according to Leung and Chan (2006). At the time of the study, the authors identified 11 foreign banks with a total of 61 branches in various cities in China, serving market segments 1 to 4. Based on December 2004 figures, the study identifies eight foreign banks with five or more branches in China. All of these banks had other operations in Asia, two of them were incorporated in Hong Kong and four had long-established operations there. In addition, most of them had been early entrants to the Chinese market, which according to the authors enabled them to gain valuable operating experience and acquire social capital in the form of business relationships and networks. Finally, several of them were major well-known international banks with ample financial human resources to take on the market-dominating local banks (Leung and Chan 2006).

These findings are mostly in line with Leung and Young (2002), who examine attributes of foreign banks in China which decided to engage into the partly liberalised RMB market, which was first partly opened on a very restricted basis in the New Pudong area in Shanghai in 1997. By the end of 1999, 24 branches of foreign banks in Shanghai and eight branches of foreign banks in Shenzhen were licensed with a limited number of Chinese local clients. Leung and Young (2002) found that being part of an Asian network and a greater market penetration in China significantly increased the likelihood of the engagement of a foreign bank in the RMB business, while the size of the parent bank had a lesser influence. The influence of financial soundness (measured by the banks’ capital asset ratio) was positive, but not statistically significant. The authors explain these findings as resulting from a better understanding of the Chinese culture, economy and political situation by these foreign banks, which allows them to better manage the credit risks associated with doing business with Chinese customers in local currency. The authors suggest that the above attributes improve a foreign bank’s position to deal with the potential liquidity and credit risks which come with an engagement in the RMB market (Leung and Young 2002).
The third strategic option suggested by Leung and Chan (2006), forming a **strategic alliance** with a Chinese partner to gain access to external resources, is related to the Chinese policy of encouraging foreign banks to become a “strategic investor” and take a minority stake in a local bank (Berger, Hasan and Zhou 2009). Leung and Chan (2006) list operating experience in the RMB market, better access to RMB funds, and an expanded market share as the major motives for becoming a minority shareholder in a Chinese bank. They also find that the strategic alliance option is complementary to the two other strategies and is mostly used by market challengers, however, some market nichers were found to have been forming strategic alliances as well. Moreover, several foreign banks have engaged in non-equity based alliances, for example the shared use of an ATM network. Some of the motives listed by the authors for forming a strategic alliance are confirmed by Hawes and Chiu (2007) who find that getting access to the extensive branch networks and the existing customer base of Chinese banks are the primary motives for foreign banks to acquire a minority stake in a local bank.

Achhorner, Chng, Michaelis and Tang (2006) describe five possible competitive scenarios for banks in China. The authors use product scope and geographic focus as the two strategic dimensions for foreign banks to position themselves in the Chinese market. Their study identifies two key drivers for the strategic dimension of geographic reach. Firstly, deregulation of the Chinese market for financial services which allows for more competition in some areas, and less in others, and secondly, the geographic fragmentation of China in terms of development and especially income distribution. As a result of the uneven economic growth in different regions, the income in some costal areas of China is significantly higher than in some inland regions, causing geographic variances in income which are far greater than in most developed countries (Achhorner et. al. 2006). Along the lines of these two dimensions, the study predicts that the Chinese banking market will develop according to one of five possible competitive scenarios, ranging from highly fragmented markets in terms of products and regions, specialised markets in terms of either geographic segmentation or product segmentation, to a market dominated by a few universal banking giants.

Based on their analysis of the Chinese banking market, the authors suggest several different “target aspirations” (Achhorner et. al. 2006, p. 23) as strategic positions foreign banks in China may strive to achieve. These include both a focus on corporate banking and serving retail clients. Besides just focusing on corporate banking services, the au-
thors see potential for other strategies to work in China as well. As a “product special-
ist” (Achhorner et. al. 2006, p. 24), a foreign bank could strive to use its specific expertise in certain areas to offer specialised products and services to a limited group of clients in China. According to the authors, this strategy limits the risk involved with an investment in the Chinese market. As a “wealth management specialists” (Achhorner et. al. 2006, p. 24) foreign banks could focus on urban areas and municipalities, where they could find a sufficient number of high income individuals to build a profitable business. The authors even see the potential for selected foreign banks with “ample financial and human resources” (Achhorner et. al. 2006, p. 24) to establish themselves as leading national banks, by building a national branch network in China and possibly serve all customer segments across all banking products.

A recent study by Chen (2009) suggests that foreign banks in China have three main strategic options: client leadership, product leadership, or a multi-objective strategy. When following the client-leadership option, foreign banks focus on maintaining their key existing clients by introducing sophisticated client portfolio management. In addition, foreign banks tend to target niche markets or neglected client segments such as rural markets and small to medium sized local private enterprises in order to avoid direct competition with domestic banks. With regard to their services offering, the author suggests that foreign banks need to shift their product focus from traditionally interest-based services to high-order fee-based banking products, which offer more potential for differentiation than traditional interest-based banking products.

2.3.8 Challenges of foreign banks (in China)

Foreign banks entering the Chinese market face a wide range of challenges and hurdles. According to two studies by Metcalfe (2008, 2007), the regulatory environment and the recruiting and retention of qualified staff are the main challenges for foreign banks in China. Other challenges discussed in literature include competition, funding, and cultural differences.

Regulatory and legal barriers. The greatest impetus of foreign banks’ activities in China so far has been the deregulation of the Chinese banking market. However, according to several scholars and foreign banks active in China, regulatory issues remain the greatest challenges for foreign banks operating in China. Previous studies cite general aspects like consistency and clarity of regulations, a lack of coordination between
Literature Review

the main three regulatory bodies as well as particular issues like foreign exchange regulations, foreign debt quotas, liquidity ratios, or capital requirements (Metcalfe 2009, 2008, 2007; American Chamber of Commerce 2008; Achhorner et. al. 2006).

In spite of three decades of reforms in China since the inception of the open-door policy in 1978, officials at various levels of the Chinese government still have considerable power to allocate resources and to approve projects, making the Chinese regulatory regime the most influential, most complex, and least predictable environmental factor in the Chinese economy (Zou and Gao 2007).

Despite the country’s inception into the WTO in 2001, and its commitment to opening its market to foreign banks by the end of 2006 (He and Fan 2004), China remains one of the least open economies according to the “Index of Economic Freedom” compiled annually by the *The Wall Street Journal* and The Heritage Foundation (Miller and Holmes 2009).

As shown in Table 2.5, China’s economy is, as expected, not only less open than Western economies like Australia and Germany, and the highly developed Asian markets like Hong Kong and Singapore, but it is also less open than many other emerging market economies of the greater Asia region like Thailand, Malaysia, The Philippines, Cambodia, India and Indonesia.

Table 2.5: Economic freedom indices of selected countries

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>1</td>
<td>92.7</td>
<td>90.0</td>
<td>90.0</td>
<td>90.0</td>
<td>83.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>2</td>
<td>98.3</td>
<td>80.0</td>
<td>50.0</td>
<td>90.0</td>
<td>93.0</td>
</tr>
<tr>
<td>Australia</td>
<td>3</td>
<td>90.5</td>
<td>80.0</td>
<td>60.0</td>
<td>90.0</td>
<td>86.0</td>
</tr>
<tr>
<td>Germany</td>
<td>25</td>
<td>90.3</td>
<td>80.0</td>
<td>60.0</td>
<td>90.0</td>
<td>78.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>58</td>
<td>70.8</td>
<td>40.0</td>
<td>40.0</td>
<td>50.0</td>
<td>51.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>67</td>
<td>71.2</td>
<td>30.0</td>
<td>60.0</td>
<td>50.0</td>
<td>33.0</td>
</tr>
<tr>
<td>The Philippines</td>
<td>104</td>
<td>49.3</td>
<td>40.0</td>
<td>30.0</td>
<td>30.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>106</td>
<td>42.7</td>
<td>50.0</td>
<td>50.0</td>
<td>30.0</td>
<td>20.0</td>
</tr>
<tr>
<td>India</td>
<td>123</td>
<td>54.4</td>
<td>30.0</td>
<td>40.0</td>
<td>50.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>131</td>
<td>46.7</td>
<td>30.0</td>
<td>40.0</td>
<td>30.0</td>
<td>23.0</td>
</tr>
<tr>
<td>China</td>
<td>132</td>
<td>51.6</td>
<td>30.0</td>
<td>30.0</td>
<td>20.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Vietnam</td>
<td>145</td>
<td>61.7</td>
<td>30.0</td>
<td>30.0</td>
<td>10.0</td>
<td>26.0</td>
</tr>
</tbody>
</table>

Notes to table: Business freedom is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation, as well as the efficiency of government in the regulatory process. Investment Freedom scrutinises a country’s policies toward the free flow of investment capital (foreign investment as well as internal capital flows) in order to determine its overall investment climate.
Literature Review

**Financial freedom** is a measure of banking security as well as a measure of independence from government control. State ownership of banks and other financial institutions such as insurers and capital markets is an inefficient burden that reduces competition and generally lowers the level of available services. **Property rights** is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state. It measures the degree to which a country’s laws protect private property rights and the degree to which its government enforces those laws. It also assesses the likelihood that private property will be expropriated and analyses the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. **Freedom from Corruption** is a measurement of the level of corruption within a country. The score for this component is derived primarily from Transparency International’s Corruption Perceptions Index (CPI), which measures the level of corruption in 179 countries.

Source: Miller and Holmes (2009, pp. 12–16)

Miller and Holmes (2009) are especially critical of China’s record on the deregulation of its financial system and the burdensome regulations imposed on foreign banks, as well as the country’s weak judicial system and its ineffective property rights enforcement.

Among the legal and regulatory barriers, previous studies in particular list certain regulations which restrict the activities of foreign banks, for example with regard to local currency business, refinancing, geographic areas, and licences for specific forms of deposits and loans, as well as foreign exchange control laws (Metcalfe 2008, 2007). In addition, high capital requirements to operate branches which serve Chinese customers in the local currency RMB may discourage some foreign banks to enter the newly opened and highly anticipated RMB market for Chinese individuals (Leung and Chan 2006; Leung and Young 2005). Another example of regulatory issues concerns the continuing need for foreign banks to engage in lengthy negotiating processes with the CBRC before being able to launch new products (Leung and Chan 2006).

Despite its strong central government, China is also a country with a much decentralised government structure. As a result, at the national laws are often only broadly drafted, leaving the specific implementation to the discretion of regional and local authorities, further decreasing the predictability of Chinese regulations (Zou and Gao 2007). This is confirmed by Metcalfe (2007) who find that regional offices of the CBRC often provide different and sometimes even contradictory interpretations of the same regulations.

**Recruiting and retention of qualified employees.** The availability of qualified staff represents another big challenge for foreign banks in China according to two studies by Metcalfe (2008, 2007) and the accounting firm PricewaterhouseCoopers (PWC) in 2007 and 2008. The demand for qualified employees in recent years has led to a steep rise in salaries across all functional areas and further increased the already high staff turnover
rate in foreign banks, with foreign bank tapping into each others’ employee pools when hiring new people. As a result, foreign banks have started to improve their efforts to better retain staff by reviewing their retention strategies and offering accelerated promotional opportunities for selected employees (Metcalfe 2008; KPMG 2008a).

**Lack of branch networks.** The lack of an extensive branch network also weakens a foreign bank’s competitive position in comparison to Chinese banks. Despite the increasing usage of online banking and other automated banking facilities in China and the developments in banking technology in general (e.g. Yuan, Lee and Kim 2010), the existing extensive “bricks and mortar” branch networks of many domestic banks in China (especially the “big four” and the city banks) is still seen as a major advantage for these banks (e.g. KPMG 2008a; Hansakul 2007; Leung and Chan 2006; Bekier and Lam 2005; Jiang, Locke and Willette 2003). Evidence from Central and Eastern Europe suggests that foreign banks find it easier to gain a market share in the credit and loans business than in the area of deposits. Bonin and Huang (2002) argue that this can be partly credited to the extensive branch network of many domestic banks, which appear to offer an advantage in the collection of household deposits. This also provides a major advantage when it comes to funding and refinancing.

**Funding and refinancing.** The availability and cost of RMB funds pose another major challenge for foreign banks operating in the Chinese banking market. The amount of local currency foreign banks can lend to their customers is restricted and that restriction is connected to the amount of deposits collected. Since most foreign banks lack a branch network to collect larger amounts of deposits, they depend on outside sources of funds. Because of the absence of RMB convertibility on capital accounts, for access to local currency foreign banks rely on the tightly controlled Chinese inter-bank market which is dominated by the “big four” banks. This situation makes it especially difficult for foreign banks to use pricing as a competitive tool in the market, particularly in the loan market (Bonin and Huang 2002; Leung and Chan 2006; Leung and Young 2005).

The resources required to incorporate locally in China is another issue for those foreign banks interested in taking this step. To incorporate a bank requires a minimum registered capital of RMB 1 billion and an additional RMB 100 million for each branch (Metcalfe 2008). Even before the current global financial crisis surfaced, some foreign banks had underestimated the financial commitment involved in incorporating in China,
and others struggled to secure the necessary commitment of their head offices (KPMG 2008a).

**Assessment of credit worthiness.** Another major issue for foreign banks in China according to the literature is the lack of a nationwide comprehensive system of credit records, making it extremely difficult for foreign banks to assess a potential borrower’s financial credibility outside of Shanghai, especially in the retail banking market (Metcalf 2007; Qi 2010; Xu and Liu 2006; Chan, Fung and Liu 2007). Here again, the long-standing relationships of Chinese banks with their clients puts the local banks in a better position. Coupled with their deeper knowledge of the market conditions in China in general, Chinese banks are better equipped than foreign banks to assess the risk associated with lending to local clients (von Emlo and Wang 2004; Jinag et. al. 2003).

**Cultural barriers.** Examples of cultural barriers for foreign banks discussed in the literature are the bank managers’ inexperience in dealing with different levels of the Chinese government bureaucracy (Ambler and Witzel 2004; Blackman 2001) as well as their relative lack of personal relationships or *guanxi* (Soukhov 2001; Graham and Lam 2004). *Guanxi*, which is often translated as “personal connections” or “personal relationships” can be defined as a relationship that bonds the exchange partners through reciprocal exchanges of favours and mutual obligations (Dunning and Kim 2007; Zou and Gao 2007; Chung 2004). While there seems to be a wide consensus in the literature concerning the importance of *guanxi* in Chinese culture and society, scholarly views appear to differ about the extent to which *guanxi* is something that is unique to the Chinese culture or more or less comparable to “social capital” or personal networks in Western culture (Dunning and Kim 2007; Chung 2004; Park and Luo 2001; Alston 1989).

According to the literature, firms develop *guanxi* as a strategic mechanism to overcome competitive and resource disadvantages by cooperating and exchanging favours with competitors, other firms and government authorities (Park and Luo 2001). In China, good personal relationships are usually considered more important than expert knowledge, which is usually dominating in Western cultures. Moreover, *guanxi* is often helpful for obtaining resources and information and more important than expertise, organisational affiliation, or existing contracts when it comes to finalising a business deal (Chung 2004; Park and Luo 2001; Soukhov 2001; Zou and Gao 2007).
The theoretical context of *guanxi* is still considered to be underdeveloped (Dunning and Kim 2007). From a resource-based view, *guanxi*, and especially *guanxi* with government officials can act as a distinct resource of a foreign company, because it is considered to be valuable, rare, non-substitutable, and only imperfectly imitable (Zou and Gao 2007). As such, *guanxi* can be the source of a competitive advantage, because it can considerably shorten the decision making process and build market entry barriers for competitors. As a result, the literature suggests, the personal relationships of foreign executives in China need to be developed and maintained through favours which match the initial contribution of the Chinese partner (Soukhov 2001; Davies, Leung, Luk and Wong 1995). Some authors even suggest that the Chinese economy in general strongly depends on *guanxi* to work, by compensating for systemic inefficiencies and institutional weaknesses (Fock and Woo 1998). This is based on the idea that when formal structures are underdeveloped or ineffective, societies have to rely more on informal structures as the major way to ensure reliability and security (Dunning and Kim 2007). In essence, according to Alston (1989, p. 29), “the Chinese bureaucracy inhibits action, while guanxi facilitates action”.

The research on how managers' micro interpersonal ties with top executives at other firms or government officials help to improve macro organizational performance of their own firms is still limited (Peng and Luo 2000). Some authors caution that there is still little evidence that foreign companies entering the Chinese market can actually develop and sustain *guanxi* and use it as a source of competitive advantage (Tsang 1998). Others warn that the considerable investment of time and money by Western firms to develop *guanxi* in China may not always pay off in the future, for example because the development process can be disrupted by something as common as staff mobility (Peng and Luo 2000; Fock, Woo 1998; Tsang 1998). Moreover, *guanxi* may even turn into a liability, for instance if Western managers are faced with unreasonable requests by Chinese competitors or high-level government officials to share critical knowledge or to hire their friends or relatives, which the manager might feel obliged to follow in order to maintain good *guanxi* with the requestor (Chung 2004; Tsang 1998). In addition, the actions necessary to develop and maintain *guanxi* often pose an ethical dilemma for managers from Western countries, because the Chinese culture of gift-giving and the granting of favours to build *guanxi* can easily become entangled with corruption and bribery (Snell and Tseng 2001; Chan, Denton and Tsang 2003).
2.4 Development of a framework for the investigation of market entry strategies of financial services providers

2.4.1 Introduction

This literature review consists of three main parts. In the first section (2.2), a theoretical foundation for this study was built by reviewing (and synthesising) major theories, models and frameworks which have been applied to the investigation and explanation of firms’ internationalisation and their entries into foreign markets.

The second part (2.3) of this literature review focused on empirical research covering several major issues with regard to the internationalisation of banks and their entry into foreign markets. Firstly, topics that shape the environment of foreign banks active in China have been reviewed. The entry of foreign banks into China has been antecedent and is now accompanied by major efforts by the Chinese authorities to deregulate and reform the country’s massive banking sectors. As such, these issues have received considerable attention in literature (e.g. Kumbhakar and Wang 2007; Brean 2007; Farrell, Lund and Morin 2006; Garcia-Herrero, Gavila and Santabarbara 2006). In addition, related topics such as the performance and competitiveness of foreign and Chinese banks in China and the issue of foreign banks acting as “strategic investors” and taking minority ownership of Chinese banks and what that means for the organisations involved (e.g. Hawes and Chiu 2007; Wu, Chen and Lin 2007; Berger, Hasan and Zhou 2009; Fu and Heffernan 2005) have also been included in this review.

After this review of topics which provide the major background for the activities of foreign banks in China, the literature with regard to the main research topics of this study was reviewed. This included research on the motives of banks to internationalise, their choice of entry mode form, their choice of market strategy or activities (which products and services they offer and which regions or customers they serve) in foreign markets, and the challenges they face in their foreign ventures.

Based on this review of the theoretical and empirical literature, the objective of this third part of the literature review is to develop a conceptual framework for an empirical analysis of the market entry strategies of German financial services providers in China in order to guide the process of data collection and analysis, to structure the results and findings of this study, and to put them into perspective with regard to existing theories and models and other empirical studies that investigate similar or related issues.
2.4.2 A framework for the investigation of market entry strategies of German financial services providers entering China

Based on the above review of the extant literature, the following “core” issues or concepts with regard to the internationalisation of financial services providers have been identified as major topics that also apply to German banks and AFIs entering the Chinese financial services market.

Firstly, these are the motives of financial services firms to enter a foreign market. Here, the two main themes that previous research has identified are “following the customer” based on pre-existing bank-client relationships and the search for market opportunities based on the size or characteristics of the host market. The second and third core issues of bank internationalisation identified in the literature review are the choice of entry mode or the organisational form a firm chooses when entering a foreign market and its choice of market strategy or activities, which include the clients and regions served, and the scope of products and services offered in the host market. Both issues are also often discussed with regard to the factors or determinants which influence the choice of entry mode and market strategy. Thus these constitute the fourth core issue of this research. Finally, the challenges banks face when entering a foreign market, are not usually the focus of previous studies, but they come up often when the complex question of foreign market entry of banks is investigated. This is the fifth core issue identified in the literature review.

A wide range of theories, models and frameworks has been applied to the investigation and explanation of firms’ internationalisation and their entry strategies into foreign markets. They all offer different (complementary as well as rivalling) perspectives on the subject matter, and contribute to the understanding of various core and related issues. Some emphasise understanding or explanation while others focus on predictions or causal relationships. The application of different theories, models and frameworks to internationalisation and foreign market entry have also led to some conflicting results. One such example is the influence of “cultural distance” between home and host country. Some scholars argue that the cultural distance between a firm’s home country and the host country should be negatively related to the level of involvement and resources commitment, because it will tend to make managers shy away from a higher investment. Others propose that cultural distance should encourage higher ownership involvement,
because it will mean that a firm entering the market has better control of its ventures in the host market (Zhao and Decker 2004).

Another issue is the situational context, which can strongly limit the application of a given theory or model. For instance, the transaction cost approach does not consider government regulations, which usually limit and define the available modes of market entry in a foreign country (Gatingnnon and Anderson 1988; Zhao and Decker 2004). As Erramilli and Rao (1993) point out, most studies applying the TCA to the entry decision implicitly assume that the actual entry mode chosen by a firm reflects its desired level of control. However, restrictions imposed by the foreign market often effectively limit the entry modes available to the entering firm, causing significant differences in the desired and actually achieved levels of control. This is also the case for foreign banks in China, where the choice of entry mode is strongly regulated.

In summary, based on the above review of the theories and models applied to internationalisation and foreign market entry, it appears reasonable to follow Coviello and McAuley (1999) in their suggestion that it is difficult to completely capture the phenomena of internationalisation and foreign market entry using one theoretical framework alone. Indeed, a review of both the theoretical literature and the empirical research on the issues under investigation suggests that there is a clear trend towards taking a more holistic or eclectic approach and attempts to apply integrated frameworks which combine concepts from different perspectives. This is the case not only for purely empirical studies, but also in research with a stronger theoretical perspective. Thus, this trend seems to follow Zinkhan and Hirschheim (1992, p. 81), who argue that science should use “whatever tools, techniques, and approaches are considered appropriate for the subject matter under study”.

One example for the integration of different theoretical models is the combination of the RBV with concepts of the network approach, as proposed for example by Ahokangas (1998). While a significant contribution of the RBV concerning internationalisation lies in the identification of international knowledge and experience in foreign markets as a valuable, hard-to-imitate key resource for successful foreign market entries (Peng 2001), the network approach suggests that network relationships can help firms to gain access to external resources which are in the possession of other network members (Cumberland 2005). The integration of the two perspectives may enhance the understanding of the successful entry of SMEs in foreign markets, which often lack the re-
sources usually expected to be necessary to successfully enter foreign markets (Ruzzier et. al. 2006).

A conceptual framework. Based on the above concepts identified from previous theoretical and empirical inquiries, the following framework of market entry strategies of foreign banks and AFIs entering China (Figure 2.4) has been developed as a starting point for the analysis of market entry strategies of German financial services providers entering China, to guide the process of data collection and analysis, to structure the results and findings of this study, and to put them into perspective with regard to existing theories and models as well as other empirical studies that investigate similar or related issues (Jabareen 2009; Morse, Hupcey, Penrod, Spiers, Pooler & Mitcham 2002).

Figure 2.4: A framework for the investigation of market entry strategies of foreign banks and AFIs entering China

In particular, this study investigates the following five research questions:

(1) What are the motives of German banks and AFIs to enter the Chinese market?

(2) Which entry modes are used by German banks and AFIs in China (including the choice of a possible local partner)?

(3) What are the market strategies or activities of German banks and AFIs in China (that is, which clients and geographic regions are being served, and which products and services are being offered by German banks and AFIs in China)?

(4) Which factors influence the choices of entry mode and market strategy of German banks and AFIs in China?
(5) What are the challenges that German banks and AFIs face when entering the Chinese market?

Research question four essentially investigates “why” the participating organizations chose their entry mode and market strategy in China.

2.5 Conclusion

In the first section (2.1) of Chapter 2, a theoretical foundation for this study was built by reviewing (and synthesising) major theories, theoretical models, and frameworks which have been applied to the investigation and explanation of firms’ internationalisation and their entry strategies into foreign markets. In the second part (2.2) of the literature review, empirical research covering several major issues with regard to the internationalisation of banks and their entry into foreign markets in general and China in particular were reviewed and gaps in the literature identified.

Based on this review of theoretical and empirical research, in the third part of the literature review a conceptual framework for an empirical analysis of the market entry strategies of German financial services providers in China was developed to guide the process of data collection and analysis, to structure the findings of this study and put them into perspective with regard to existing theories and models and other studies that touch on similar or related issues. In addition, the main five research questions for this study have been developed.

Chapter 3 will now describe and justify the main research methodology and the specific research method used in this study. In addition, Chapter 3 will discuss data collection and analysis as well as ethical considerations of this study.
3 Research Methodology

3.1 Introduction

The previous chapter reviewed the extant literature with regard to the research problem, the market entry strategies of German financial services providers in China. Based on this review of the relevant literature, gaps in the literature and issues which are worth researching have been identified and a framework to guide the research process, and to structure and put them into perspective with regard to previous research, has been developed.

Chapter 3 will now describe and justify the main research methodology and the specific research methods used in this study. In addition, this chapter will discuss data collection and analysis as well as ethical considerations to ensure that appropriate procedures were followed.

The reminder of this chapter is organised as follows. After this introduction, the choice of case study as a qualitative research methodology is discussed and justified in Section 3.2. The description of the case study method includes the following subsections: characteristics and definitions (3.2.1), advantages and strengths of case study research (3.2.2), criticism and limitations of case study research (3.2.3), quality and integrity of case study research (3.2.4), inductive and deductive reasoning in case-based research (3.2.5), case selection and number of cases (3.2.6), and data collection and sources of evidence (3.2.7). Section 3.3 describes the processes and procedures of the data analysis. The chapter concludes with a discussion of the ethical considerations (3.4) and the chapter conclusion (3.5).

3.2 Justification of case study as research methodology

The internationalisation and foreign market entry of banks and other financial services firms has been investigated using both quantitative and qualitative research methods (e.g. Buch and Lipponer 2004; Metcalfe 2007).
This section of the chapter explains and justifies the application of case study, a qualitative approach, used in this research. The first part of this section will focus on the justification of using a qualitative approach. The second part of this section will then explain and justify the particular research method, **case study** used in this research.

Literature has distinguished and defined qualitative and quantitative approaches on the basis of various criteria (Bazeley 2004). Common examples include the type of data used (numeric or textual), the sample size (small or large), the logic employed (inductive or deductive), the type of investigation conducted (descriptive, exploratory, explanatory or confirmatory), the research questions asked (“why” and “how” or “what” and “how many”), the method of analysis (interpretive or statistical), the format or path of the research (sequential or recursive, linear or non-linear), the combination of data collection and analysis (integrated/simultaneous or separated), the role of theory (theory testing or theory building), and the presumed underlying paradigm (positivism, constructivism, critical theory, or realism) (Bazeley 2004; Ticehurst and Veal 2000; Neuman 2006; Carson, Gilmore, Perry and Gronhaug 2001; Easterby-Smith, Thorpe and Lowe 1991; Lincoln and Guba 1985; Perry 1998). Thus, it is no surprise that various definitions and descriptions of quantitative and qualitative research exist in the literature.

Malhotra (1993, p. 159) defines **quantitative research** as a methodology, “that seeks to quantify the data and, typically, applies some form of statistical analysis”. According to Neuman (2006), quantitative research consists primarily of precisely measuring variables and testing hypotheses that are linked to general causal explanations. Other authors point out that quantitative research is usually applied to support or reject a hypothesis, and therefore requires large samples (Easterby-Smith, Thorpe and Lowe 1991; Zikmund 2003).

In contrast, **qualitative research** can be defined as “an array of interpretive techniques which seek to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occurring phenomena in the social world” (van Maanen 1983, p. 9). According to Neuman (2006, p. 157), qualitative researchers employ “a language of cases and contexts”, examine “social processes and cases in their social context”, and look at “interpretations or the creation of meaning in specific settings” and “multiple points of view” and try to “explain how people construct identities”. Ereaut, Imms and Callingham (2002) point out that qualitative re-
search generally tries to make sense of and interpret the researched phenomena in terms of the meanings people bring to them, and Mariampolski (2001, p. 7) suggests that qualitative research investigates the “meanings and motivations” behind behaviour and seeks to create a “thorough account of behavioural facts and implications” through the encounter “with people’s own actions, words and ideas”. Thus, instead of numbers, data in qualitative research are often in the form of words and images from transcripts, documents or observations. The analysis of these data usually comprises extracting themes or generalisations from the evidence and organising data to present a coherent, consistent picture (Neuman 2006).

In the face of the various definitions of qualitative and quantitative methodologies that can be found in the literature, Bazely (2004, p. 142) suggests that the qualitative and quantitative methodologies may be set along a continuum, “with a number independent dimensions upon which any particular research can be placed.”

There are several strong proponents and opponents of both qualitative and quantitative research. Some authors suggest that a researcher’s paradigm or worldview has important consequences for the practical conduct of scientific inquiry and consequently consider certain paradigms, methodologies and research methods as philosophically incompatible (Guba and Lincoln 1994; Bazeley 2004).

While the issues around the alternative research paradigms may not have been solved and continue to be discussed in the literature, more and more scholars point out that qualitative and quantitative methods are not incompatible and that they should rather be seen as complementary, with even the combination and integration of both seeming to be possible and useful (Mayring 2001; Ticehurst and Veal 2000). In this view, pragmatism should overrule methodological “purity” and the choice of research methods should mainly be based on a thorough assessment of which methods are best suited to answer a given research question (Ticehurst and Veal 2000). As Grossnickle and Raskin (2001, p. 50) point out, “qualitative research can probe into hard-to-define areas, like the underlying reasons for attitudes and opinions. Quantitative research is strongest when measuring hard facts”. When studying social phenomena, quantitative methods require the use of standardised measures, in order to be able to fit the varying perspectives and experiences of people into a limited number of predetermined responses (Patton 2002). In contrast, qualitative inquiry can provide “richness and subtlety of understanding” (Parkhe 1993, p. 248–249) because it offers a better opportunity for clarifica-
tion of questions or elaboration of answers than surveys and secondary data (Parkhe 1993).

### 3.2.1 Characteristics and definitions

The term “case study” has become increasingly popular in various disciplines, in particular in the economics and business literature. It is also often used in doctoral dissertations in the areas of marketing, strategy and organisation (Gummesson 1991). This increased popularity goes along with a wide range of definitions, typologies and descriptions of case study research (Gerring 2007; Bitsch 2001; Al Qur’an 2005).

Case-based research today is usually considered to be a research method or research strategy (e.g. Gerring 2007; Yin 2003; Gillham 2000; Perry 2000, 1998). However, some authors don’t define case study as a method, but as a way to present the results of research (Patton 2002; Bitsch 2001). Another exception is Stake (2003), who suggests that case study is not a methodological choice but rather the choice of what is to be studied.

While case study is often applied to answer “how” and “why” questions, it is not considered to be exclusively qualitative or exploratory, as case-based research is also used in explanatory and descriptive studies, and the research methods applied and the data collected may be both qualitative and quantitative (Stake 2003; Gerring 2007; Yin 2003, 1994). While case study is seen as largely qualitative in nature (Perry 2000), in predominantly quantitative research, case study is sometimes used in the pilot study or early phase of the research project (Tellis 1997). This variety can also be found in the typologies provided in the literature. For example, case-based research may be exploratory, descriptive, or explanatory (Yin 2003), particularistic, descriptive, or heuristic (Merriam 1988) and snapshot, longitudinal, pre-post, patchwork, or comparative (Jensen & Rodgers 2001).

One of the most common definitions of case-based research is presented by Yin. According to Yin (2003, p. 13), a case study is an empirical inquiry that

- investigates a **contemporary** phenomenon within its real-life **context**, especially when

- the boundaries between phenomenon and context are not clearly evident.

In addition, Yin (2003, p. 14), points out that case study
• relies on **multiple sources** of evidence, and

• is a comprehensive research strategy including the logic of design, data collection techniques and specific approaches to data analysis.

A similar definition is suggested by Orum, Feagin, and Sjoberg (1991, p. 2), who define case study as an “in-depth, multifaceted investigation” of a “single social phenomenon”, which is conducted in “great detail” and often relies on the use of “several data sources”.

### 3.2.2 Advantages and strengths of case study research

The literature points to several advantages and strengths of case study research. The following examples were important in the choice of case study for this research.

Case study is considered to be able to provide a more **holistic** view of complex settings and processes, for example by collecting information from several sources and over a period of time (Orum et. al. 1991). In this context, holism could be viewed as the opposite of reductionism, which is more aligned with quantitative research and which is a means for understanding the nature of complex structures by breaking them down into smaller subsystems or well defined parts (Gummesson 1991). Case-based research can provide insight into the complexities of real-life situations, which may not be captured by other research methods (Zainal 2007). To investigate why foreign banks enter the Chinese market, which entry mode and market strategies they choose and which factors influence their choices appears to benefit from a more holistic approach which can capture the full complexity of the market entry process.

Case study is usually conducted within the **context** of its subject of analysis. It therefore permits the observations to take place in “natural settings … at close hand” (Orum et. al. 1991, p. 6, Yin 2003). This was another argument for using case study in this research, since based on the analysis of the situational context of this research, the conditions in the host market China, and some characteristics of the banking industry in the home market of Germany, were expected to strongly influence the choices made by the participating organisations.

Closely related to the above characteristics is another strength of case study research. Because of its nature, case-based research is considered to be particularly useful in applied research and to provide practitioners with operational advice for their work. Case
study research shares many characteristics with the work of management consultants, for example in terms of the range of information gathering techniques and multiple sources they use and the importance of context (Gummesson 1991). Since this research also aims to be able to provide bank managers with practical advice, using case study, again, seems to be an appropriate choice.

Case study research allows the researcher to investigate developments over time, thereby enabling the researcher to better capture the dimension of time and to examine continuity and change patterns (Orum et. al. 1991). Since foreign banks entering China are operating in a very dynamic environment, case study appears to be a suitable research strategy for this topic. For instance, in this study several interviewees distinguished between different time periods (e.g. pre-WTO inception, the transition period between 2001 and 2006, and the full opening of the market since December 2006) and explained how their perception of the Chinese market and their subsequent strategies changed over time until they settled on their current entry mode and market strategy. Such a consideration and investigation of these very individual considerations would have been difficult with a more pre-determined research method.

Case study research is flexible and often develops as it proceeds, which is especially helpful when dealing with complex and dynamic research subjects (Nykiel 2007), as it allows the researcher to immediately react to emerging themes with follow-up questions and does not require a research design which is as detailed and pre-structured as some other research methods like experiments or surveys. Depending on the purpose of the research and the subject under investigation, case studies may be pre-structured or “emergent” (Robson 1993).

3.2.3 Criticism and limitations of case study research

Various scholars have criticised case study as a research method and have pointed to several alleged weaknesses which could make it a less desirable form of inquiry (Yin 2003). These points of criticism have also been considered in the choice of case study for this research.

Perhaps the strongest criticism of case study research concerns the concepts of scientific rigour, validity and reliability or the lack thereof (Yin 2003; Parkhe 1993; Gummesson 1991). However, as suggested for example by Yin (2003), Merriam (1988) and Perry (2000, 1998), case study research can be conducted rigorously, and validity and reliabil-
ity can be established, if an appropriate structure and procedure is used for preparation, data collection and data analysis. The concepts of rigour, validity and reliability for this research are further discussed below in Section 3.3.4.

Another major point of criticism of case-based research refers to the concept of generalisation. Since case study is usually only based on a limited number or sometimes only a single case, it does not fulfill the criterion of statistical representativeness (Bitsch 2001). However, several scholars suggest that other criteria could be used instead. Yin (2003, p. 10) points out that “case studies, like experiments, are generalisable to theoretical propositions” instead of populations, thus case-based research can be used “to expand and generalize theories (analytical generalization) and not to enumerate frequencies (statistical generalization)”. A similar argument is made by Parkhe (1993, p. 227–268), who suggests that “the power of the case study method stems from its capacity to aid theory development beyond the immediate case at hand, not through statistical generalization (as in most quantitative studies), but through analytic generalization in which the researcher tries to generalize a particular set of results to a broader theory through induction”. Since any case study usually also includes a review of related theory and previous research, case study research can be considered to commonly include both inductive and deductive reasoning, based on existing theory and theory emerging from the newly collected data (Perry 1998). Finally, there is the question of the purpose of the research. Flyvbjerg (2006) makes the point that formal generalisation is only one source of scientific progress. Even knowledge that cannot be statistically generalised can be of high value and enter the collective process of knowledge accumulation in its field.

Related to the question of scientific rigour in case-based research is the issue of researcher bias. That is, the problem that case study research is more likely to contain a bias toward verifications, which means a tendency to confirm the researcher’s preconceived notion, because case study provides more room for the researcher’s subjectivity and arbitrary judgment than other research methods (Flyvbjerg 2006; Smith 1991). While it is important to be aware of one’s possible preconceptions, Flyvbjerg (2006) points out that various authors of case studies have reported that the study’s results forced them to change their previous views or assumptions. Therefore, he concludes, case studies are particularly useful for falsification, and not verification. For this study, several precautionary steps suggested in the literature were adopted in the process of da-
ta collection and analysis to deal with the problem of bias. These are discussed below in Sections 3.2.4 and 3.4.

After a thorough consideration of both the strengths and weaknesses of case-based research in comparison to other research methods, case study was chosen as the appropriate research method to investigate the research questions presented above.

3.2.4 Criteria for judging the quality and integrity of case-based research

This section discusses the criteria that were applied to establish validity and reliability in this research. In dealing with the issues of qualitative research and in particular with the criticisms of case-based research, several scholars have developed a number of different approaches to increase the integrity and validity of qualitative research (Riege and Nair 1996; Christie, Rowe, Perry, and Chamard 2000).

In case-based research, validity and reliability can be established through the concepts of (1) construct validity, (2) objectivity or confirmability, (3) internal validity or credibility (4) external validity or transferability, and (5) reliability or dependability (Miles and Huberman 1994; Yin 2003; Christie et. al. 2000).

(1) Construct validity

Construct validity refers to having adequate operational measures for the concepts which are under investigation (Christie et. al. 2000; Yin 2003), that is, construct validity is “the ability of a measurement instrument to measure a concept or construct” (Aaker, Kumar and Day 1995, p. 770). In this research, construct validity was established by developing its constructs through a literature review, the use of multiple sources of evidence, the establishment of a chain of evidence, and by having external experts review selected draft case study reports (Christie et. al. 2000; Yin 2003).

Firstly, multiple sources of evidence were used in this research. These sources include an extensive review of the literature (Chapter 2), interview protocols, documents provided by the participating organisations, and external sources including journals and newspaper articles, and data provided by market research firms and government organisations (e.g. the CBRC).

Secondly, a chain of evidence was established for this research to enable the reader to follow the evidence used in the sense of an audit trail, from the initial research ques-
tions, through data collection to the final conclusions (Yin 2003). Measures taken to establish a chain of evidence included the application of a structured interview process and a structured processes for recording, transcribing and interpreting the data (Christie et. al. 2000).

Finally, interview protocols and draft reports of the case studies (with disguised participants’ identities) were reviewed by external experts and key respondents to corroborate the essential facts and evidence presented in the case reports (Yin 2003):

- selected interview protocols and draft reports were reviewed by the informants,
- in some cases, a second interview with a different informant from the same company was conducted,
- an experienced academic researcher reviewed selected interview protocols and the conclusions drawn from the interviews with regard to the research questions, and finally,
- after the initial interviews with the participating organisations, all research issues were discussed with an experienced management consultant who has worked in China for several years and whose work involves consulting Chinese and German banks and Chinese authorities with regard to banking sector reform.

In addition, when this study was conducted, the potential impact of Common Method Bias and Common Method Variance was also taken into account (e.g. Podsakoff, Mackenzie, Lee, & Podsakoff 2003; Meade, Watson, and Kroustalis 2007).

Common Method Variance represents the “variance that is attributable to the measurement method rather than to the constructs the measures represent” (Podsakoff, MacKenzie, Lee, & Podsakoff, 2003, p. 879). As such it can create a false internal consistency, pointing to an apparent correlation among variables which is actually generated by their common source (Chang, van Witteloostuijn, and Eden 2010). Common Method Bias describes the degree to which correlations are altered due to a methods effect, as such it refers to the divergence between observed and true relationships among constructs (Meade, Watson, and Kroustalis 2007; Doty and Glick 1998). In this study, the following steps were taken to address the potential effects of Common Method Bias (Chang et. al. 2010; Meade et. al. 2007; Podsakoff at. al. 2003; Chung, Rose, and Huang 2010):
• Different sources of information were used for some of the key measures. In particular, when possible, the dependent variable was established or confirmed using information from other sources than the interviewees (e.g. with regard to the entry modes chosen and the activities performed by the participating organisations).

• In some cases, a second interview with a different informant from the same company was conducted.

• An experienced academic researcher reviewed selected interview protocols and the conclusions drawn from the interviews with regard to each individual research question.

• Anonymity was guaranteed to all respondents. It was emphasized that the study had been approved by a university ethics committee, that participation was completely voluntary and that no firm’s or individual’s identity would be revealed, and only aggregated results would be published.

(2) Objectivity or confirmability

Confirmability can be described as the ability of others to satisfy themselves that the investigation conducted was carried out in the way described by the researcher and that it is reasonably free from unacknowledged researcher bias (Lincoln & Guba 1985; Miles & Huberman 1994; Riege & Nair 1996; Christie et. al., 2000).

The available procedures to establish confirmability are partly similar to those used in establishing a chain of evidence discussed above. In this research, confirmability was established by providing a record of all data collected (e.g. interview transcripts, notes, and secondary sources), to enable third parties “to trace the logical progression of reasoning from the evidence presented to the conclusions drawn” (Christie et. al. 2000, p. 17), including the selection of cases, interview procedures, and interpretations made (Miles & Huberman 1994; Burns 1994;). In addition, selected drafts of case reports were reviewed by external experts and key informants (Yin 2003; Miles and Huberman 1994).
(3) **Internal validity or credibility**

In quantitative research, internal validity refers to the identification of causal relationships between certain variables (Christie et. al. 2000). In qualitative research, instead of internal validity the criterion of credibility is often used (Miles and Huberman 1994; Lincoln and Guba 1985). Credibility refers to the question whether the results of a study appear to be credible, plausible, or authentic, both to a third party and to the participants of the research (Lincoln and Guba 1985; Gummesson 1991; Miles and Huberman 1994). The criterion of credibility applies to the whole research process, from the research questions, through data collection and analysis, to the final research report (Gummesson 1991). It is especially concerned with whether possible rival explanations have been systematically explored by the researcher before conclusions were drawn, how findings relate to previous research and theory, and which areas of uncertainty still exist (Yin 2003; Miles and Huberman 1994).

In this study, various techniques were used to establish credibility by corroborating or verifying findings and conclusions drawn, by systematically exploring possible rival explanations for the results at hand, and by identifying areas of uncertainty (Christie et. al. 2000; Miles and Huberman 1994; Yin 2003):

- Interview protocols and draft case reports were reviewed by key informants and external experts with regard to the research issues and the conclusions drawn.
- The conclusions drawn from individual cases were systematically compared with each other, looking for similar or contrary results based on predictable reasons (cross case analysis and pattern matching).
- All results were compared to the findings of previous research and the explanations offered by theoretical research.
- In addition, areas with major uncertainty with regard to the findings were documented in the research report (Miles and Huberman 1994).

(4) **External validity or transferability**

External validity or transferability in case-based research refers to the question of whether a study’s results are generalisable beyond the immediate case study. As discussed above, case-based research cannot be used for statistical generalisation, however
it can be used for analytical generalisation, in which the research is striving “to general-
ize a particular set of results to some broader theory” (Yin 2003, p. 37), which could
then be tested using a quantitative approach (Perry 2000). Generalising to a theory
means to be able to provide evidence which supports the theory in the making, but does
not confirm it definitively (Firestone 1993). However, in order to be able to make such
analytical generalisations, it is necessary to be able to replicate and corroborate the find-
ings in multiple cases (Yin 2003; Christie et. al. 2000).

Multiple case studies and cross-case analysis, (Christie et. al. 2000), theoretical and lit-
eral replication (Parkhe 1993; Yin 2003), and the comparison of findings to the extant
literature (Eisenhardt 1989; Miles and Huberman 1994) have been used to establish
transferability in this research. In addition, this research attempts to provide “the thick
description necessary” (Lincoln and Guba 1985, p. 316) for readers to assess the poten-
tial transferability and appropriateness of the findings for their own settings and con-
texts (Miles and Huberman 1994). The above were also useful for dealing with the poten-
tial respondent bias of the non-probability sample used in this research.

(5) Reliability or dependability

The final criterion of reliability or dependability generally refers to how consistently a
technique measures concepts so that other researchers applying the same procedures
would get to the same results (Perry 2000). Applied to case-based research, the question
is therefore whether another investigator using the same case and following the same
procedures as the original study would arrive at the same findings or conclusions. The
objective of this criterion is to minimise the errors and biases in a study (Yin 2003;
Gummesson 1991). Thus, to establish reliability/dependability, it is necessary to use a
very structured research process, in particular for data collection and analysis, to enable
other researchers to follow the same path (Perry 2000).

The following measures were taken in this research to ensure reliability/dependability.
Firstly, a case study protocol was developed as “the standardized agenda for the investi-
gator’s line of inquiry”, which provides an “overview of the case study project”, “field
procedures” used, the research questions, and a “guide for the case study report” (Yin
2003, p. 68–69). Secondly, a case study database was set up, which contains all raw da-
ta (e.g. interview transcripts, documents provided by the participants, and evidence from
external sources) collected and used in this research (Merriam 1988; Yin 2003). Finally,
cross-checks of selected findings and conclusions were conducted by selected interviewees and an experienced management consultant who has worked in China for several years and whose work involves consulting Chinese and German banks and Chinese authorities with regard to banking sector reform. In addition, the whole research process was reviewed by an academic research expert (Christie et. al. 2000).

Table 3.1: Criteria used to establish validity and reliability in this research

<table>
<thead>
<tr>
<th>Criteria / Test</th>
<th>Definition (for this research)</th>
<th>Techniques applied in this research</th>
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<tbody>
<tr>
<td>Construct validity</td>
<td>The operational measurement instruments really measure the constructs or concepts intended to measure (Emory and Cooper 1991; Yin 2003, p. 34; Aaker, Kumar and Day 1995, p. 770)</td>
<td>• Use of multiple sources of evidence</td>
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<td></td>
<td></td>
<td>• Establish and document chain of evidence</td>
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<td></td>
<td></td>
<td>• Review of case report drafts by external experts</td>
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<tr>
<td>Objectivity / Confirmability</td>
<td>The findings of the research are logical and unprejudiced (Hirschman 1986)</td>
<td>• Use of multiple sources of evidence</td>
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<td></td>
<td>The ability of others to satisfy themselves that the investigation conducted was carried out in the way described by the researcher (Christie et. al. 2000)</td>
<td>• Case study protocol</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Review of interpretations by third parties</td>
</tr>
<tr>
<td>Internal validity / Credibility</td>
<td>The findings reflect the reality of the phenomenon under investigation (based on sufficient evidence provided) (Gummesson 1991, p. 159; Miles and Huberman 1994)</td>
<td>• Use of multiple sources of evidence</td>
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<td>• Pattern matching in data analysis</td>
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<td>• Review by interviewees</td>
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<td>• Systematic consideration of competing explanations</td>
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<tr>
<td>External validity / Transferability</td>
<td>Transferability of results to similar groups to allow for generalisation to a broader theory (Gummesson 1991; Yin 2003)</td>
<td>• Comparison of findings with literature</td>
</tr>
<tr>
<td>Reliability / Dependability</td>
<td>The degree to which measures are free from error and can be repeated (Lincoln and Guba 1985) Consistency and stability of the findings (Batonda 1998) Consistency of procedures and techniques used in the research (Riege and Nair 1996)</td>
<td>• Case study protocol</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Case study database</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cross checks of certain findings and review of the case study process by independent third parties</td>
</tr>
</tbody>
</table>

Source: Developed for this research, partly adopted from Yin (2003)

3.2.5 Combining inductive and deductive reasoning and the role of prior theory

The nature of case-based research with regard to inductive and deductive reasoning has been a source of controversy in the literature. According to Patton (2002, p. 453):
inductive analysis involves discovering patterns, themes, and categories in one’s data. Findings emerge out of data, through the analyst’s interactions with the data, in contrast to deductive analysis where the data are analyzed according to an existing framework.

In this sense, induction does not necessarily need to build a new theory and deduction does not necessarily need to test an existing theory. Rather, inductive reasoning tries to develop theoretical concepts or propositions based on empirical observation, and deductive reasoning compares theoretical propositions based on previous research and literature to empirical observations (Neuman 2006).

Some scholars argue that case study should be mostly inductive, and literature should be used as little as possible prior to data collection as the “research question may shift during the research” (Eisenhardt 1989, p. 536). Especially in theory-building research, Eisenhardt (1989) argues, that the research should be “as close as possible to the ideal of no theory under consideration and no hypothesis to test”, because “preordained theoretical perspectives or propositions may bias and limit the findings” (Eisenhardt 1989, p. 536). In addition, some social anthropologists and phenomenologists consider “social processes to be too complex, too relative, too elusive” to be approached with “explicit conceptual frames” (Miles and Huberman 1994, p. 17). However, others like Yin (2003) recommend relying more on previous theory and reviews of previous research to develop and test competing hypotheses, and following a very structured research protocol.

Carson et. al. (2001, p. 99) warn that researchers who only use induction in case-based research risk drifting away from the initial problem or “rediscovering” already existing theory, which could also have been found in the literature, and thus they are not making a new contribution to academic research. Furthermore, without a guiding framework, everything may look important to the researcher, making it a very time-consuming process to identify regularities and key-concepts which emerge from the cases (Carson et. al. 2001).

This study attempts to follow a “middle road” (Carson et. al. 2001, p. 96), using and combining both inductive or “exploratory” and some deductive or “confirmatory” reasoning. This approach makes it possible to both benefit from and build upon previous research on the internationalisation of financial services and to discover or develop new propositions and concepts with regard to the research questions (Parkhe 1993, p. 253). This approach is especially useful, when “something is known conceptually about the phenomenon”, for example in the form of a “rudimentary conventional framework” as
well as a “set of general research questions”, “but not enough to house a theory” (Miles and Huberman 1994, p. 17).

This research applies a combination of exploratory and confirmatory/disconfirmatory reasoning (Carson et. al. 2001). The literature review helped to discover “gaps” in the research, which are not expressed “as precise, testable, closed yes/no propositions or hypotheses, but as general broad, open research issues” (Carson et. al. 2001, p. 100). In addition, the literature review and especially the review of theories on internationalisation (Section 2.2) helped to identify various external and internal factors which potentially influence market entry strategies or are being considered by management in their choice of market entry strategy. Since many theories rely on monocausal explanations, several theories were reviewed to cover a broad range of possible internal and external contingencies of the choice of market entry strategy (Perlitz 2004).

In the data collection stage, the framework of market entry strategies of foreign banks in China developed in Section 2.4 of Chapter 2 was used to keep focus and avoid being “sidetracked” by various random “indigenous concepts” (Carson et. al. 2001, p. 98) emerging from the cases under investigation. Such random indigenous concepts or typologies (often contrasted with constructed concepts or typologies) may have some significance for the interviewees in their particular setting, however they are often not related to the specific research issues under investigation. Here, the conceptual framework developed for this research helped to keep a balance between the research issues identified in the literature review, the research questions under investigation, and new emerging concepts and propositions (Gibbs and Taylor 2010; Ryan and Bernard 2003; Carson et. al. 2001).

3.2.6 Criteria for case selection and number of cases

The selection of cases in case-based research is considered to be of key importance (Veal 2005), and the literature offers various criteria for the selection and number of cases to be studied (e.g. Yin 2003; Carson et. al. 2001; Patton 2002; Miles and Huberman 1994). A major point made by several authors is that the representativeness, and in particular, the statistical representativeness of a case, should not and cannot be a criterion for case selection or for the number of cases included in the study (Stake 2003; Miles and Huberman 1994). Furthermore, the inappropriateness of random sampling in case-
based research is pointed out, for example by Eisenhardt (1989, p. 537), who suggests that “random selection of cases is neither necessary, nor even preferable”.

There are several examples of case studies, which are based on a single case (Carson et. al. 2001; Yin 2003). According to Yin (2003, pp. 40-42), research can be based on only a single case if one is dealing with a “critical”, “extreme”, or “unique” case, and the appropriateness of two or more theories can be tested with that case. However, a case study design with more than one case is usually preferable, because it offers the additional dimension of cross-case analysis (Carson et. al. 2001).

When multiple cases are being used, instead of representativeness or “sampling logic”, the criterion of “replication logic” can be applied (Carson et. al. 2001, p. 102). In this sense, Yin (2003, pp. 46–49) suggests that multiple cases should not be seen like multiple respondents in a survey, but as “multiple experiments”, in which after one case study is finished, the researcher tries to possibly replicate the findings in the next case study. Cases for multiple case studies should be carefully selected so that they either predict similar results for predictable reasons (that is, “literal replication”), or produce contrary results for predictable reasons (that is, “theoretical replication”) (Yin 2003, p. 47).

**Criteria for the selection of cases.** The literature offers various criteria for the selection of cases. In general it can be said that the selection of a particular case should be based on the purpose of the research (Stake 2003; Patton 2002). Patton (2002, p. 230) states that “information-rich” cases should be selected, which are worthy of in-depth study, and Stake (2003 p. 152) suggests that while the “typicality” of cases should be considered, researchers should focus even more on those cases which seem to offer the best “opportunity to learn”. With reference to Glaser and Strauss (1967), Miles and Huberman (1994, p. 29) argue that sampling should be “theoretically driven”, based on conceptual considerations of the researcher, independent of whether those concepts are being drawn from the literature of have emerged from the study itself. Perry (1998) adds that purposeful sampling in case study research should largely depend on the conceptual framework developed from prior theory.

Typical sampling strategies applied in case study research, depending on the purpose of the study and the resources available to the researcher are displayed in Table 3.2.
Table 3.2: Selected sampling strategies for case selection

<table>
<thead>
<tr>
<th>Sampling strategy</th>
<th>Description of the sampling strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extreme case</td>
<td>The case demonstrates an unusual manifestation of the phenomenon, such as outstanding success and notable failures</td>
</tr>
<tr>
<td>Intensity case</td>
<td>The case is information rich but not an extreme case</td>
</tr>
<tr>
<td>Maximum variation</td>
<td>Cases, despite having diverse variations, exhibit important common patterns that cut across variations</td>
</tr>
<tr>
<td>Homogeneous</td>
<td>Variation between cases is minimised, analysis is simplified and study is focused</td>
</tr>
<tr>
<td>Typical case</td>
<td>Case illustrates what is typical, normal or average</td>
</tr>
<tr>
<td>Stratified purposeful case</td>
<td>Case illustrates characteristics of a particular subgroup to facilitate comparison (not for generalisation or representation)</td>
</tr>
<tr>
<td>Critical case</td>
<td>Case that permits logical generalisation to other cases because if it is true to this one case, it’s likely to be true to other cases</td>
</tr>
<tr>
<td>Criterion</td>
<td>Cases selected because they meet one or more predetermined criteria</td>
</tr>
<tr>
<td>Theoretical</td>
<td>Cases that are manifestations of a theoretical construct and are used to examine and elaborate on it</td>
</tr>
<tr>
<td>Confirming and dis-confirming</td>
<td>Cases that elaborate on initial analysis to seek exceptions or test variations</td>
</tr>
<tr>
<td>Opportunistic</td>
<td>Cases that emerge from following leads during field work</td>
</tr>
<tr>
<td>Random purposeful case</td>
<td>Cases are randomly selected from a large sample for the purpose of increasing credibility (not for generalisation or representation)</td>
</tr>
<tr>
<td>Politically important case</td>
<td>Cases are selected or dropped from the sample because they are politically sensitive cases</td>
</tr>
<tr>
<td>Convenience</td>
<td>Cases are selected based on convenience, e.g. access, availability of time and resources</td>
</tr>
</tbody>
</table>

Source: Patton (2002, pp. 243-244), Miles and Huberman (1994, p. 28)

All German banks with a presence in China were initially identified based on a list published by the Germany Embassy in Beijing on its website (German Embassy in Beijing 2008). The AFI s with a presence in China were initially identified based on publicly available information. A first contact was established using email or telephone to inquire whom to contact within the organisation with regard to the organisation’s possible participation in academic research projects. After an appropriate contact person had been named, this person was contacted by email or telephone. During this first contact, the research project was briefly described to the contact person and the general possibility of participation was discussed. In three cases, the initial contact person within the organisation could not immediately name an appropriate contact person for this research, but agreed to inquire about it. In these three cases the researcher was then later contacted directly by the appropriate contact person. After the contact person accepted the invitation to participate in this research in principle, a cover letter and information
sheet was sent to the contact person after which a time and place for the interview was arranged.

The selection of cases for this research was based on the following considerations:

With regard to the conceptual framework developed for this research in Chapter 2, those cases were selected which appeared to cover a wide range of variations with regard to the entry modes and market strategies chosen by the participating organisations, as well as certain characteristics of the participating organisations (maximum variation sampling, Patton 2002).

**Entry mode choice and market strategy applied.** Cases were selected so that all entry modes available to foreign banks in China (rep. office, foreign bank branch, local incorporations, and joint venture with a Chinese partner) were included in the sample. In addition, cases were selected so that all major market strategies with regard to clients and product/currencies combinations available to foreign banks in China were included in the sample. It was especially challenging to include German financial services providers which also serve Chinese individuals in local currency because serving this client/product/currency combination requires local incorporation of foreign banks in China. This was one reason the participating AFIs were included in the sample, because these institutions are less restricted than foreign banks in serving Chinese individuals in local currency.

**Bank characteristics.** Cases were selected so that the sample reflected the large variety with regard to certain characteristics that exists in the German banking industry. These included size, business model and degree of internationalisation within and outside of Asia. In addition, the sample also reflects the traditional German “three pillar” banking system. The last two approaches were taken to address the issue of a potential respondent bias caused by non-probability sampling applied in this research.

**Critical cases.** Some critical cases were selected as well, to allow for logical generalisation and application of the knowledge gained to other cases (Patton 2002). These critical cases included a bank that introduced a consumer financing product which was completely new to the Chinese market, and a third, non-German AFI from another Western country, which was added to the sample for the following reason. The two German AFIs already included in this study chose the same entry mode when they entered the Chinese market (as wholly owned subsidiaries). In order to better understand the factors
influencing this important decision, this third international AFI was added to the sample because this company chose a different market entry mode (as a joint venture with a Chinese partner) for its operations in China.

Incorporating cases based on maximum variation sampling (Patton 2002) and the above criteria (entry mode choice and market strategy applied, bank characteristics, “critical cases”) also helped to minimize the potential respondent bias.

**Accessibility to cases.** Accessibility played a role in the case selection as well. When inquiring with several German banks operating in China about the possibility of investigating their market entry strategies, naturally, some banks were more inclined to offer access for academic research than others. After considering the trade-off of choosing between a more relevant or information-rich case and a case with better access to sources of information, it was decided to choose those cases which offered more access and thus a better opportunity to study their entry strategies (Yin 2003).

**Number of cases.** The literature does not offer a clear rule on how many cases should be included in a multiple case study (Carson et. al. 2001). In particular, as mentioned above no rule could be based on statistical representativeness (Miles and Huberman 1994). While even one case may be sufficient (Yin 2003), some scholars recommend increasing the number of cases within emerging categories to enable findings to be replicated within these categories or possibly until “theoretical saturation” (Eisenhardt 1989, p. 533) or “the point of redundancy” (Lincoln and Guba 1985, p. 202) has been reached.

Like the selection of cases, the sample size should be based on the context and purpose of the research, as well as the time and resources available. With fixed resources and limited time, a trade-off is usually required between breadth (more cases) and depth (less cases) (Patton 2002).

For multiple case study designs, Yin (2003) recommends six to 10 case studies while Eisenhardt (1989) recommends between four and 10 cases. Based on reviews of related literature, Carson et. al. (2001) as well as Perry (1998) suggest a minimum of two to four cases, and 10 to 15 cases as the maximum in a typical academic research project.

Considering the purpose of this research, the research questions developed, the complexity of the phenomenon of market entry strategies, and the context of foreign banks in China, as well as the available time and resources, it was decided to investigate 12
cases. These included nine German banks active in China and two Automotive Financial Institutions (AFIs), which are mainly active in the auto financing business. In addition a third AFI from another Western country was added to the sample in order to add depth and breadth to the investigation in a particular area of interest. The reason for this is that by choosing to set up a joint venture with a Chinese partner this particular company opted for a different entry mode than its two German competitors. Moreover this company also offered ample access to study its entry strategy. At the time of the data collection, the participating nine German banks represented three quarters of all German banks with a presence in China.

**Interviews.** Altogether, 16 interviews were conducted with employees of the 12 participating organisations. The interviews were approximately one to two hours in length and were conducted in March and April 2008. The number of interviews in each case was determined individually with the participating organisation. The interviewees in each case were usually members of the organisation’s management as well as employees working in their local operations in China. Most interviews were conducted in Shanghai and Beijing. In addition four interviews were conducted in Germany. All interviewees were German native speakers and all interviews were conducted in German. As such no Chinese translators were needed. All, except for two interviews were conducted face-to-face in either China or Germany. Two interviews were conducted via telephone.

**3.2.7 Data collection and sources of evidence**

Yin (2003, p. 85) identifies the six primary sources of evidence most commonly used in case-based research. While all sources have their own strengths and weaknesses, they are considered to be highly complementary. The rationale behind the use of multiple sources of evidence is triangulation. In this context, triangulation corroborates the data collected from various sources and increases both the reliability of the data collection process and the reliability of the data itself (Tellis 1997). Table 3.3 shows the six sources of evidence in case-based research and their relative strengths and weaknesses according to Yin (2003).
### Table 3.3: Sources of evidence and their relative strengths and weaknesses

<table>
<thead>
<tr>
<th>Source of Evidence</th>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Documentation</td>
<td>stable – repeated review</td>
<td>retrievability – difficult</td>
</tr>
<tr>
<td></td>
<td>unobtrusive – exist prior to case study</td>
<td>biased selectivity</td>
</tr>
<tr>
<td></td>
<td>exact – names etc.</td>
<td>reporting bias – reflects author bias</td>
</tr>
<tr>
<td></td>
<td>broad coverage - extended time span</td>
<td>access – may be blocked</td>
</tr>
<tr>
<td>Archival Records</td>
<td>same as above</td>
<td>same as above</td>
</tr>
<tr>
<td></td>
<td>precise and quantitative</td>
<td>privacy might inhibit access</td>
</tr>
<tr>
<td>Interviews</td>
<td>targeted – focuses on case study topic</td>
<td>bias due to poor questions</td>
</tr>
<tr>
<td></td>
<td>insightful – provides perceived causal inferences</td>
<td>response bias</td>
</tr>
<tr>
<td></td>
<td></td>
<td>incomplete recollection</td>
</tr>
<tr>
<td></td>
<td></td>
<td>reflexivity – interviewee expresses what interviewer wants to hear</td>
</tr>
<tr>
<td>Direct Observation</td>
<td>reality – covers events in real time</td>
<td>time-consuming</td>
</tr>
<tr>
<td></td>
<td>contextual - covers event context</td>
<td>selectivity - might miss facts</td>
</tr>
<tr>
<td></td>
<td></td>
<td>reflexivity – observer's presence might cause change</td>
</tr>
<tr>
<td></td>
<td></td>
<td>cost – observers need time</td>
</tr>
<tr>
<td>Participant Observation</td>
<td>same as above insightful into interpersonal behavior</td>
<td>Same as above</td>
</tr>
<tr>
<td></td>
<td></td>
<td>bias due to investigator's actions</td>
</tr>
<tr>
<td>Physical Artefacts</td>
<td>insightful into cultural features</td>
<td>selectivity</td>
</tr>
<tr>
<td></td>
<td>insightful into technical operations</td>
<td>availability</td>
</tr>
</tbody>
</table>

Source: Yin (2003, p. 86)

The sources of evidence used in this research included:

- interviews with employees of the participating organisations and other informants from consulting firms and universities. In most cases, the key informant was the head of the organisation’s Chinese operations residing in China. Other interviewees included high ranking managers, vice presidents and one head of a bank’s “Chinese desk” in Germany. In addition, an experienced academic researcher reviewed selected interview protocols and the conclusions drawn from the interviews with regard to the research questions, and finally after the initial interviews with the participating organisations, all research issues were discussed with an experienced management consultant who has worked in China for several years and whose work involves consulting Chinese and German banks and Chinese authorities with regard to banking sector.

- Documents (hardcopy and in electronic form) provided by the participating banks and AFIs (e.g. reports, memoranda, presentations).  


Research Methodology

- Documents (hardcopy and in electronic form) provided by external sources, including consulting and research firms, universities and other academic institutions, and government organisations.

In addition, subsequent to the interview sessions with each of the participating organisations, various short follow-up telephone interviews and electronic mail contacts were made with participants to clarify remaining or newly emerging questions related to the research issues. Furthermore, following the preparation of the case study findings, selected case reports were sent to key participants via electronic mail for reviews to validate the information collected in the interviews.

All collected data were put into a case study database, including tabular materials, narratives and other notes. As discussed above, the case study database enables other investigators to review the evidence used in this research directly and not to be limited to written case study reports (Yin 2003).

**Interviews.** In this study, the interviews were the most important sources of information (Tellis 1997). A standard interview protocol (Appendix A) was developed for this research and used in all interviews conducted. The interview protocol was briefly discussed with each interviewee at the beginning of each interview (Yin 2003; Wong 2006).

In the first part, some background information about the research project was provided to the interviewee. This overview included the topic and objectives, as well as the expected outcomes and benefits of this study. Next, the ethical procedures used in this research were explained to the interviewee, including the interviewee’s right to confidentiality, after which the informed consent form (Appendix B, which had been sent to all interviewees prior to the interviews) was signed by the interviewee (Carson et. al 2001). After that, the interviewee’s details, such as his or her role in the organisation were discussed.

The second part of the protocol focused on the general research topic under investigation and aimed to obtain a broad assessment of market entry strategies of foreign banks/AFIs in China from the interviewee’s point of view.

The third part of the protocol focused specifically on the four research issues identified in the literature review and the corresponding interview questions. The interview questions included both open-ended questions to increase the depth of the data collected as...
Research Methodology

well as more structured Likert-style questions to gradually filter down to some key topics (Yin 2003; Carson et. al. 2001). Table 3.4 provides an overview of the research issues and the corresponding interview questions.

Table 3.4: Research issues and the corresponding predetermined interview questions

<table>
<thead>
<tr>
<th>Research Issue</th>
<th>Predetermined interview questions</th>
</tr>
</thead>
</table>
| Research Issue 1: Motives of German banks/AFI to enter the Chinese market | • What were your initial major motives to enter the Chinese market?  
• Have these motives changed since then?  
• What were your subsequent goals in the Chinese market?  
• Have these goals changed since then? |
| Research Issues 2/4: Choice of market entry mode and possible partners in China Factors influencing these choices | • What is your choice of entry mode in China?  
• Which internal factors have been influencing this choice?  
• Which external factors have been considered in this choice?  
• Which factors have been considered in your choice of a local Chinese partner (applicable only to organisations with a joint venture and strategic investment)? |
| Research Issues 3/4: Choice of market strategy/activities in China Factors influencing these choices | • What is your choice of market strategy in China?  
• Which internal factors have been influencing this choice?  
• Which external factors have been considered in this choice? |
| Research Issue 5: Challenges/hurdles in China | • What are the main challenges/hurdles for your business in China when you first entered the market?  
• today? |
| Research Issues 1-5: Future development of the market for financial services in China in general Future development of the organisation’s engagement in China | • How will China’s market for financial services develop in the future?  
• How will your organisation’s engagement in China develop in the future? |

Source: Developed for this research

In case of the two telephone interviews, the interview protocol was sent to the interviewees prior to the interviews via email.

For all interviews, the approach of interviews being “flexible and opportunistic data collection methods” was adopted, allowing the adding of questions during the interview in case of “emergent themes and unique case features” (Eisenhardt 1989, p. 533). Regularly, probe questions for specific topics were used if the interviewee had not discussed them already in the context of the more general questions (Carson et. al. 2001).
3.3 Data analysis

According to Yin (2003, p. 109), the analysis of case study data “consists of examining, categorizing, tabulating, testing, or otherwise recombining both quantitative and qualitative evidence to address the initial propositions” of the study. The analysis of qualitative data requires the describing and summarising of the large volume of words obtained by interviews and the subsequent search for relationships between various themes that have emerged throughout the analysis with regard to the research issues (Lacey and Luff 2009).

Since qualitative research deals mostly with words, rather than numbers, there are only limited rules and guidelines on how to analyse qualitative data (Eisenhardt 1989; Yin 2003; Miles and Huberman 1994; Patton 2002). This study followed Miles and Huberman (1994, p 10), who propose the use of three “concurrent” activities of analysis of qualitative data, comprising of (1) data reduction, (2) data display, and (3) conclusion drawing and verification.

**Data reduction** can be described as the process of reducing the large volume of collected data by means of selecting, simplifying, abstracting, summarising, and converting data. A major element of data reduction is the **coding** of the collected data, which refers to “tags or labels for assigning units of meaning to the descriptive or inferential information compiled during a study” (Miles and Huberman 1994, p. 56). In the first stage of coding (open coding), the collected data is condensed into preliminary analytic categories or themes. In the second stage (axial coding), the developed codes or themes are examined in terms of possible causes and consequences, conditions, and interactions which may lead to further analytic categories or concepts that cluster together (Neuman 2006). Data reduction is not separated from the data analysis but is part of it, as it helps to sharpen, sort, focus and organise the collected data (Miles and Huberman 1994). Consequently, all activities relating to the reduction of data used the research questions and the conceptual framework developed for this research as guidelines (Maione 1997; Al Qur’an 2005).

The second concurrent technique suggested by Miles and Huberman (1994) refers to the extensive use of systematic **data displays** in the data analysis, including matrices, graphs, charts, and networks, which were also applied in this research. The use of displays enables the researcher to:
assemble organized information into an immediately accessible, compact form so that the analyst can see what is happening and either draw justified conclusions or move on to the next-step of analysis the display suggests may be useful (Miles and Huberman 1994, p. 11).

**Conclusion drawing and verification** is the third concurrent stream of analysis activities. These activities include the assignment of meaning, by noting regularities, patterns, causal flows, and propositions, as well as the verification or testing of meaning emerging from the data for plausibility, for example by the review of notes, the consideration of rival explanations, or the cross-check of conclusions by key participants or external third parties (Miles and Huberman 1994; Yin 2003; Creswell and Clark 2007).

In this research, the following steps were used to analyse the collected data:

After the transcription of the recorded interviews and the familiarisation with the transcribed text, all interviews were coded by reading and rereading the text to identify coherent themes or categories. Theme identification is one of the most critical tasks in qualitative research. Themes or categories typically come from previous research, characteristics of the phenomenon being studied, and already agreed upon, commonsense constructs. On an operational level this mainly involves tagging data and grouping tagged data (Ryan and Bernard 2003; Baptiste 2001).

In a first round, the data was searched, tagged and labelled without a defined set of themes or categories, but based simply on what appeared to be interesting. In a second round, each transcript or case was searched based on a pre-set of themes derived from the literature and the research issues under investigation (for example, the motives of the participating organisations to enter the Chinese market, or the factors influencing a choice of entry mode). In a third round, the data was searched in parallel, by reading and comparing responses to the same question across different cases, looking for patterns, similarities and differences between the cases under investigation by making systematic comparisons across units of data (Taylor-Powell and Renner 2003; Ryan and Bernard 2003; Baptiste 2001).

During this iterative process, the initial list of themes or categories did change over time, because some categories had to be adjusted, or new categories had to be defined in order to reflect the nuances in the data being analysed. In addition, some categories were broken down into smaller, more defined subcategories to allow for greater dis-
crimination and differentiation between cases. Besides the reading and re-reading of the interview transcripts and the themes and categories identified in previous research, complementary data sources like memos and reports provided by the participating organisations, as well as follow-up clarifications with selected interviewees via email, were used as additional guidelines to ensure the right categorisation of data (Taylor-Powell and Renner 2003; Ryan and Bernard 2003; Baptiste 2001).

Especially when it came to the factors influencing the choices of entry mode and market strategy, as well as the challenges the participating organisations are facing in the Chinese market, it became apparent that classifying data “is a messy process that goes back and forth between ... tagging, labelling, defining, and redefining” (Baptiste 2001, p. 8). Various categories and subcategories had to be redefined several times, expanded, narrowed or split, because they appeared to be too overlapping or incomplete to capture the answers given in the interviews and to make sure that categories were adequately developed and sufficiently supported by tagged data (Baptiste 2001). For instance, one of the major factors initially described by many participating organisations as influencing the choices of entry mode and market strategy was “regulation” or the regulatory environment in China. However, looking at the specific explanations given based on follow-up questions, it became clear that various developments in the Chinese financial services market are driven or influenced by some form regulation, which makes “regulations” a very broad category. Again, based on an iterative reading and labelling process across all cases, complementary data sources like memos and reports provided by the participating organisations, as well as follow-up clarifications with selected interviewees via email it was decided to keep regulations as a category and further distinguish between specified and unspecified regulations as subcategories (see Chapter 4).

The data analysis procedures used in this research also included the techniques of pattern matching and explanation building (Yin 2003). Yin (2003) suggests pattern matching is one of the most desirable techniques to be used in within-case analysis, especially in exploratory research. Pattern matching compares an empirically based pattern with a predicted one, or with several alternative predictions. If the patterns match, the internal reliability of the study is strengthened (Tellis 1997).

The following four levels of analysis were carried out in the data analysis stage of this study (Christie et. al. 2000): (1) within-case analysis, (2) cross-case analysis, (3) case-group analysis, and (4) case-summary analysis.
Within-case analysis mainly consisted of the review of the interview transcripts and notes to discover key patterns and themes with regard to each individual case. The emerging themes were then compared with findings and propositions derived from the review of previous research and theory.

The second level of analysis consisted of cross-case analysis, in which the findings from the first level of analysis were compared and analysed for patterns of similarities and differences between the individual cases. If possible, the patterns were then ordered or sorted along analytical dimensions which had been suggested by the research problem or by existing literature (Miles and Huberman 1994; Eisenhardt 1989). The comparative analysis also involved representing each case as a combination of causal and outcome conditions, which were then compared and logically simplified using a bottom-up process of paired comparisons (Patton 2002). The results of these comparisons can also be new categories and concepts which the researcher did not anticipate, or they can be extracted from the literature (Eisenhardt 1989). The main reason for cross-case analysis was to deepen understanding and explanation of the issues under investigation while retaining the strength of holism embedded in the context-rich individual cases. In addition, cross-case analysis was used to enhance the generalisability of the research findings (Miles and Huberman 1994; Patton 2002). Finally, cross-case analysis helps to tackle the information process bias of humans. People sometimes leap to conclusions based on limited data. They sometimes tend to be overly influenced by vividness or more elite respondents, or they inadvertently discard disconfirming evidence. Cross-case analysis helps the researcher to avoid reaching premature conclusions by looking at the data in divergent ways (Eisenhardt 1989).

The third level of analysis focused on groups of cases with similar patterns. Based on findings of the cross-case analysis, groups of cases were put together and comparative analyses of the resultant grouping were conducted (Christie et. al. 2000). These groups were mainly based on similar patterns with regard to the categories derived from the research questions investigated in this study, as well as similar patterns with regard to certain characteristics of the participating organisations. For instance, cases were assigned to groups based on similar choices of entry mode and market strategy. Other groups included organisations with similar business models and client foci, or similar levels of international experience.
On the fourth level of analysis, patterns of groups of cases or summaries of several cases (level three) were compared with the individual cases.

The last two levels of analysis were especially useful when investigating connections or relationships between two or more themes. An example is the connections between the group of banks stating to “follow their customers” into the Chinese market, the group of banks only or mostly serving existing clients from Germany in China, and the group of banks only operating on the level of a representative office in China. The different levels of analysis also involved the selected use of systematic data displays including matrices, graphs, charts, and networks, to assess possible cause and effect relationships and other connections, which could help to provide explanations for why something occurred (Taylor-Powell and Renner 2003; Miles and Huberman 1994).

Spreadsheet software was used in the data analysis, especially for the coding, categorising, and comparison of data.

### 3.4 Ethical considerations

All research has an ethical dimension. Every researcher faces the challenge of balancing the pursuit of scientific knowledge and the rights of those being studied or participating in the research (Neuman 2006).

Researchers have to consider ethical concerns when designing a study in order to protect the rights of the respondents or participants (Zikmund 2003; Creswell 2003). In fact, as Neuman (2006) states “the researcher has a moral and professional obligation to be ethical, even when research subjects are unaware of or unconcerned about ethics” (Neuman 2006, p. 129).

The following procedures and processes were used in this research to address ethical concerns and especially to protect the rights of the study’s participants with regard to confidentiality and privacy:

**Informed consent and information sheet.** In this study, an “informed consent” form and an “Information sheet” were provided to all interviewees prior to data collection. The information sheet provided a brief overview of this study, and explained the interview-process and confidentiality and privacy issues regarding the research procedures. In addition the rights of the participants and the responsibilities of the researcher were
briefly described. By completing the informed consent form, the interviewees agreed to participate in this study and gave their written permission for the interview to be digitally recorded or for handwritten notes to be taken by the interviewer. In addition, interviewees were informed that they could discontinue their voluntarily participation and withdraw from the interview and the study itself at any time.

Protection of identity and confidentiality of data collected. In this study, the identity of the participating individuals and that of their organisations is not disclosed. When describing characteristics of the participating organisations (for example “asset size”), the study always refers to a range or category with regard to the characteristic, instead of a particular number to make sure that the organisation cannot be identified via a specific organisational characteristic.

Approval by the Southern Cross University Human Research Ethics Committee. Prior to the data collection via interviews, this study, including the data collection procedures, were reviewed and approved by the Tweed Campus Sub-Committee of the Human Research Ethics Committee of Southern Cross University.

3.5 Conclusion

Chapter 3 has described and justified the research methodology (qualitative research) and the specific method (case study) used in this research. In addition, procedures, techniques and tools of data collection and analysis as well as ethical considerations have been discussed. The following chapter, Chapter 4, details the results of the data analysis.
4 Data Analysis

4.1 Introduction

The previous chapter (Chapter 3) presented and justified the selection of the research methodology used in this research. This chapter (Chapter 4) will now present the collected data and analyse them with regard to the research questions of this study:

1. What are the motives of German banks and AFIs to enter the Chinese market?,

2. Which entry modes are used by German banks and AFIs in China (including the choice of a possible local partner)?,

3. What are the market strategies or activities of German banks and AFIs in China (that is which clients and geographic regions are being served, and which products and services are being offered by German banks and AFIs in China)?,

Which factors influence the choices of entry mode and market strategy by the participating organisations?, and

What are the challenges that German banks and AFIs face in the Chinese market?

The remainder of this chapter is organised as follows. After this introduction (Section 4.1), Section 4.2 presents an overview of the sample of twelve financial services providers participating in this research as the main sources for primary data collection. Sections 4.3 to 4.7 then present the data collected for this research and an analysis of this data with regard to the five research questions. The chapter ends with a brief conclusion (4.8).

If not attributed to a specific source or reference, all information presented in this chapter is based on information given by the interviewees.

4.2 Description of cases selected for this research

4.2.1 Types of financial service companies participating in this study

This research is based on the following sample of foreign financial services providers and their activities in the People’s Republic of China (“cases”). All participating organi-
sations, as well as all interviewees, were guaranteed anonymity in any publications resulting from this study. The portraits of the participating organisations are therefore relatively brief and the companies are mainly described in terms of characteristics, categories and groups instead of actual names and numbers.

The main part of the sample is made up of nine German banks with a presence in China. At the time of the data collection in March and April of 2008, a total of 13 German banks had established a presence in China, thus these nine banks represented 69% of all German banks with a presence in China at this time (German Embassy in the People’s Republic of China 2008). The nine sample banks can be divided into three groups (essentially based on their legal form), representing the traditional German “three pillar” banking system described in Section 1.7.2 (Association of German Banks 2005).

The first group is made of private commercial banks, which refers to the fact that these institutions are privately or publicly owned by individuals or companies (Association of German Banks 2005).

The second group is made up of savings banks, specifically the so-called Landesbanks which act as central institutions of the savings banks and bankers to the German state in which they reside (DSGV 2008). They are usually jointly owned by a regional group of savings banks and their federal home state in Germany, or by another Landesbank.

The third group of banks is made of cooperative commercial banks (in English also referred to as “credit cooperatives”) which are mainly owned by their members, individuals and SMEs, which are also often clients of these banks.

In order to preserve the anonymity to the participating organisations, and because they are considered to be very similar in ownership structure and business model (see Section 1.7.2 on the German banking system), the cooperative banks and the Landesbanks participating in this study have been treated as one group in the data analysis.

In addition to the nine participating German banks, two financial services companies with their main focus on financing cars for individuals and car dealerships (Automotive Financial Institutions or AFIs) owned by two German car manufacturers (Original Equipment Manufacturers or OEMs) were included in the sample, because these corporations are less restricted than foreign banks in offering specific banking services, in particular consumer loans to Chinese individuals. Since consumer loans are a major part of retail banking services, it was considered that their inclusion added depth and
breadth to the study by covering a wider range of services, which so far can only be offered by very few foreign banks (see restrictions on foreign banks in Section 1.7.1). Finally, a third, non-German AFI from another Western country was added to the sample for the following reason. The two German AFIs included in this study chose the same entry mode when they entered the Chinese market. In order to better understand the factors influencing this important decision, a third international AFI was added to the sample because this company chose a different entry mode for its operations in China.

4.2.2 Characteristics of the participating organisations – services offered and customer segments

The first way to characterise the participating organisations is by the range of products and services they offer. The Germany banking sector is dominated by so-called “universal banks”, which traditionally have combined commercial and investment banking, including the securities business (Mullineux and Murinde 2003). In contrast, “specialist banks” (e.g. mortgage banks, special purpose banks, building and loan associations) only provide a few specific banking services (Cai 2006; Association of German banks 2005). Beside the three automotive financing companies, only one “specialised bank” is among the participating organisations (Table 4.1).

Table 4.1: Product/service range of participating financial services providers

<table>
<thead>
<tr>
<th>Type of organisation</th>
<th>“Universal banks”</th>
<th>“Specialized banks”</th>
<th>Automotive financing companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in the sample</td>
<td>8</td>
<td>1</td>
<td>2+1*</td>
</tr>
</tbody>
</table>

* two German companies and one company from another developed Western country

Source: Developed for this research (based on publications of the participating companies)

While universal banks often engage in business both with individuals (“retail banking”) and with corporate clients (“wholesale banking”) (Carew 1996), not all participating financial services providers serve both client segments. One sample organisation only serves corporate clients, and does not offer any banking services directly to individuals. In contrast, another participating financial services company applies a business model which only focuses on retail clients. The client segments being served by the sample organisations in their home market can be found in Table 4.2
### Table 4.2: Client segments served by the participating financial service providers

<table>
<thead>
<tr>
<th>Client segments served</th>
<th>Only corporate clients</th>
<th>Only retail clients</th>
<th>Corporate clients and retail clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in the sample</td>
<td>1</td>
<td>1</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on publications of the participating companies)

### 4.2.3 Characteristics of the participating companies – Size of total assets

Total assets is a common measure of the size of banks and other financial service providers (Leung and Young 2002; Lu and Dewhurst 2007). The banks and auto financing companies participating in this study vary significantly in size, ranging from less than €100 billion to over €1,000 billion in total assets. The distribution of asset classes within the sample can be found in Table 4.3.

### Table 4.3: Size of participating financial services providers (in total assets)

<table>
<thead>
<tr>
<th>Asset size in bn € (2007)</th>
<th>0 to 100</th>
<th>&gt; 100 to 250</th>
<th>&gt; 250 to 500</th>
<th>&gt; 500 to 1,000</th>
<th>&gt; 1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in sample</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on publications of the participating companies)

### 4.2.4 Characteristics of the sample companies – links to Asia

“Experience in Asia” or “links to Asia” (for example measured by the number of presences in Asian countries) is considered to influence market entry decisions in other Asian markets (Leung and Young 2002). The organisations taking part in this research vary considerably in the size of their Asian networks. While two companies have no other presence in Asia other than the one under investigation in this study, two companies are active in more than 10 Asian markets. The numbers of Asian countries (other than mainland China) in which the sample companies have a presence are displayed in Table 4.4.

### Table 4.4: Number of offices, branches or subsidiary companies of the participating financial service providers in Asian countries (including Hong Kong and Taiwan) other than mainland China

<table>
<thead>
<tr>
<th>No. of Asian countries other than mainland China</th>
<th>0</th>
<th>1 to 3</th>
<th>4 to 6</th>
<th>7 to 10</th>
<th>more than 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in sample</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on publications of the participating organisations)
4.2.5 Characteristics of the sample companies – international network

The ongoing internationalisation of the financial services industry is reflected by the sample of the participating organisations. None of the companies taking part in this research is present (in the form of an office, branch or subsidiary company) in less than six countries, while eight participating companies are present in more than 20 countries. The number of countries being served by the financial service providers taking part in this study (with a presence in the form of an office, a branch or a subsidiary company) can be found in Table 4.5.

Table 4.5: Number of countries being served by the participating financial services providers (with an office, branch, or subsidiary company)

<table>
<thead>
<tr>
<th>No. of countries with a presence</th>
<th>1 to 5</th>
<th>6 to 10</th>
<th>11-20</th>
<th>21-35</th>
<th>more than 35</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in sample</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>4</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on publications of the participating organisations)

4.2.6 Characteristics of the sample companies – conclusion

In conclusion, the organisations in the sample are reflective of the high degree of internationalisation in today’s banking industry. All participating institutions have at least some international experience, while others are active on a global scale. It also shows that while many banks from Western countries have entered the developing regions of Central and Eastern Europe and Latin America, the entry into Asian markets is still lagging behind (Domanski 2005). In terms of asset size, the sample reflects the low degree of consolidation and the large variety in the German banking industry. The sample includes five of the ten biggest German banks, seven of the twenty biggest German banks and eight of the fifty biggest German banks (Kuck 2009). At the time of the data collection in 2008, the sample included more than two thirds of all German banks with a presence in China.

4.3 Research Question 1: motives of German banks and AFIs to enter the Chinese market

With the first research question, this study seeks to investigate the motives which are driving the internationalisation of German banks and AFIs into the Chinese market. Based on the interviews conducted for this research, seven different motives have been
identified as drivers of German banks’ entry into China. In addition, five motives of the participating AFIs to enter the Chinese market have been found. The identified motives and the corresponding number of organisations citing these motives for their engagement in China can be found in Tables 4.6 and 4.7.

Table 4.6: Motives of the participating German banks to enter the Chinese market (multiples are possible)

<table>
<thead>
<tr>
<th>Motives of the participating banks for entering the Chinese market</th>
<th>No. of banks in this category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Serving existing clients (&quot;follow the customer&quot;)</td>
<td>6</td>
</tr>
<tr>
<td>Serving existing clients of associated saving banks or co-operative</td>
<td>4</td>
</tr>
<tr>
<td>Potential of the Chinese market (&quot;market seeking&quot;)</td>
<td>4</td>
</tr>
<tr>
<td>Looking for &quot;market niches&quot; based on special &quot;skills&quot;, &quot;expertise&quot;, or &quot;resources&quot;</td>
<td>3</td>
</tr>
<tr>
<td>Strategic considerations</td>
<td>3</td>
</tr>
<tr>
<td>Networking with Chinese corporations / winning Chinese clients for business in Germany</td>
<td>2</td>
</tr>
<tr>
<td>Client retention (&quot;protection&quot; of client relationship)</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on information given in the interviews conducted)

Table 4.7: Motives of the participating AFIs to enter the Chinese market (multiples are possible)

<table>
<thead>
<tr>
<th>Motives of the participating AFIs for entering the Chinese market</th>
<th>No. of AFIs in this category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential of the Chinese market (&quot;market seeking&quot;)</td>
<td>3</td>
</tr>
<tr>
<td>Sales promotion (of cars and trucks)</td>
<td>3</td>
</tr>
<tr>
<td>Customer retention (strengthen of customer loyalty)</td>
<td>2</td>
</tr>
<tr>
<td>Support of dealership network</td>
<td>3</td>
</tr>
<tr>
<td>Strategic considerations</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Developed for this research (based on information given in the interviews conducted)

4.3.1 Motives of German banks to enter the Chinese market

4.3.1.1 Follow the customer

The most-cited motive of the participating banks for establishing a presence in China is the desire to serve existing clients which have entered the Chinese market (six mentions). This motive is often referred to in the literature as to “follow the customer” (e.g. Leung 1997). One banker explained, “I would like to say that [the bank] did not go to China because of the Chinese market, but actually because of our home market having moved to China”.

The importance of “following the customer” is also reflected in the information provided by the banks with regard to their client structure in China. For example, one bank
specifically stated that about 70% of its clients in China are SMEs from its “home market”, which is one of Germany’s 16 states. Another bank explained that only very rarely, did companies which are not already clients in Germany become clients in China. A third bank described existing clients from Germany as its “major clients” in the Chinese market. In fact, only one of the six banks claiming to “follow the customer” as a motive to be in China is actively perusing a strategy to include “Chinese” risk in its portfolio, which includes not only Chinese banks, but also “carefully selected Chinese corporations”. These are chosen on the basis of whether they have got some form of “business connection” to Germany, and as such offer potential for further business, possibly outside of China.

The motive to “follow the customer” is strongly related to the type of bank. Four of the six banks citing this motive to enter the Chinese market are savings banks or cooperative banks. Conversely, only two of the six banks belonging to either of these bank groups don’t name “follow the customer” as a motive to enter the Chinese market, and one of those does so because its clients from Germany don’t do any business in China.

4.3.1.2 Serving existing clients of associated savings banks or cooperative banks

Somewhat related to “follow the customer” is the motive to serve existing clients of associated savings banks or cooperative banks. All four banks in the savings/cooperative group citing to “follow the customer” as one motive to enter the Chinese market also named service to clients of their associated savings/cooperative banks (which are business partners as well as shareholders of these participating banks) as a motive for being active in China.

In these cases, the participating organisations use their presence in China to provide access to the Chinese market, mostly in the form of syndicate business. These transactions are often conducted in a “division of labour” process. While the participating Landesbank or central cooperative bank functions as a product and process specialist, the smaller savings or cooperative bank in Germany usually retains the role of catering for their customers. These arrangements are mainly based on cost and risk considerations. For most regular savings and cooperative banks in Germany, it would be “too costly” or “too risky” to establish their own presence in China in order to be able to serve their clients directly. Therefore, the savings and cooperative banks in Germany
utilise the international networks of the participating *Landesbanks* or central cooperative banks, which act as “outlets” and agents of their associated savings or cooperative banks.

Two banks participating in this research stated that this syndicate service provided by them is the main reason why their respective owners, the savings/cooperative banks, approved the entry of their *Landesbank*/central cooperative bank into the Chinese market. These savings/co-operative banks as shareholders approved the entry of their *Landesbank*/central cooperative bank into China, because they considered them a business partner and service provider for their own clients, however, they would not have approved an “investment” which was based on just the potential of the Chinese market for financial services.

### 4.3.1.3 Client retention / “protection” of the client relationship

While discussing the service to existing clients or the clients of the associated savings or cooperative banks, two participating banks particularly mentioned a related motive to have a presence in China, which is to **“protect” the client relationship** and stop competitors from “stealing” the client.

In the German banking market, *Landesbanks* and central cooperative banks and their owners, the regional savings and cooperative banks, usually divide their business along the lines of client size (often measured in terms of client turnover or the value of loans taken out by a client) and complexity of the transactions, with the regular savings banks and cooperative banks mostly serving SMEs, and providing comprehensive day-to-day banking services, and the *Landesbanks* and central cooperative banks serving big corporations and providing more complex and international services. Thus, having a presence in China ensures the associated savings/cooperative bank that when “sharing” clients with its associated *Landesbank*/central cooperative bank, the latter will not try to lure away that client in other business areas as well. However, without the international network of an associated *Landesbank*/central cooperative bank which will not try to steal the client, any regional savings/cooperative bank in Germany would always be in danger of losing the client’s business to a competitor which could offer the needed international service, not only in China, but possibly in Germany too.

This risk applies not only to the associated savings/cooperative banks, but also directly to the participating *Landesbanks*/central cooperative banks. One bank pointed out that
several big international banks (e.g. HSBC, Citibank, Standard Chartered) which are locally incorporated in China, can approach foreign companies and offer more services in China than the participating bank itself. After having established a business relationship in China, these banks could then also approach the same client in Germany and try, not only to take away the business in China, but also the main business with that client in Germany. Thus, having a presence in China is seen as a means to protect existing client relationships not only with regard to the (often limited) business in China, but also the much more valuable relationship in the home market in Germany.

The banker explained “when an SME client goes abroad, into China, into India, into Vietnam, every time, HSBC knocks on its door … and at some point the SME may give in. … Then the danger exists that these foreign banks, via a business relationship in China, will also approach the same client in Germany”.

4.3.1.4 Potential of the Chinese market (“market seeking”)

Four of the participating banks stated that the huge potential of the Chinese market for financial service (“market seeking”) was a motive for them to enter the Chinese market. However, the importance of this motive varies considerably among these institutions.

Two banks ranked the market potential in China among their most important reasons for entering the Chinese market. One of these banks reported it had realised that the company’s growth in its traditional geographic markets will be limited in the near future by the demographic developments in Europe. As a result, the bank started to look for new markets and selected China and India based on their huge market potential. Part of this consideration according to the bank was the conclusion that there is a stronger correlation between entrepreneurship and private wealth in China than in other countries, giving this particular customer segment a higher potential and allowing the bank to target the same group of clients with a broader set of products and services.

Another bank, which is a specialist in mortgage loans, sees a huge potential in China for the financing of residential homes based on the following considerations explained by the interviewee:

China has a substantial backlog in the construction of homes. One reason is that only since the 1990s has it been possible for Chinese individuals to take out a loan and buy
their own homes. As a result, the Chinese need more homes and they need ways to finance these homes.

In addition, real estate property is more and more moving into the focus of retirement savings for Chinese workers. While some state or employer-based retirement funds exist, many Chinese are facing a “retirement gap”, to be filled by private savings, which could come in the form of real estate for which this bank wants to become a provider of funds. Finally, the growing number of middle class households in China is further increasing the number of potential clients in this market.

The two other banks citing the potential of the Chinese market for financial services as a motive to enter this market considered the “market potential” as clearly less important than or, just a complement to, the “follow the customer” motive, which both described as their main motive to be in China. One of these banks is planning to start serving Chinese corporations in foreign currency as well as RMB in the near future, and at the time of the data collection had already applied for the appropriate licence. Based on its market research, this bank said it saw enough potential in this segment (beyond its existing German clients) to be able to serve it profitably. The other bank already started serving carefully selected Chinese corporations as clients, including taking “Chinese” risk into its loan portfolio.

However, while the bank obviously sees further potential in this market, the “market potential” was not the only reason for this bank to also start serving Chinese clients. One of the other reasons is based on a political consideration. The Chinese government wants foreign banks to also take “Chinese” risks into their portfolios, instead of just serving foreign customers which are considered to be of “lower risk” than Chinese corporations, because this would relieve the Chinese banks from financing the “riskier” Chinese corporations all by themselves. In addition, also targeting Chinese corporations helps this bank to set itself apart from the competition of the other German banks, most of which serve only German or other foreign corporations.

**4.3.1.5 Looking for market niches based on special skills, expertise, or experience**

Two of the participating banks stated that they possessed specific skills, expertise, or experience which put them in a position to successfully operate in China and that this was a major motive of these organisations to enter the Chinese market.
One bank reported that it is building all its business activities on its specific skills or resources. Being rather small and “conservative”, this bank is always looking for “market niches” where it can “do things better or differently” than other banks, based on special skills, experience, or resources. Because of its size, this bank is usually not the main provider of banking services for most of its clients. Thus, in order to be chosen as a transaction partner by a client, it needs “to go the extra mile” and must do things “better” than its competitors. As a result, the bank only actively offers services in areas where it can see itself competing strongly. According to the bank, this approach was applied when the decision was made to enter the Chinese market. One example given by the bank was the strong personal relationships that are still very important in China and which its employees have forged with Chinese individuals and business partners over several years. Many large foreign banks change their organisational structure or employees regularly, which makes it harder for personal relationships to develop. In contrast, this bank has been working with the same employees, often for more than a decade, making it easier for them to develop a “high level of trust” with their Chinese partners. In addition, the bank has been regularly working with “trainees” from China – Chinese individuals who come to Germany for a couple of weeks to a year to work in the bank, many of whom later make a career in China. Since the late 1970s, over 200 trainees from China have worked at this bank’s headquarters in Germany. This has helped the bank’s employees to build a large network of personal contacts in the Chinese banking community and other industries in China.

The other bank citing this motive has been specialising in a business model in which its customers first save money and can later receive a mortgage loan with below-market interest rates. According to one interviewee, many years of experience in this business, in Germany and other international markets, have given this company an advantage based on its skills, experience, and resources over potential competitors in this particular product segment, which it can also successfully apply in the Chinese market.

### 4.3.1.6 Networking with Chinese corporations / winning Chinese clients in Germany

Two of the participating banks specifically stated that one motive for them to having established a presence in China is to network with Chinese corporations and individuals in order to win Chinese clients in the banks’ home market in Germany.
For one of these banks, this was even given as the main reason to be in China. The bank reported that it was not interested in doing normal banking business in China but it plans to use its Chinese presence to actively look for business relations with Chinese or other Asian clients in Germany, where it sees a growing potential with these clients. According to the bank, in the last decade many foreign banks followed the flow of foreign capital into China. However, since China recently became an exporter of capital, the country is now actively looking for ways to invest its money abroad. China already has the world’s largest foreign exchange holdings and they keep growing rapidly because of the country’s huge trade surpluses. Most of the reserves it accumulates, China still conservatively invests in US treasury bonds and other government securities, which represent a safe investment, yet earn little return for China. In order to earn higher returns on its foreign exchange holdings, China has started to invest part of this money in corporations, stocks, corporate bonds or real estate in other parts of the world. For potential Chinese investments in Germany, this bank hopes to become a preferred partner, based on its strong position in Germany, particularly in real estate financing and its networking efforts in China.

For the second bank stating the desire to win Chinese clients in their home market in Germany, this motive for being in China clearly comes second to serving its existing German clients in China. Based on obtaining a licence allowing it to serve Chinese corporations in foreign currency and RMB, the banks plans to establish contacts and relations with Chinese corporations. However, one banker admitted “whether or not a lot of business will be done with these Chinese corporations in China is a different question” and serving Chinese corporations in China is not the main focus of the bank’s management. Instead, the bank wants to use its contacts with Chinese corporations to create business opportunities with these corporations in its home market in Germany. As the banker explained, “there is also the other way that Chinese corporations enter the German market and are being financed, for example by [our bank] … . It’s not just a one-way street from Germany for German corporations, but also for Chinese subsidiaries, which need financing in Germany”.

4.3.1.7 Strategic considerations

Finally, three of the participating banks reported “strategic considerations” as one of their motives to enter the Chinese market.
One bank, that had already opened a branch in China in the 1990s and which has operations in more than 50 countries worldwide, reported that it aims to have an operational presence in all major banking markets across Asia. Another bank in this group strategically distinguishes between its investment banking services and its commercial banking services. On its investment banking side, the bank is committed to remaining a “big international player”, providing all major investment banking services in all major markets. On its commercial banking side, the bank aims to “balance” its strong investment banking, which has enjoyed high growth rates in recent years and strongly contributes to profits, with a growing commercial banking business, in order to achieve a diversification of risks and revenue sources.

Both of these banks belong to the bigger institutions in the sample. Both also possess large international networks and strong links to Asia (see characteristics of participating organisations in Section 4.2). The third institution citing strategic considerations for its move into the Chinese market did not have any presence outside of Europe before stepping into China. However, foreign markets in general have been very important for this product specialist in recent years, where it has usually become the market leader in its product segment. Thus, with its expansion into China, the company intended to further expand its foreign network and for the first time “gain a foothold outside of Europe”.

4.3.2 Motives of the participating AFIs to enter the Chinese market

In contrast with the banks, the motives given by the participating AFIs for entering the Chinese market are much less diverse, with all three companies stating the same three motives. These are, as one company put it, “universal” in the sense that they are not specific to the Chinese market, but could apply to other geographic markets as well. In addition, two other motives were given by two of the participating companies.

4.3.2.1 Sales promotion

The first motive for the participating AFIs to enter the Chinese market is to promote the sales of cars and trucks, manufactured by the associated manufacturing joint ventures utilising financial services products, in particular by giving loans to Chinese buyers of new cars.
**Consumer finance**, according to various participating organisations, is still in its “early stages” in China. It has only been in the last few years that Chinese citizens have been able to buy their own homes or to open bank accounts other than saving accounts. While in many more developed markets like Europe and the US, more than 50% of car purchases are financed, the **financing penetration rate** in China is only around 10% to 15%. According to the participating companies, this can be attributed to several reasons:

**Average loan size.** The sale price of some cars in China, and as such the corresponding loan size, is “too low” to be financed, because the associated costs of financing don’t allow the financing provider to earn a big enough margin (for example, some commercial vehicles manufactured in China sell for around US$4,000 – 5,000. If 60% to 80% of that sales price is being financed, it cannot be done profitably according to one manager).

**Large savings.** The main “demographic group” targeted by the AFIs for car financing (with a size of around 30–40 million people a the moment) often possess considerable savings. Households in China still save a lot of their disposable income, because a public “safety net” to protect them in cases of illness, accidents, or job loss is still “under construction” in China and many people feel the need to make safety arrangements themselves. In addition, many people have saved a lot of money to pay for their children’s education, which is still considered to be a very important investment in China. As a result, people in the target market who can afford to buy new cars often use part of their savings and don’t need to take out a loan to buy a car.

**Attitude towards financing.** The concepts of taking out loans and especially of financing consumer goods are generally new and still unfamiliar to the Chinese consumer. Even today many people prefer “to wait until they have saved money” instead of taking out a loan to buy consumer goods. This is especially the case for the generation older than 40.

**Insufficient infrastructure.** Finally, the underdeveloped technical infrastructure in China has been holding back the development of car financing. For example, the availability of cheque accounts for individuals is a technical prerequisite for the business model of car financing to work, because the repayment of the loan is based on **monthly instalments**, which are deducted from the retail clients’ bank accounts via direct debit. In addition, there is still a lack of reliable **consumer credit information**, and very few
integrated or shared databases (which are often limited to the big metropolitan areas) to check the credit history of potential clients.

However, despite these still existing “hurdles”, all participating AFIs expect the penetration rate in car financing to keep increasing relatively quickly, based on changing consumer behaviour and continued strong growth of car sales.

4.3.2.2 Client retention / strengthen of customer loyalty

While the financing of car sales increases vehicle turnover and sales of cars, it also strengthens customer brand loyalty by increasing the re-buy rate of existing clients. This is another motive for the participating AFIs to offer their services in China. This motive is more important for two of the participating AFIs that are “captives”, separate companies owned by auto manufacturers to finance product sales, and which only finance auto brands that belong to the car manufacturing parent company. The third AFI also finances car sales of other car makers in order to increase the volume of car financing. One manager explained, “I see us more… going into other brands, which is being done now. The slower the others develop, the more the market leader can strengthen its position by going into other brands, which is something the others don’t like, naturally”.

4.3.2.3 Dealership network support

The third motive for the participating AFIs to operate in China is the desire to support the dealerships by loans to associated car dealerships, which are used by the dealerships to purchase cars from the manufacturer as stock for sale to individual car buyers. Moreover, according to one participating company, dealership loans help to “stabilise” and “discipline” the dealerships, giving the AFI some influence and “leverage” over the dealerships, which can then be used to improve the quality of the services provided by the dealerships. According to one manager, “you can then of course tell the dealerships to do things ‘this’ or ‘that’ way, or it will cost more or we won’t be able to give you money, which … improves the quality of the dealership network”. As a result, as one AFI manager put it, “we cannot afford to leave dealership financing to others”, for example banks. In addition, establishing a strong business relationship with the dealerships can help “to infuse the group company’s ‘DNA’ into the dealership network.”
4.3.2.4 Potential of the Chinese market

The range of services offered in China by the participating AFIs is still limited in comparison to the more developed markets in the US, Europe and Australia. This is mostly rooted in the lack of approval by the authorities, the lack of appropriate regulation, or the lack of development of conditional markets – for example the lack of a strong used car market in China. A strong used car market is considered to be vital for car leasing to work as a business model. Besides leasing, all three participating AFIs also named fleet management and more insurance services as business areas for which they see great potential in the Chinese market.

In addition, one of the participating companies has already started to finance sales of other car brands where it sees an additional potential for its car loan business. Expanding its business into other brands offers this company several advantages. The increased number of credit contracts helps it to achieve economies of scale, and facilitates risk diversification in the firm’s loan portfolio. Moreover, car loans for other auto brands usually involve a slightly higher interest rate margin than financing associated brands.

One AFI manager, summarising the potential of the Chinese market for car financing, explained, “the demand [in China] is driven by the local market – it’s not coming from outside of China. When you take a look at how many cars are being manufactured in China and how few people actually already drive a car, then you can say that there is potential in the market for the next 20 years. And then in 20 years, [China] will have overtaken the US as the biggest auto market in the world, and they only have 300 million people, here they have 1.3 to 1.4 billion. There are still so many development opportunities just based on the size of the country. There is so much backlog demand in many areas, not only on the coast, but over in the western parts of the country as well. … I see this as very positive”.

4.3.2.5 Strategic considerations

Finally, one of the participating AFIs noted that its activities in China are also based on strategic considerations. In mature markets, more and more revenue streams have been coming from auto-related services like financing, insurance, repair services, selling car parts and accessories, and other after-sales services. Based on this development, auto manufacturers and their associated AFIs try to integrate more and more revenue-
generating areas along the “automotive value chain” into their business portfolio, including retail and dealership financing, leasing, insurance and warranty, fleet management, and loyalty products. By integrating these services, the car makers can profit from the complete automotive value chain while gaining key marketing tools to drive sales, manage customer relationships, strengthens the dealership networks, and accelerate car turnover.

4.4 Research Question 2: Market entry modes of German banks and AFIs in China

With the Regulations on the Administration of Foreign Invested Banks, passed by the Chinese State Council on November 11th, 2006 and effective on December 11th, 2006 (Pinsent Masons 2006), China formally fulfilled its WTO commitment with regards to the banking market by lifting the remaining geographic restrictions as well as all the non-prudential restrictions on banking services provided by foreign banks, giving foreign financial service providers the right to engage in business with foreign and domestic enterprises as well as individuals in all Chinese regions, if they meet a new set of requirements (Brean 2007; Asia Pacific Foundation of Canada 2006; see Section 1.7.1 above).

According to this new regulation, foreign invested banks (FIE banks) can operate in China under any of the following four structures (Mallesons Stephen Jaques 2006a, 2006b):

- **wholly foreign-owned banks** (WFOE banks), wholly-owned by one foreign bank or jointly owned by several foreign banks,
- **joint venture banks** (JV banks), jointly funded by a foreign financial institution and one or more Chinese companies,
- **foreign bank branches** (branches of a foreign-incorporated bank),
- **representative offices** of foreign banks (rep. office).

In addition, foreign banks can become “strategic investors” (see Section 2.4.4) in Chinese banks, by obtaining a minority stake in the Chinese institution, limited to 20% for a single foreign investor and 25% for all foreign investors in a single Chinese bank combined (Hawes and Chui 2007; Berger et. al. 2009; Hansakul 2007).
With the second research question, this study seeks to investigate the market entry modes which are being applied by the German banks and AFIs when they enter the Chinese market. Since some entry modes include cooperation with a Chinese bank in the form of a joint venture or as a “strategic investor”, Research Question Two also seeks to investigate the choice of Chinese partners, where applicable to the bank’s market entry strategy.

The applied market entry modes of the participating banks and AFIs and the corresponding number of organisations choosing these entry modes for their engagement in China can be found in Table 4.8.

Table 4.8: Market entry modes applied by the participating financial services providers

<table>
<thead>
<tr>
<th>Market entry mode choice*</th>
<th>Rep. office</th>
<th>Branch</th>
<th>Local incorporation</th>
<th>Joint venture</th>
<th>“Strategic investor”</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in sample</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>2**</td>
<td>1</td>
</tr>
</tbody>
</table>

* Representative office, branch, and local incorporation are entry modes with increasing resource commitment and possible scope of business. Some of the participating organisations may operate two or even all of these entry modes at the same time. In these cases, only the entry mode with the biggest resource commitment is counted and presented in the table. For example, if a bank operates a branch as well as a rep. office in China, only the branch is counted and presented in the table.

** In one of the joint ventures, the German company holds a 24.9% minority stake. The ownership shares in the other joint venture have not been disclosed by the shareholding organisations.

Source: Developed for this research

The most applied market entry mode by the participating organisations is still the representative office, with five banks using this entry mode. One of these banks also operates a joint venture with a Chinese partner. Three banks within the sample have set up a foreign bank branch in China. Of the three wholly foreign-owned local incorporations, one is a bank, and the other two are AFIs. One bank has set up a joint venture with a Chinese bank. The other joint venture in the sample is a joint venture between a foreign AFI and a Chinese partner, offering automotive financial services. Only one of the participating banks (which is also locally incorporated in China) has become a “strategic investor” in a Chinese bank (see Section 2.4.4).

4.4.1 Entry mode and asset size

As discussed in Section 2.3.6, several studies have found a strong relationship between bank size (usually measured in total assets) and entry mode choice, with larger banks tending to choose entry modes which require a bigger commitment of resources (Blan-

For the nine participating German banks in this study, the following observations can be made:

- The largest participating bank is also the only German bank which chose the strongest form of commitment for foreign banks in China, a wholly owned, locally incorporated subsidiary bank.

- Of the three biggest banks in the sample, two operate at the level of foreign bank branches, one is locally incorporated.

- Of the three smallest banks in the sample, two only operate rep. offices in China, the weakest possible form of commitment for foreign banks in China. The third of the smallest three operates a joint venture with a Chinese partner, which represents a commitment seen as stronger than a rep. office and branch. However, this company is a product specialist which has partly founded its decision to enter the Chinese market on its unique skills and its desire to serve Chinese individuals with RMB-products and this requires local incorporation.

- Of the remaining participating banks, two have chosen branches, and one is operating a rep. office in China.

The entry modes chosen by the participating banks and their corresponding asset size (total assets in billions of EUR) are illustrated in Figure 4.1.
In summary, it appears that of the participating German banks, the bigger banks (in terms of total assets) tend to choose entry modes in China which require a higher commitment of resources and allow more business activities (e.g. branch, subsidiary), while the smaller banks tend to stay with the a rep. office. One exception is the product specialist bank in the sample, which needed to set up a joint venture to be able to offer home loans in RMB to Chinese individuals.

4.4.2 Entry mode and international experience

Another relationship between bank-specific factors and entry mode choice described in the literature is the link between banks’ international experience (often measured by the number of countries the banks have some form of presence in) and their choice of entry mode. As discussed in Section 2.3.6, several studies have found a strong relationship between the international experience of banks and entry mode choice, with more experienced banks tending to choose entry modes which require a bigger commitment of re-

For the participating organisations in this study, the following observations can be made. Six of the participating organisations are active in more than 30 countries. Four of these strongly committed themselves to China, with three choosing to establish subsidiaries, and one setting up a joint venture with a Chinese partner. At the other extreme, four of the participating organisations are active in less than 20 foreign countries. Two of these only set up rep. offices in China, one is operating a branch, and one has set up a joint venture.

The entry modes chosen by the participating organisations and the number of countries they are active in can be found in Figure 4.2.

**Figure 4.2: Entry mode and international experience of the participating organisations**

<table>
<thead>
<tr>
<th>Number of countries with presence</th>
</tr>
</thead>
<tbody>
<tr>
<td>40 and above</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>10</td>
</tr>
<tr>
<td>Rep. office</td>
</tr>
<tr>
<td>Branch</td>
</tr>
<tr>
<td>Joint venture (locally incorporated)</td>
</tr>
<tr>
<td>Subsidiary (locally incorporated)</td>
</tr>
</tbody>
</table>

Number of organisations:

1: Number of organisations

Source: Developed for this research (asset size taken from publications of the participating organisations)

In summary, it appears that of the participating organisations, those with ample experience in international markets tend to choose entry modes into China which require a
higher commitment of resources and allow engagement in more business activities (e.g. branch, joint venture, subsidiary), while those organisations with less international experience stay with rep. offices. There seem to be two exceptions. One bank which is active in over 30 international markets also only runs a rep. office in China. The other exception is the product specialist bank in the sample, which is active in less than ten other countries but which needed to set up a joint venture to be able to offer home loans in RMB to Chinese individuals.

4.4.3 Entry mode and experience in Asia

Similar to international experience in general, experience in Asia in particular has also been shown to increase the commitment of foreign banks in China (Leung and Young 2002).

As can be seen in Figure 4.3, for the participating organisations this does not seem to play a role. Of the four organisations which are active in seven or more Asian markets beside mainland China, only one has established a subsidiary, while two only operate rep. offices and one has a branch. Of the six organisations with three or less presences in Asian countries other than mainland China, two operate rep. offices, two operate branches, and two have set up locally incorporated joint ventures with Chinese partners. Thus, a relationship between experience in Asian markets and entry mode choice does not seem evident for the participating services providers.
Figure 4.3: Entry mode and number of Asian countries (other than mainland China) with a presence

Number of Asian countries (other than mainland China) with a presence

More than 10
7 to 10
4 to 6
1 to 3
0

Rep. office Branch Joint venture (locally incorporated) Subsidiary (locally incorporated)

1: Number of organisations

Source: Developed for this research (asset size taken from publications of the participating organisations)

The factors influencing the choice of market entry mode (as well as the choice of market strategy) will be presented below in Section 4.6.

4.5 Research Question 3: The choice of market strategy/activities of German banks and AFIs in China

Research Question Three seeks to investigate the choices of market strategies made by German banks and AFIs operating in China. As discussed in Section 2.4.7 of Chapter 2, in this study, the market strategy of the participating banks and AFIs is defined by the following five dimensions:

- **customer segment** served by the bank or AFI (corporations/individuals),
- **currency** of products and services being offered (foreign/RMB),
- **nationality of clients** served by the bank or AFI (foreign/Chinese),
The WTO accession agreement gave China a transition period of five years to open up its market for foreign banks, especially to allow foreign banks to conduct business in the local currency renminbi (RMB) by 2007 (Brean 2007). The customer restrictions on foreign exchange business conducted by the foreign-funded banks were immediately removed after China’s WTO accession in 2001. In the following years, the RMB business activities of foreign-funded banks were gradually expanded from the four major cities of Shanghai, Shenzhen, Tianjin and Dalian to the entire nation, and foreign-funded banks were allowed to expand their RMB business clients from foreign enterprises and individuals to domestic corporations and residents (CBRC 2007).

By increasing the capital requirements and limiting the business scope of foreign-incorporated bank branches in comparison to locally incorporated banks, the Chinese banking regulations encourage foreign banks to incorporate in China. In particular, foreign bank branches may only conduct “large-volume” RMB business with Chinese citizens with a minimum deposit of RMB 1 million, thereby limiting their business to that of very affluent Chinese customers and keeping a large portion of the population out of the reach of foreign bank branches (Pinset Masons 2006; Mallesons Stephen Jaques 2006a, 2006b). Moreover, foreign bank branches need to satisfy certain requirements. One is that they must be profitable for two consecutive years within three years of operation, before being eligible to apply for an RMB licence (Deloitte 2006). Foreign banks which only operate a representative office in China are completely barred from offering RMB products or services. As a result, the activities or market strategy applied by foreign banks in China is limited and in part determined by their choice of market entry mode (Research Question 2, Section 4.4).

In comparison, foreign AFIs, which in terms of the Chinese regulation are “non-bank financial institutions”, have been less restricted than foreign banks. Auto-financing by “non-bank financial institutions” is among those activities which have been allowed without any geographical or client-based restrictions since China’s accession to the WTO (Deloitte 2006).
4.5.1 Customer segments served by German banks and AFIs in China

As discussed above, banking services offered by foreign banks to Chinese individuals are heavily restricted by the current regulations, depending on the type of entry mode as well as the possession of the required licences. The customer types/customer segments being targeted by the financial services providers participating in this study are displayed in Table 4.9.

Table 4.9: Customer segments served by the participating financial service providers

<table>
<thead>
<tr>
<th>Client segments served</th>
<th>Only corporate clients (wholesale banking)</th>
<th>Corporate and individual clients (wholesale and retail banking)</th>
<th>Only individual clients (retail banking)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in the sample</td>
<td>7</td>
<td>4</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Developed for this research

A majority of the participating organisations at this time only serve corporate clients. Based on the regulatory restrictions, this includes all banks that only run a rep. office in China as well as the banks which operate at the level of a foreign bank branch. The corporations being served include mostly German corporations active in China, foreign corporations of other nationalities, Chinese banks (usually acting as counterparts in trade-related banking transactions), and in some cases carefully selected Chinese corporations.

The second largest group of sample organisations serves both corporate clients and individuals in China. This group includes all three participating automotive financing companies, which engage in financing business with both individuals (mostly for auto loans) and corporate clients (mostly car dealership financing). Finally, one of the participating organisations only targets individuals in China. This company operates a joint venture with a Chinese bank, offering mainly home loans to Chinese individuals on a special license.

4.5.2 Currency in which products and services are being offered

The currencies, in which the participating organisations are offering products and services in China are displayed in Table 4.10.
Table 4.10: Currency of products and services being offered by the participating financial service providers in China

<table>
<thead>
<tr>
<th>Currency of products and services</th>
<th>Only foreign currency</th>
<th>Foreign currency and RMB</th>
<th>Only RMB</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in the sample</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Developed for this research

Based on the “currency of products and services offered”, the sample of participating organisations can be divided in three groups with four companies each. In the first group are financial services providers which only offer services in foreign currency to their clients in China. All organisations in this group are foreign banks that only operate a rep. office in China, which technically is not allowed to conduct any operational business activities in China and limits the bank to “advising” or “consulting” its clients and to “supporting” banking transactions which are being conducted via the bank’s headquarter in Germany or operational units in offshore locations like Hong Kong or Singapore.

One banker of a bank with a rep. office in China interviewed for this study explained “we have the problem that for regulatory reasons we are not allowed to be engaged in operational business. It is relatively difficult to follow this in our day-to-day work because there is no clear definition of what ‘being involved’ actually means. Differing points of view exist about this and there are differing ways this is being ‘lived’ in the banks’ daily work. … The question is, when an office of our bank which is not located in China is doing business with somebody in China, in which way can I be involved, in which way may I be allowed to initiate transactions like that? Can I get involved if a problem arises?”

The second group is made up of four banks, which have a foreign currency licence as well as an RMB-licence and thus offer their clients in China services in RMB as well as foreign currency. Three of these organisations are operating on the level of a foreign bank branch. The fourth bank in this group is locally incorporated in China.

A third group of the participating financial services providers focuses on products and services in the Chinese currency, the yuan. This group includes the three participating AFIs, and a foreign bank which operates a joint venture with a Chinese bank, offering mainly home loans in RMB to Chinese retail clients.
4.5.3 Nationality of clients served

The nationalities of the clients served by the participating organisations in China can be found in Table 4.11. In this analysis, “Chinese clients” means either Chinese *individuals* or Chinese *corporations*. It does not include Chinese *banks*, with which many foreign banks also interact, for example when offering trade-related service or when seeking refinancing in China. However, they are not seen as “regular” clients of the participating foreign banks.

<table>
<thead>
<tr>
<th>Nationality of clients served</th>
<th>Only/mainly foreign clients</th>
<th>Chinese and foreign clients</th>
<th>Only/mainly Chinese clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in the sample</td>
<td>5</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Developed for this research

Of the participating organisations, five serve only or mainly *foreign clients*. Four of these companies are banks which just have a rep. office in China, the fourth organisation is a bank which operates on a foreign bank branch level. Three sample companies serve foreign as well as Chinese clients. These include a locally incorporated bank, and two banks operating on the level of a foreign bank branch. Finally, four of the participating financial services providers have set their focus on *Chinese clients*. These are the three AFIs and a bank which operates on the level of a joint venture with a Chinese bank.

4.5.4 Geographic reach or focus of operations

Since December 2006, the geographic restrictions on banking services provided by foreign banks in China have been lifted (Pinsent Masons 2006). In fact, only one of the participating banks is still limited in its geographic market, based on an individual licence which limits its business to a specific region. Auto financing by non-bank financial institutions has been without geographical restrictions since China’s WTO-inception in 2001 (Boning and Hunag 2002). The geographic focus of the participating financial services providers can be found in table 4.12 (Banks) and table 4.13 (AFIs).
Table 4.12: Geographic focus of the participating German banks in China

<table>
<thead>
<tr>
<th>Geographic focus of operations</th>
<th>Big metropolitan areas and dynamic business centres</th>
<th>Shanghai and Beijing</th>
<th>Only one region</th>
<th>No active business in China (yet)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in sample</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Developed for this research

Most German banks focus on China’s big metropolitan areas and other dynamic business areas like some of the country’s coastal regions. Three banks mainly do business in the country’s economic centre, Shanghai, and, usually to a lesser extent, China’s political centre, Beijing. One bank’s licence is limited to a specific region of China and one bank reported that it was not interested in doing “classic” banking business activities in China but plans to use its presence in China to actively look for business relations with Chinese or other Asian clients in Germany.

Table 4.13: Geographic reach/focus of the participating AFIs in China

<table>
<thead>
<tr>
<th>AFI (1)</th>
<th>AFI (2)</th>
<th>AFI (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The company is currently active in over 70 Chinese cities. On the retail side of the business, the company is working together with over 460 car dealerships.</td>
<td>On the retail side of the business, the company is active in the country’s major metropolitan areas, and is adding more and more second tier cities as well. It is currently working together with about 70-75 dealerships, a number which is also still increasing. With regard to commercial clients, the company is active nationwide, because these clients are less concentrated in major cities.</td>
<td>On the retail side of the business, this company currently covers a network of about 140 Chinese cities. This network is still being expanded as more and more second tier cities are added.</td>
</tr>
</tbody>
</table>

Source: Developed for this research

In order to grant car loans to retail clients, the AFIs need to be able to assess the creditworthiness of their potential clients, which regularly involves home visits to clients’ residences. Thus, AFIs need to hire and train field investigators in all the geographic markets they want to service. Therefore, the three participating AFIs have established networks of “field investigators” which cover major Chinese metropolitan areas. The participating AFIs described the expansion of their networks as a time-consuming process which is still continuing, gradually spreading their network from the major metropolitan areas to “second tier cities” in China. One manager admitted, “the country is very big. We need … to further expand our offerings within the country into more cities, … which means I still need to do four or five times as much as has been done so far”.

163
Of the participating AFIs, the company which first entered the Chinese market has got the largest network today.

4.5.5 Scope of product and services being offered

The scope of products and services offered by the participating financial services providers in China can be found in Table 4.14.

Table 4.14: Product/service scope of the participating financial service providers

<table>
<thead>
<tr>
<th>Product/Service scope of the participating financial service providers</th>
<th>Only Trade related services and finance/“correspondence banking”/advisory and consulting</th>
<th>In addition to trade related services and finance.: Financing, loans, and some financial markets products</th>
<th>“Specialised” financial service</th>
<th>Universal banking service</th>
<th>No banking services offered yet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus on German/non-Chinese corporations</td>
<td>For German and selected Chinese corporations</td>
<td>Auto and car dealership financing</td>
<td>Mortgages loans</td>
<td>Also serving Chinese individuals</td>
<td>Goal is to “win” Chinese clients for business in Germany</td>
</tr>
</tbody>
</table>

| No. of organisations in this category | 3 | 2 | 1 | 3 | 1 | 1 | 1 |

Source: Developed for this research

Three of the participating banks only operate rep. offices in China. While technically these offices cannot engage in operational banking business or enter into a business contract, a certain “grey” area exists with regard to a rep. office’s possible activities. These, for example, may include an involvement in an existing business transaction between a client in China and the bank’s headquarters in Germany if a problem arises, or the “initiation” of a new business transaction. As a result of the existing regulatory environment, the banks which operate on the level of a rep. office mainly do “advisory” and “consulting” for their clients in China. The areas they are mostly involved in are trade related services and products and dealing with their Chinese correspondence banks.

The three sample banks which operate on the level of a foreign bank branch offer a wide range of products and services in China. In addition to trade related products and services, they usually offer deposits, corporate financing, and some financial markets products. The financing products include short-term working capital loans, medium and long term financing for fixed assets, infrastructure projects, syndicated loans, ship financing, and aircraft financing. However, only one of these banks actively takes care-
fully selected “Chinese risks” into its portfolio. The other two banks only give loans to German, or possibly other non-Chinese corporations.

Four of the participating organisations are “product specialists” which focus on specialised financial services. This group includes the three AFIs with their special focus on auto loans and dealership financing. In addition, this group includes a bank which operates on the level of a joint venture with a Chinese bank and focuses on home loans. In contrast to this group of product specialists, there is only one company in the sample which offers “universal” banking services, with a wide rage of commercial and investment banking services, including RMB products to Chinese individuals. This is the only bank in the sample which is a wholly foreign-owned local corporation and thus can serve Chinese residents in local currency.

4.6 Research Question 4: Factors influencing the choice of market entry mode and market strategy/activities of German banks and AFIs in China

Based on the review of both theoretical research and empirical studies, as well as the interviews conducted for this research, eleven different categories of factors have been identified, which have been considered by the participating organisations in their choice of entry mode and market strategy in China. The identified factors and the corresponding number of organisations citing these factors as influencing their entry mode and market strategy choices in China can be found in Table 4.15.

Table 4.15a: Factors influencing the choice of entry mode and market strategy/activities (part 1)

<table>
<thead>
<tr>
<th>Factors influencing the choice of entry mode and market strategy</th>
<th>Regulation</th>
<th>Regulation alignment of entry mode and market strategy with the business model applied in China</th>
<th>Competition in China</th>
<th>Risk / costs associated with the investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in this category</td>
<td>5</td>
<td>4</td>
<td>8</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Developed for this research
Table 4.15b: Factors influencing the choice of entry mode and market strategy/activities (part 2)

<table>
<thead>
<tr>
<th>Factors influencing the choice of entry mode and market strategy</th>
<th>Economies of scale</th>
<th>Refinancing</th>
<th>Chinese policy goals / &quot;expectations&quot;</th>
<th>Early mover advantage</th>
<th>Possible future mergers or acquisitions</th>
<th>Complexity of management and operations / considerations of &quot;size&quot; and &quot;manageability</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in this category</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Developed for this research

4.6.1 Regulation

The factor or consideration most cited by the participating organisations as having influenced their choices of entry mode and market strategy (activities) is regulation (altogether nine mentions). Of these nine, five organisations cited regulation or the regulatory environment in China in more general terms as having influenced their choices. Four organisations referred to more specific pieces of regulation as being influential on their decisions.

Two banks (one operating on the level of a rep. office, the other operating on the level of a foreign bank branch) argued that the current regulatory environment would favour “bigger banks” and would put “smaller banks which just got a branch to a disadvantage”. One example given by a banker is funding: “All regulations introduced which concern the funding of foreign banks, are the harsher, the smaller the bank is”. A second explanation given was that bigger institutions simply possess more of the resources necessary to meet the complex regulatory requirements in China. The bank which is locally incorporated in China stated that the regulatory environment in China favours locally incorporated banks over foreign bank branches, especially when it comes to applying for specific business licences. Another bank confirmed this assessment, adding that it expected that in the future the Chinese regulators will push foreign banks towards only two options, (1) a rep. office or (2) local incorporation, while “the branch office will be a thing of the past”. Therefore, for this bank which currently operates a rep. office in China, a branch is not an option anymore. Another bank with a rep. office predicts, that future regulations will also increase the cost of operating a locally incorporated bank, making this option less attractive as well.
Four participating banks named specific pieces of regulation which influenced their choice of market entry strategy. Three banks which all operate on the level of rep. offices in China specifically singled out the **three year waiting period**, before a newly established foreign bank branch would be able to obtain an RMB-licence. All three banks argued that this waiting period acted as a major disincentive to opening up a foreign bank branch in China. Referring to anecdotal evidence, one banker argued that after the three years, it may still take up to nine months before the bank can actually start working with RMB products. In addition, the bank might also need a preparation time of up to one year before it is fully prepared to apply for the RMB licence. As a result, one banker stated, “*after making the decision to go into the RMB-business, it could take a foreign bank up to five years till it can start offering RMB-service*”. However, the bank’s clients, mostly German SMEs need RMB-financing “*today and not in 4–5 years*”. Therefore getting a branch in China would not improve the bank’s position immediately. Finally, one bank specialising in home loans has built its business on a specific regulation, introduced by the Chinese authorities to develop more private home ownership in China. For this bank, adequate regulation was necessary for its business model to work in China and as such this was a major factor influencing its market entry strategy choices.

### 4.6.2 Alignment of entry mode and market strategy with the applied business model in China

The second-most cited factor or consideration which influenced the choices with regard to entry mode and market strategy of the participating organisations is the **alignment** or “*fit*” of the selected entry mode with the applied **business model** (eight mentions).

All eight organisations citing this factor are banks. One of them is locally incorporated, one operates as a joint venture with a Chinese partner, two operate of the level of a foreign bank branch, and four run rep. offices. The locally incorporated bank, the joint venture-bank, and the two banks with branches all argue that their business model in China requires their chosen market entry strategy. In contrast, three of the banks with a rep. office describe the **lack** of an appropriate business model in China as a reason for staying with their existing rep. offices and not expanding their presence into a branch or even a local corporation.
The locally incorporated bank stated it wanted to be able to serve Chinese individuals in RMB (beyond the “large volume” RMB business of RMB 1 million or more that foreign bank branches can engage in. See Section 1.7.1) and thus required local incorporation in China. In addition, local incorporation also opens the door for this bank to engage in bank card business. The bank operating in a joint venture with a Chinese partner explained it needed the joint venture in order to basically transfer its business model from Germany to China which includes offering home loans to Chinese individuals in RMB. One of the banks operating on the level of a foreign bank branch explained it chose a branch over a rep. office to be able “to become operationally active in China” instead of just supporting or advising existing German clients. The bank plans “selective organic growth” with both foreign and Chinese clients in China and thus says it can base its business model on the existing foreign bank branch and does not need to invest in the much more expensive local incorporation in China. The second bank within this group operating on the level of a foreign bank branch explained that it opted for this mode of operation because it sees a market potential beyond its existing German clients and wants to be able to also serve Chinese corporations with both foreign currency and RMB products which requires a branch. One banker explained, “we are also interested in winning clients in China, with whom we don’t have any business relations in Germany yet. … According to our licences, we are not yet allowed to serve Chinese corporations, at the moment we can only serve 100% subsidiaries [of foreign companies] or joint ventures. This is the licence we still don’t have – we are working on it”. In contrast, “retail banking does not fit into the bank’s business model” according to the interviewee, and therefore it does not need to be incorporated in China.

One of the banks in this group with just a rep. office argued that in order “to justify the investment in a branch, the bank would need a ‘business model’, which can create high enough returns”. For such a business model to work, the bank’s manager explained, “a focus on German clients is not enough; it would require also taking ‘Chinese risk’ into the bank’s portfolio”, which the bank’s owners are not willing to do at this time. Investing in a branch would also require a basic strategic choice to be made between being “a niche player, with a limited number of locations and products, or a full service bank, which requires an even higher investment”. For example, “financing for international companies … requires a larger branch network. Complex investment products require the appropriate risk-management system.” As a niche player, the foreign bank would
run the risk that “one day the client says ‘I need the full service now’ and switches to a ‘big player’.” The manager also acknowledged that the success of any strategy “very much (depends) on the development of the Chinese banking market, which is very uncertain”. In addition, any strategy based on setting up a branch in China would take at least 3–5 years before yielding any profits, making it a strategic decision.

However, one banker commented, “I have the feeling that many decisions by foreign banks to open up a branch in China are being taken with a kind of ‘Lemming view’. Under the slogan, ‘there are so many (foreign banks) here now, this market is so huge, there must be something to it, we’ll try that now too’. We belong to the more cautious banks. When I look at my colleagues – I do not know what your other interviewees told you – but when I look at this, there are actually very few (foreign bank branches in China) which are really happy.”

Another bank with just a rep. office pointed out that a newly opened foreign bank branch can only serve clients in foreign currency for the first three years, before an RMB-licence can be approved. However, foreign companies in China do not need foreign currency, but RMB. Another bank with a rep. office made the same argument for Chinese clients, adding that “Chinese companies don’t need foreign currency loans by foreign banks, because China has got the biggest foreign currency reserves in the world”. The fourth bank with a rep. office stated that having a rep. office in China was “just about right” for its applied business model. The bank’s manager explained that the bank’s strategy is to focus on its “areas of strength where it can do things better or differently” than its competitors by using special skills, experiences, or resources. He added that while bigger banks may often feel the need to be able to offer their clients all kinds of services to maintain the business relationship and not lose the client, his bank could “afford” to say no to specific business transactions, if it felt it lacked the necessary skills or resources to do this kind of business well. As a result, the bank does not see “the need to expand [its] presence in China at the moment and probably not even within the next five years”. With a rep. office, the bank said it was very well able to do its China-related business in a very profitable way.

4.6.3 Competition

The competition which the participating organisations are facing in the Chinese market is the third-most cited factor or consideration which influenced the organisations’
choices with regard to their entry mode and market strategy in China (seven mentions). Three banks which operate rep. offices in China described competition as one factor which influenced their decision not to open a branch in China. One of these banks referred to the competition of German banks. There are already six German banks in China with an RMB-licence. According to the bank, a seventh bank from Germany was going to obtain the licence in the near future. Together with the participating bank there would then be eight German banks “with basically the same business model in China”. However, there would not be enough German corporate clients active in China, “to make so many banks happy”.

Another bank with a rep. office pointed to the competition from Chinese banks. According to this banker, Chinese banks have an advantage over the foreign banks with regard to refinancing, which they will keep for the years to come. This makes it very difficult for foreign banks to earn sufficient margins in the Chinese credit market. A similar argument is made by a bank which operates at the level of a foreign bank branch. According to the bank’s manager, currently, margins are still basically guaranteed because interest rates are set by the regulators. In the future, however, the setting of interest rates will “loosen up”, which will increase the competition among banks based on pricing. In such a competitive environment, higher refinancing costs will put foreign banks at a disadvantage, mainly because they lack a large branch network which is necessary to collect enough deposits that can be used for refinancing. In addition, the bank expected that the “maturing” of the Chinese banking market will also work against foreign banks, eventually rendering many of them unnecessary. In the bank’s assessment, Chinese banks will be able to improve the quality of their services within the next couple of years to a level which is sufficient to attract German and other non-Chinese companies as clients. At the same time, the more established foreign companies in China will feel comfortable and experienced enough to mostly work with Chinese banks and won’t need the “help” or “support” of foreign banks anymore.

Two banks reported that they adjusted their market strategy based on competition from other banks in China. One bank operating at the level of a foreign bank branch explained that competition, especially from other German banks, influenced its loan policy. While most German banks consider Chinese clients as “too risky”, this bank decided “to take a broader approach” to set itself apart from the competition by actively taking selected “Chinese risks” into its loan portfolio as well. The other bank changed its loan
policy and introduced additional lending products to its product line in China because it felt growing Chinese competition.

The still existing “weaknesses of Chinese banks” in the areas of operations, consulting, and customer service was a factor in one bank’s decision to locally incorporate in China and to offer products and services in local currency to affluent Chinese individuals. The bank reported that in many Chinese banks, “customers still need to ‘take a number’ and then sit and wait to be served, sometimes for three hours”. Moreover, many Chinese banks still promote a culture of “product selling” instead of client consulting, “sometimes even the janitor in Chinese banks has got a ‘sales goal’ to win a certain number of new clients”. Thus, according to the interviewee, good customer service and client consulting is one of the few ways for foreign banks in China to set itself apart from the competition. In addition, as pointed out by the bank’s manager, the quality of the services provided is even more important at the moment in China, because many interest rates are still being set by the regulator, making competition via pricing in many areas (e.g. deposits) almost impossible. As a result, the participating bank does not consider the Chinese banks its greatest competitors, but other major international banks, which also have a lot of experience and expertise in offering private banking services and especially financial planning, which depends on high service quality.

4.6.4 Risk/cost considerations with regard to the investment in China

The risk and/or cost associated with their investment in China were also mentioned by six of the participating organisations as a major factor influencing their choices with regard to entry mode and market strategy. One banker explained “when you decide to enter this market to become operationally active in China, the question is what will be your strategy. Are you going in as a niche player, with a small branch to offer a limited range of products, or are you going in with full force, which means you need to be prepared to make the investments necessary”.

Two banks currently operating rep. offices in China described their banks’ “culture” or “business strategy” as being very conservative and risk averse. Thus, these institutions deemed it as too risky to enter into the kind of business transactions which are required to justify the investment required to establish a branch in China. Moreover, one of these banks expected there would be pressure on its rating if it was to invest the resources necessary to open a branch in China.
Two other banks also working out of rep. offices in China explained that their owners or shareholders were not willing to take the risk associated with the investment required to establish a foreign bank branch in China. One of these banks is still partly owned by individual partners, who are personally liable for the bank’s debt. The other bank is a Landesbank, which is jointly owned by one of the German states and a group of German savings banks. One bank said receiving an RMB licence via a foreign bank branch would require at least RMB 300 million (about EUR 30 million) equity “plus some expenses”. However, based on the situation in China and the bank’s “strategic positioning”, the bank’s shareholders have come to the conclusion that the opportunity cost of such an investment was too high and that “this money is better spent elsewhere” in other areas where the bank does business. Another bank pointed out that besides the necessary equity, having a branch in China also means significantly higher operating costs. According to the bank, this may include higher labour costs because more and higher qualified employees are needed, a higher investment in the bank’s IT-infrastructure, and higher rent cost for more and “better located” office space. One banker noted “it’s expensive to operate a foreign bank branch in China. The equity requirements are very high, I have very high labour cost, I have very high equipment cost, I also usually have very high rent cost, because bank branches naturally need to offer representative office space”.

A bank already operating a foreign bank branch in China, however, did not confirm this view. While certain investments in the IT and branch infrastructure were necessary, a “full investment” could be avoided in the beginning, by improvising, running the branch with minimum staff, or combining lower wage levels with bonuses and commissions. According to this bank, establishing a branch offered foreign banks the opportunity to become operationally active in the Chinese market without having to put up the high investment of local incorporation. One banker explained “In many areas I can work with employee bonuses and commissions, … when I am getting started I can do a lot of things with spread sheets until I reach a certain scale where I have to say ‘I cannot use spread sheets any more, now I need a proper system’ ”.

A bank operating at the foreign bank branch level argued that the high cost of local incorporation discourages many foreign banks from taking this step. The current regulation requires foreign banks to commit at least RMB 1 billion (about EUR 100 million) in registered capital to their Chinese subsidiaries and to capitalise each branch with an-
other RMB 100 million (about EUR 10 million). However, as one banker explained “with 1 billion RMB you cannot run a locally incorporated bank in China because a locally incorporated bank needs its own rating. ... and the major rating agencies require at least RMB 3 billion (about EUR 300 million), before a bank will have a chance to get rated”. Thus, according to this banker, local incorporation in China is only an option for major international players.

4.6.5 Economies of scale

A factor discussed in relation with the above described factors “business model” and “cost of investment” is the issue of economies of scale. Five of the participating organisations said that the opportunity to benefit from “economies of scale”, or an inability to do so, influenced their choice of entry mode and market strategy in China. Three banks argued that the necessary investment in IT alone would require a certain scale of business, which not all foreign banks were able to generate. Other areas which require a critical mass in operations are the hiring of Chinese employees and the setup of a Chinese accounting system. According to one bank, the opportunity to realise economies of scale in these areas was a factor for the bank to set up a branch in China. Another bank argued that the offering of certain services (e.g. cash management) only made sense if the bank was able to win enough clients to use and pay for these services. Two banks said that their inability to reach a critical mass in their Chinese operations was one reason for them not to aspire to incorporate in China.

Economies of scale are also a factor considered by the participating AFIs in their China strategies. One example given by the participating AFIs is the network of field investigators used by these companies to investigate the credit worthiness of potential clients, which regularly includes “home visits” to the clients’ residences. Hiring these field investigators in several locations all over the country only makes sense economically if the number of potential clients in a field investigator’s designated area of responsibility reaches a critical mass. Another area where economies of scale play a role for AFIs is refinancing. While refinancing remains a challenge for many foreign financial services providers in China (see Section 4.7.6 of this chapter), so far one of the participating AFIs has been able to issue a bond to cover parts of its refinancing needs. Since the transaction costs for capital market transactions are high, according to the company this
only made sense because its operations in China had reached a large enough scale to justify the transaction.

4.6.6 Refinancing

As will be discussed below in Section 4.7.6, refinancing is seen as a major challenge by many foreign financial services providers in China. Four of the participating organisations pointed to the problem of refinancing as one of the factors influencing their choices of entry mode and market strategy in China.

According to several of the participating organisations, the major problem for foreign players with regard to refinancing is their lack of the large branch network which is necessary to collect larger amounts of saving deposits. The main alternative, the Chinese inter-bank market, is described as a rather expensive source of funding by several interviewees. An additional hurdle for foreign banks are the “foreign debt quotas” which limit the amount of money foreign banks are allowed to borrow. Metcalfe (2008) points out that the term “quota” is incorrect, and that “restriction” or “limitation” would be more appropriate, however, several interviewees referred to “quotas” to describe the conditions imposed by the CBRC at the end of 2007 limiting RMB and foreign currency loans.

The problems foreign banks are facing in China with regard to sources of refinancing are discouraging some of the participating organisations from increasing their engagement in the Chinese market. Two banks with rep. offices and one bank operating at the branch level described refinancing as a major hurdle for stronger engagement in China which influenced their choice of market entry strategy. Another bank said its current inability to collect sufficient RMB deposits puts limits on its product scope in China. Therefore, the banks has only been offering home loans in foreign currencies. By focusing on affluent clients, it plans to be able to collect some RMB deposits despite the lack of a large branch network in the future, which would allow it to also offer home loans in RMB.

4.6.7 Considerations of Chinese policy goals

Three of the participating organisations reported that their choices with regard to entry mode and market strategy in China also partly reflected policy goals put forward by the Chinese banking regulators and the Chinese government. One locally incorporated bank
described its decision to set up a Chinese corporation as being influenced by the often publicly stated “encouragement” of the Chinese government of foreign banks to incorporate locally in China.

Another bank, which operates at the level of a foreign bank branch in China, stated that it partly adjusted its **product scope** to the **expectations of the Chinese government**. As one banker explained, currently many foreign banks only focus on foreign clients because giving loans to Chinese corporations is often considered to be “too risky”, resulting in the “risk” of Chinese corporations being mostly borne by Chinese banks. According to the banker, the Chinese government is trying to encourage more foreign banks “to share some of that burden” by also taking “Chinese risks” into their loan portfolios. Hoping to create “a win-win situation” the bank decided to take selected “Chinese risk” into its portfolio, to set itself apart from the competition while at the same time meeting the expectations of the Chinese government.

Another bank operating a rep. office in China reported that its analysis of the situation of foreign banks in China in general and the bank’s in particular had produced strong arguments for leaving the country based on a risk/return calculation. Nevertheless, the bank decided against closing its rep. office in China for the following reasons. Firstly, an already existing rep. office offers a “relatively inexpensive way” to have a presence in China and to “watch the market and be there in case new opportunities arise in the future”. Secondly, as the interviewee explained, closing the office would not be a smart thing to do politically, because the Chinese authorities would not appreciate such a step. Thus, such a move could hurt the bank in the future if it ever decided to come back to China. In addition, the bank is connected to another financial services provider which is also active in China, and which could also be affected by such a decision. The interviewee’s final comment on the matter was: “you don’t leave China”.

### 4.6.8 Early mover advantage

Two of the participating organisations argued that the opportunity to take advantage of entering the Chinese financial services market early in comparison to other banks (**early mover advantage**) influenced their choice of entry mode and market strategy. One of the **Landesbanks** referred to an early mover advantage in relation to other German banks. The bank pointed out that at the time of the data collection in April 2008, Germany still had seven independent **Landesbanks** and two central cooperative banks and
“all of these bank have a more or less comparable business model in Germany”. Seven out of these nine banks are also active in China with at least a rep. office. Based on the similarities in terms of business model and focus on German SMEs, it made sense for the bank to set up a branch as one of the first German banks in China, because “there might not be enough ‘space’ for all of these banks to be present with a branch”.

One of the participating AFIIs also considered its potential “early mover advantage” when it decided to enter the Chinese market early. One reason for this company to set up a joint venture with its Chinese manufacturing partner (instead of a wholly foreign-owned enterprise) was the assumption that working with a Chinese partner would speed up the process of setting up the company and getting it to work. According to the interviewee, being early in the market helped to quickly reach “the critical mass necessary to be profitable”, for example with regard to the large network of field investigators necessary to assess the creditworthiness of potential customers. Reaching this critical mass before other AFIIs also helped the company to use the capital market for refinancing via a bond.

**4.6.9 Potential future mergers or acquisitions**

Potential future **mergers or acquisitions** have also been a factor influencing the choices of two of the participating organisations with regard to their entry mode and market strategy in China. One of the banks operating a rep. office in China said that the bank’s owners were in serious talks with the shareholders of another German bank about a possible merger of the two institutions. This potential merger partner already operates a branch in China (and is one of the sample banks in this study). According to the interviewee, the merger would spare the bank the time and resources needed to go through the application process to set up the branch itself. As a result, the possible merger has been one consideration in the bank’s decision to not set up a branch in China at this time.

Another bank, which is operating on the level of a foreign bank branch in China, has also been subject to several rumours about possible mergers with or acquisitions by other German and international banks. At least two of the banks discussed in the industry as possible future banking partners of this bank are already locally incorporated in China. Thus, the bank has put its own considerations of local incorporation in China on hold till its future with regard to a pending merger or acquisition has been decided. In addi-
tion, the bank’s current owner, an international financial services provider, has already invested in another locally incorporated bank in China, giving a possible local incorporation of the bank in question a lower priority.

4.6.10 Complexity of operations and considerations of “size” and “manageability”

Two of the participating organisations named the complexity involved with the management of a particular form of entry mode as a reason to choose a less complex form of organisation. The complexity associated with operating and managing a branch office in China was one of the factors influencing one bank’s decision to not open a branch in the Chinese market. Considering itself to be “small and beautiful”, the bank, which operates a rep. office in China, argued that it has been a successful strategy to keep “things small and manageable” and explained that it is always trying “to do things form its headquarters in Germany as much as possible”. According to the interviewee, this approach greatly improves the bank’s ability to effectively communicate with its customers and manage its business transactions abroad.

One AFI which chose to set up a wholly owned subsidiary and decided against a joint venture with a Chinese partner said that one reason for its decision was the complexity that would be involved in managing a joint venture and the relationship with the local partner. The manager explained, “the management challenge is of a very different complexity if one is to work together with a Chinese joint venture partner, who may have very different ideas, for example with regard to financing products”.

4.6.11 Market entry mode choice of AFIs – doing it alone or with a Chinese partner

All of the three participating AFIs described the choice of entry mode into the Chinese market as a major strategic decision when first entering the Chinese market for auto financing in 2004 and 2005. According to the AFI managers interviewed for this study, by April 2008 there were nine foreign AFIs active in the Chinese market. Six of these companies operate as wholly foreign-owned enterprises with full ownership and management control in the hands of the foreign parent company. The other three have set up joint ventures with the ownership and control shared between the foreign parent company and the mostly one (and in one case two) Chinese partners. A fourth joint venture
was planned to be set up in late 2008. In all four AFI joint ventures, the Chinese JV partner is economically and legally connected to the Chinese car manufacturing company with whom the parent of the foreign AFI is manufacturing cars in China. By the end of 2009, there were 10 auto financing companies operating in the Chinese market (Fangfang 2009).

When asked about their entry mode decisions the managers interviewed for this study stated their arguments for both entering the market via a sole venture as well as sharing ownership and control with a Chinese partner in a joint venture. They also reflected on whether their presence in China may change in the future. Both AFIs which chose to enter the Chinese market with wholly foreign owned enterprises (WFOEs) rather than by setting up a joint venture with a Chinese partner noted that in the future they may change strategy and start working with a local partner. One manager remarked, “I can quite imagine that some day there will be pressure on the auto financing companies to be converted into joint ventures as well”.

The arguments and considerations with regard to the entry mode choice of the participating AFIs and their outlook for their presence in China are displayed in Table 4.16.
Table 4.16: Arguments for the choice of market entry mode by the participating AFIs

<table>
<thead>
<tr>
<th>Arguments for setting up a joint venture (JV) with a Chinese partner</th>
<th>Arguments for setting up a wholly foreign owned enterprise (WFOE)</th>
<th>Outlook for the AFI’s presence in China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AFI I (WFOE)</strong></td>
<td>The Chinese car manufacturing partner could bring in its “weight” on the sale side in an JV-AFI and work to increase the sale of cars which in turn increases the need for financing of cars offered by the JV-AFI</td>
<td>To preserve the company’s original “DNA”</td>
</tr>
<tr>
<td></td>
<td>Both Chinese car manufacturing partners of the parent company of this AFI have their own auto financing companies which are currently competitors of this AFI</td>
<td>To reduce the complexity and the management challenge which would be involved in a joint venture with a Chinese partner</td>
</tr>
<tr>
<td></td>
<td>Working together with a Chinese partner in a JV-AFI could make refinancing easier and increase the company’s liquidity</td>
<td>To avoid disagreement with a Chinese partner, e.g. with regard to the goals of joint venture, the product offerings, and market development</td>
</tr>
<tr>
<td><strong>AFI II (joint venture)</strong></td>
<td>Setting up an AFI with the Chinese car manufacturing partner offered the opportunity to enter the market early</td>
<td>To maintain full control of the operations</td>
</tr>
<tr>
<td></td>
<td>Being in the market early offered the opportunity to reach economies of scale sooner</td>
<td>Chinese car manufacturers usually work together with several competing foreign car makers; the Chinese partner may choose to use its influence via the JV-AFI to lower sales of one particular partner</td>
</tr>
<tr>
<td></td>
<td>The Chinese partner agreed to giving the AFI a majority stake and management control in the joint venture</td>
<td>In the future the company may choose to work together with a Chinese partner</td>
</tr>
<tr>
<td><strong>AFI III (WFOE)</strong></td>
<td>To keep full ownership and management control over the company</td>
<td>By now, the company has enough “weight” which it could bring into negotiations with a potential Chinese partner</td>
</tr>
<tr>
<td></td>
<td>In contrast to the manufacturing of cars, where the Chinese regulations require joint ventures between foreign car makers and Chinese corporations, the regulations with regard to auto financing do not require that foreign AFIs need to have a Chinese partner</td>
<td>New regulation allows foreign AFIs to operate more than just one company, thus the company may choose to set up an additional AFI in the form of a joint venture with a Chinese partner</td>
</tr>
<tr>
<td></td>
<td>In a period of five to six years more foreign AFIs will be organised as joint ventures with Chinese partners</td>
<td>In the future there may be pressure on foreign AFIs to form joint ventures with Chinese corporations, because the Chinese car manufacturing partner wants to be involved in the financing business</td>
</tr>
</tbody>
</table>

Source: Developed for this research
4.7 Research Question 5: Challenges which German banks and AFIs are facing in China

With the final question, Research Question 5, this study seeks to investigate the challenges which German banks and AFIs are facing in the Chinese financial services market. Based on the review of theoretical research and empirical studies and the interviews conducted for this research, nine different categories of “challenges” have been identified. These challenges and the corresponding number of organisations citing these challenges can be found in Table 4.17. Whenever the interviewees were able to elaborate on how their organisation deal with the challenges described, this also noted in this chapter.

Table 4.17a: Challenges of German banks and AFIs in China (part 1)

<table>
<thead>
<tr>
<th>Challenges faced by the participating organisations</th>
<th>Regulation / regulatory environment</th>
<th>Employee Recruiting and Retention</th>
<th>Competition by Chinese competitors</th>
<th>Competition by foreign competitors</th>
<th>Lending / assessment of creditworthiness</th>
</tr>
</thead>
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<td>9</td>
<td>8</td>
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</tr>
</tbody>
</table>

Source: Developed for this research

Table 4.17b: Challenges of German banks and AFIs in China (part 2)

<table>
<thead>
<tr>
<th>Challenges faced by the participating organisations</th>
<th>Legal system</th>
<th>Refinancing</th>
<th>Management of Relationships / Partnerships with Chinese partners</th>
<th>Commitment / Support from headquarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of organisations in this category</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Developed for this research

4.7.1 Regulation

Regulation or the regulatory environment remains the biggest challenge for the participating organisations in China (nine mentions). This includes more general or across-the-board issues like “equal treatment”, complexity, or implementation of regulations as well as specific regulatory issues like restrictions on foreign currency loans. The importance of the regulatory environment as a “driver” for the development of foreign banks in China is further amplified by the fact that several of the other challenges for foreign banks (which are discussed below) are also related to regulation.

Several banks described the “interpretation”, “implementation”, and “execution”, and of new regulations as often difficult and “unclear”. One banker commented “new regulations are often very general, and their implications on the operational level re-
main unclear”. According to another interviewee, “many regulations are not properly codified, or they can be interpreted in different ways”. Often, new regulations are published without “explanations” or without an “implementation rule”. One bank manager reported that enquiries with the CBRC by phone about specific explanations concerning new regulations could often not be answered by the CBRC employees. In addition, not all regulations are implemented or enforced equally by the regulators. While some published regulations are not enforced for years, others are published with “retrospective effect”.

Another issue for the participating organisations is the complexity and volume of relevant regulations. As one bank pointed out, there are several institutions in China which can act as sources of regulation applying to foreign banks and non-bank financial institutions (e.g. AFIs). They include: the CBRC, the People’s Bank of China (PBOC), China’s State Administration of Taxation (SAT), the State Administration of Foreign Exchange (SAFE), the China Securities Regulation Commission (CSRC), and the China Insurance Regulatory Commission (CIRC). According to one interviewee, “almost every week new laws and regulations are being published”, and another manager commented “the regulations foreign banks have to deal with seem to be unlimited”.

Another problem reported by several interviewees is a “lack of uniformity” with regard to decisions made by the Chinese regulators. For example, one AFI reported that the regulation on the registration on auto mortgages can be very different depending on the city or province. This causes a lot of extra work for the company and increases its costs with regard to mortgage administration. The manager noted “there you realise that China is a big country”. In addition, one bank explained, Chinese regulators would “often decide on a case-by-case basis”, treating similar applications or requests by foreign banks differently, with the reasons for the differing treatments remaining hidden to the banks involved. Another banker reported that sometimes “regulators in China still decide as they please”.

Three of the participating organisations (two of which operate rep. offices in China) reported that the Chinese regulators, as well as the regulatory environment in general, favour bigger over smaller foreign banks. One banker argued that banks with a “bigger engagement” in China would receive “better treatment” by the CBRC in comparison to foreign banks which are “just riding along”. The different treatment of foreign banks in China, as one banker explained, is not related to guanxi or corruption, “but clearly po-
According to the interviewee, with this policy the Chinese authorities aim to actively develop the country’s banking industry and to manage which “banks, business models or special skills they want to have in the market and which they don’t”.

The differing interests of larger and smaller foreign banks also affect their ability to lobby with the Chinese regulators. One manager of a bank operating a rep. office commented “the big players will lobby their issues with the CBRC and don’t worry too much about the issues which concern the smaller banks”. In addition, information about regulations with regard to locally incorporated banks or foreign bank branches will often not be passed on by the regulators to banks which just operate rep. offices, making it very difficult for these banks to stay fully informed on regulatory matters. However, another bank manager reported that at least the cooperation among the German banks and with German trade and commerce promoting organisations in China was very good. She added “people know each other in this community” and “we work on the same team”.

Another issue for the participating organisations is the communication between the CBRC and other regulatory bodies and foreign banks in China. One example given is that different regulators are responsible for different branches and sub-branches of the same company. As a result, several different bank employees are dealing with different regulators discussing similar problems, making communication with the regulators a complex and time-consuming process. In addition, the personal relationships between the bank employees and their counterparts at the CBRC are still very important, like many relationships on a personal level in China. To solve these problems, one banker explained that the bank is trying to “channel” all communication with the CBRC through designated employees by establishing communications with the CBRC and other institutions on a “country level” instead of a “business unit level”. He also acknowledged, “if somebody at [the bank] or the CBRC leaves, ‘new relationships’ with the ‘replacement’ have to be developed”. In such a case, German law would not even allow his company “to invite the regulator for lunch”, however, the interviewee also suspected that “with some competitors it does not stop at the lunch invitation”.

Four of the participating organisations expressed the opinion that the Chinese government is using banking regulations as “market entry barriers” against foreign banks and is actively discriminating against foreign banks in China in favour of Chinese banks. Moreover, according to one company, the progress of deregulation in the Chi-
nese financial service industry is “still very much dominated by the relative weakness” of the Chinese banks. One banker commented “I don’t think the Chinese authorities are interested in having a lot of foreign banks in China”. And he added “only once the big Chinese banks have reached competitive positions in Western markets will ‘real’ competition be allowed in China”. Another interviewee expressed his opinion that currently foreign banks are mainly allowed in China so “the Chinese authorities can learn and strengthen the Chinese banks…real competition is not welcome”. Another bank manager pointed out that in many areas the Chinese authorities are behind the schedule defined in China’s WTO commitment to open and deregulate domestic markets. However, the interviewee also acknowledged that foreign banks had to be patient, “to demand quick results does not work in China”.

Despite a lot of criticism, several of the participating organisations also defended the Chinese regulators. One banker acknowledged the “deep knowledge” and “high qualification” of the CBRC employees and praised the great progress which has been made in China within the last ten years “in developing a modern banking framework”. He added “the CBRC is caught up in a balancing act between modernisation, deregulation and political constraints” and that “the CBRC is honestly trying but trapped in the system”. One manager working for an AFI confirmed this view, adding that “a complex overlapping structure of competencies exists in China” with regard to financial service, forcing the CBRC to coordinate several different opinions of several different regulatory bodies. In addition, he explained that the priorities of the CBRC are the development of the Chinese banking sector and not the “good arguments” and needs of foreign banks in China, which still represent less than two per cent of the market. Nevertheless, he commented “the CBRC does what it can to support the foreign banks”. However, as another banker noted, “a bureaucracy is a bureaucracy and the Chinese have practised bureaucracy for over 5,000 years”. Another manager also working for an AFI did not confirm most of the problems reported by some of the participating German banks when dealing with the Chinese regulators. In his experience, “in general, the relations and cooperation with the regulators are very positive in comparison to other industries”. According to the interviewee, the regulators dealing with AFIs have been very open to the requests of the foreign companies. Especially when it comes to the details of new regulations, the regulators are “open for discussion and suggestions” by foreign companies. One example given is the recent introduction of regulations allowing the AFIs to offer leas-
ing products. When asked about the differing experiences of foreign AFIs in contrast to foreign banks when dealing with the Chinese regulators, the interviewee suggested that since auto-related financing was a relatively new field in China, the regulators may want “to learn” a lot about this business and therefore may leave the foreign AFIs more room to develop.

4.7.2 Recruiting and retention of qualified Chinese employees

One of the biggest challenges for the participating organisations is the recruiting and retention of qualified Chinese employees. Nine out of twelve sample organisations referred to this problem with several rating it among their most pressing issues. As one bank manager put it, “highly qualified employees have become ‘a key bottleneck’ for the growth of foreign banks in China.”

Several banks reported that the demand for qualified Chinese employees increased strongly in 2007. This “war for talent” was even further fuelled because several foreign banks incorporated in China in 2007/2008 and started to expand their workforce accordingly. At the same time, “the talent pool of qualified Chinese employees” is very limited and mostly fuelled by the training efforts of foreign banks. As two banks argued, this has to do with the “culture” and “the way the business is run” in many Chinese banks and its effect on the training of their employees, who still focus more on “product selling” and less on service quality. In addition, as one bank reported, it is difficult to find Chinese employees, who are “motivated”, and can “work independently without being pushed all the time”. Therefore, most foreign banks try to hire Chinese employees from other foreign banks who usually also possess “some English skills” and try to avoid hiring from Chinese banks.

As one result of the increased demand for qualified employees, two banks reported, “the wages of qualified Chinese employees have increased dramatically” and “are growing more quickly than the productivity in the banking sector”. According to another bank manager, “some Chinese employees, who switch jobs can double their salaries”. In turn, the turnover rate among Chinese employees in foreign banks has grown as well. One bank reported, Chinese employees often apply for a job with another bank, then “take that counter offer and present it to their current employer”. However, the smaller German banks usually lack the resources to match the remuneration offered by the big international banks. In addition, four banks which operate rep. offices and branches point-
ed out that foreign banks with smaller operations in China cannot offer their employees the same **promotional opportunities** as bigger banks which are locally incorporated, operate several branches and thus have many more management positions available. One banker noted, “Chinese employees expect to be promoted every year”. Thus, banks with smaller operations in China soon run out of opportunities for promotion. This has severe consequences for foreign banks, which “can lose somebody who often has been trained and developed for years”. Moreover, younger Chinese who have just graduated from university “already have very high expectations with regard to their salaries”. Finally, foreign banks in China are not the only ones competing for qualified Chinese employees. On higher management levels, experienced Chinese managers are also sought by international banks in Hong Kong.

Beyond paying **competitive wages** and offering sufficient **promotional opportunities**, the participating organisations see only limited means at their disposal to try to retain their Chinese employees. These include offering **training opportunities**, creating a “**positive working environment**”, shorter working **hours** than big international banks, offering **savings plans** which require a commitment of a couple of years, building **personal relationships** with their employees, and the inclusion in **international projects** or **overseas assignments** for more experienced employees. Two interviewees also pointed to joint “**company trips**” or “**company outings**” and emphasised their importance and huge popularity among Chinese employees. However, while company outings are recognised as a great way to for the company “to connect with its staff”, one banker acknowledged that they can also cause problems with the German tax authorities, because the German tax code strongly limits the deduction of such activities against the company’s tax liability.

In one banker’s conclusion, “the lack of qualified and trained personnel and the rising cost of personnel present a very serious problem for foreign banks in China”. One interviewee even motioned a rumour she had heard about foreign banks going back to staffing their operations in China with more **expatriates** again. While expatriates would be more expensive than Chinese employees, they would also be “more productive” as well as “more loyal” to their employers.

While two of the participating AFIs also recognised the lack of qualified people in China’s financial services industry, both companies reported that the actual recruitment and retention of qualified employees presented less of a problem for them. Besides offering
competitive salaries and promotional opportunities, both companies emphasised their strong focus on recruiting many younger Chinese graduates and a big investment in comprehensive training of their employees. In addition, one manager assumed that “auto financing” may just be perceived to be more interesting as a career than banking at the moment.

### 4.7.3 Competition

Another issue high on the list of challenges for German banks and AFIs in China is competition. This includes both competition from Chinese companies (eight mentions) as well as competition from other foreign financial services providers (five mentions).

#### 4.7.3.1 Competition from Chinese firms

Among the banks citing competition from Chinese banks are institutions with all three major forms of representation in China – rep. offices, foreign banks branches and local incorporation. Overall, according to the participating organisations, the competition by Chinese financial services providers depends on the business field, geographic location, and client segment. One banker admitted, that “despite their problems, Chinese banks are not dumb or underdeveloped”. In addition, “Chinese banks are learning ... and banking products can be copied”, for example in the area of investment banking, mortgage loans, and auto financing, where operational processes and IT systems have been copied by Chinese competitors as well. According to one manager, there is especially “fierce competition among all foreign banks in China for high quality clients which offer low risk business”.

Pricing is not being seen by the participating banks as an option to compete and to set themselves apart from Chinese banks. Since many interest rates are still set by the Chinese authorities, several participating banks conclude that they have to find other ways to compete. One banker explained that the quality of consulting services was the best way for it to set itself apart from the Chinese competition, especially because service quality is something that cannot easily be copied by Chinese banks. One banker noted “Chinese banks are improving their service quality, but they are still not doing very well and it will take more than five years for them to reach the benchmark set by major foreign banks”. Another issue brought up by several interviewees was the trust in and the reliability of German banks in the eyes of their clients. For example, one manager explained that with German banks, “loans will not be cancelled before due date, this
can happen with Chinese banks based on some regulations”. One banker added that although English is widely spoken among German managers working in China, having **German speaking employees** was a major advantage for German banks when dealing with German clients in China.

Even some of the German banks which confine themselves to a rep. office, and as such cannot be operationally active in China, are concerned about competition from Chinese banks. In general, German banks with rep. offices in China are mostly involved in trade-related products and services and in dealing with their Chinese correspondence banks (see Section 4.5.5). One bank with a rep. office in China explained, “Since (the bank) cannot be operational active in China, it refers its clients to selected Chinese banks”. Thus, “Chinese banks are mostly complementary business partners, rather than competitors”. However, another bank with a rep. office in China reported that Chinese banks have started to set up their own branches in Germany, which they use to process trade-related products and services, something which was previously done for them by the German bank. One banker admitted “as soon as one of these Chinese banks sets up shop here in Germany and is able to carry out the business from here…we realise that the volume of our business is going down”.

In contrast to some of the German banks, the participating AFIs don’t feel a lot of competition from Chinese banks at this time. According to several interviewees, Chinese banks have become very **risk averse** in consumer financing. One explanation given is that Chinese banks lost a lot of money in auto financing in the years 2003/2004. One manager explained, “this attempt ended tragically ... for two reasons: firstly, they worked with down payment rates which were way too low, only around 10%. In a market where car prices – back then even more than today – are falling. It was often so that after three month a new car would (already) cost less than the buyer had paid. Sometimes they even worked with 100 % financing”. Secondly, according to the manager, Chinese banks used to be collateral based lenders. They often based their credit decisions on the available collateral, and not on the predicted or planned future cash flows of the clients or an analysis of the client’s ability to generate these cash flows. This also contributed to the Chinese banks’ high loses in car financing.

Another reason given for the Chinese banks being risk averse is their lack of knowledge and experience in handling the risks and processing of “smaller loans” typical in consumer financing. One manager noted, “to copy a product is easy, to offer the same kind
of financing we offer, ... to close the deal, that’s easy. The problem is, I need to get the money back. ... For us, that’s usually a three-year-long process where I virtually need to check every day, is the client paying or is the client not paying. And in order to secure repayment I need to take measures accordingly. Otherwise, I can lose money in an AFI very very quickly. ... this is a bit more difficult than ... copying and selling a product”. However, the participating AFIs expect the Chinese banks to start engaging more in consumer financing again some time in the future. Many Chinese banks now have big international banks as minority shareholders and strategic investors. These banks usually possess strong skills and experience in consumer financing and may be able to assist their Chinese partners to better manage the risk of these products.

According to one AFI manager, the biggest competition for AFIs in China is currently coming from “loan guarantee companies”, which work together with banks by guaranteeing these banks the repayment of a customer loan for a fee. These companies are much less regulated than banks or AFIs and together with a Chinese bank usually offer low interest rates combined with high fees to cover their risk costs. However, the sustainability of this business model is being questioned. One manager commented, “how good the guarantee companies are, especially if business ever goes bad, I don’t know”.

4.7.3.2 Competition from foreign firms

Five of the participating organisations reported competition from other foreign financial services providers as a major challenge in China. Three banks which are either operating on the level of a rep. office or a branch said that a lot of competition is coming from other German banks, because many German banks apply similar business models and focus on the same limited product range such as trade-related products and services and the consulting of German companies which are active in China. One banker admitted, “our beloved German competition does not sleep either, is always out there looking for business. There is pretty tough and hard competition. These days, you have to consider that what we do, be it a letter of credit or a money transaction is no miracle, but a simple service which in principle anybody can provide”.

According to the participating banks, most foreign banks in China compete particularly for the business of the same “low risk high quality clients”. In addition, one bank which is incorporated in China pointed out that many of the locally incorporated foreign banks in China use similar business models to compete for the same customer segments. For
example, many big international foreign banks in China are targeting affluent Chinese individuals, mainly by focusing on high quality consulting services and financial planning offerings. Moreover, one bank reported that it has to compete with the big international banks in China because these banks are not only targeting the banks’ client relationships in China, but also in its home market Germany. One banker explained that this can happen “when the clients reach a certain size, when they develop from SME to multinationals. A personal relationship is not important for them. They just say I need a bank which can offer me the same products in every corner of the world”. This is especially an issue for banks which only have a rep. office and cannot become operationally active in China. One representative of such a bank admitted “foreign banks which are operational active in China and offer ‘broader’ services can approach [our] clients differently, … then the danger exists that these foreign banks via a business relationship in China also approach the same client in Germany”.

According to the participating AFIs, competition from foreign financial service providers does not play a role yet. However, at least one of the foreign AFIs in China has already started to offer auto financing outside of its own group to buyers of other auto brands. In the opinion of one AFI manager, this may evolve into an area of competition in the future.

### 4.7.4 Lending and assessment of creditworthiness

Several of the participating organisations described issues surrounding lending in general and especially the assessment of creditworthiness as a challenge for their business activities in China (eight mentions).

Four banks noted that a general lack of transparency made it very difficult for foreign banks to assess the creditworthiness of Chinese corporations. According to the banks, the accounting systems and financial reporting of most Chinese companies simply does not meet the standards necessary for a risk-oriented assessment of these companies’ ability to meet their long-term loan obligations. And while the Chinese accounting standards are moving towards alignment with international standards, one banker added “these changing times open additional room for error and fraud”.

As a result, many foreign banks only lend to Chinese companies which are listed on a stock exchange because the rigorous accounting and reporting requirements listed companies have to fulfil considerably facilitate the assessment of their creditworthiness. One
banker noted, “based on the experience of auditors, in would be crazy to give loans to Chinese corporations at this time, except maybe for companies which are listed on a stock exchange”. Due to the lack of transparency, another banker added, “to ‘know your customer’ is even more important in China”.

Two banks which closely partner with Chinese banks reported that internal deficiencies at their partner banks make it even harder for these institutions to properly assess the creditworthiness of potential clients. The credit approval process in many Chinese banks is still underdeveloped. According to one banker which works closely with a Chinese partner bank, a comprehensive analysis of the financial situation of a loan applicant is not done regularly in Chinese banks. In addition, this banker reported, the credit approval process often lacks transparency, leaving it unclear how the Chinese bank came to its final decision.

Another banker working closely with a Chinese bank pointed out that while “in Western countries most big banks introduced independent central decision making in risk management about 10 to 15 years ago, many credit decision in Chinese banks are still being made on a local level, by local managers with lending authority”. These managers are often very “close” to their clients which makes it harder for them to make an “independent” decision based on economic and risk-oriented considerations.

All three participating AFIs and one of the banks cited the lack of a nationwide “credit bureau” or “credit database” as a major challenge in their lending business. While a national credit database to store comprehensive information on outstanding credit and loans is now being developed, many “blank” areas still exist all over the country. According to one manager, so far only Shanghai and Beijing have reliable databases which are more than just blacklists of bad debtors. As a result, all the participating AFIs have instead been working with field investigators to assess the creditworthiness of potential borrowers.

4.7.5 Legal System / court system / law enforcement

Seven of the participating organisations named issues relating to the Chinese legal system and the execution of laws and court orders as challenges they have to deal with. Issues brought up are the independence and the reliability of the court system in China in general, the lack of qualified and trained lawyers and judges, and the large volume of new laws and regulations. One manager stated “there are many new laws in China;
that’s a problem for all companies. Almost every week new laws are published, often with retrospective effect”.

Another major problem for German banks and AFI s remains the enforcement of legal claims through the Chinese court system. While rulings of Chinese courts are often in accordance with the law and thus offer a certain level of reliability, the problem remains the enforcement of the court ruling according to two banks. Therefore, foreign banks usually try to avoid going to court, because even if the court rules in their favour, it is still very difficult to have a court order enforced by the authorities. One banker added, “if you have to go to court to claim your collaterals, then all your work has been in vain, thus a bank has to try to avoid loan defaults from the start. ... As a result, almost no foreign banks are getting involved in lending to Chinese SMEs ... they prefer to do business with larger corporations, where the default probability is much lower”. Two banks reported that the circumstances described above are an even bigger problem for some of their own clients, German companies which work as suppliers to Chinese corporations and regularly need to grant credit to their Chinese business partners.

Similar problems have been reported in the area of mortgage loans and auto financing. Unlike in other countries, in China AFI s need a court order to repossess a financed car with the help of the police – they cannot just repossess a car with a second key if the auto loan is not being repaid. In addition, AFI s also need a court order to enforce their claim and get their money back. This turns the retrieval of loans or collaterals into a difficult and time consuming process. One manager explained the recovering process “takes a lot longer than in Western countries. That means one has to go through at least six months of judicial proceedings before something can be enforced*.

4.7.6 Refinancing / funding of foreign and local currency

Refinancing is another major challenge for the participating corporations in China. Six organisations reported that their inability to obtain adequate funds at a fair rate strongly limits their ability to fund their balance sheets profitably and hurts their chances to earn a sufficient margin on loans. One AFI manager even said, “currently this is the number one challenge in the Chinese market” because it presents a serious hurdle for the further growth of the banking business.

One major reason for this situation is the lack of client deposits. Only two of the participating organisations are allowed to collect savings deposits from Chinese individuals.
One is a bank which is locally incorporated in China, the other is a JV bank. Their ability to collect funds from individuals, however, is limited by their lack of a large branch network, especially in comparison to the extensive networks of some Chinese banks. Other participating banks which operate on the level of a foreign bank branch can only accept deposits from corporations. However, because interest rates are set by the Chinese authorities, it’s very difficult, especially for the smaller German banks, to attract deposits from corporate clients.

Other liquid sources of funding for foreign banks are limited too. Four of the participating organisations specifically criticised the imposition of foreign loan “quotas”. In order to tighten China’s monetary policy, the country’s State Administration of Foreign Exchange (SAFE) has significantly cut offshore debt quota limits for banks based on levels of late 2007, thus limiting foreign banks’ ability to borrow funds through their regional treasury centres, often located in Asian financial centres like Hong Kong, or Singapore (Metcalfe 2008). Another alternative is the Chinese inter-bank market, which is still being developed. However, according to three participating organisations, the general limitation of funds has made refinancing at the Chinese inter-bank market relatively expensive, making it very difficult for these organisations to fund their balance sheet profitably. One banker explained, “this means that even a small bank here must employ a money trader, who then obtains money at the Chinese inter-bank market. Money, of which there is less and less. Lately, the short term refinancing rates reached up to 10 % and 11 %. This is more than double of what is being paid in international markets”. Because of these limitations on funding, one banker reported that some foreign banks are actually still using their initial equity stock to fund their loan businesses in China.

While the participating AFIs face similar problems as foreign banks when it comes to funding, since the beginning of 2008 they have two new options for funding available to them: shareholder loans and refinancing via the issue of a bond. However, since the issue of bonds is expensive, this option only makes sense for companies which have reached a critical mass in their operations. So far, only one of the participating AFIs has made use of this option.

### 4.7.7 Management of relationships / partnerships with Chinese partners

Several interviewees spoke quite candidly about the relationship with Chinese business partners. Five of the participating organisations described the management of the rela-
tionship with Chinese partners as a challenge for foreign companies in China, citing issues as trust, guanxi, or cultural differences in general as possible hurdles in a relationship with a Chinese business partner.

One banker noted, “you never know the true intentions of your Chinese business partners. As a foreigner, you always have ‘to be on the watch’”. In addition, the banker warned that there was always the danger of “hidden corruption” for foreign companies. He further explained that “part of the Chinese culture is the assumption ‘I do something for you today, you do something for me tomorrow’”. Another manager added that “reciprocal relationships” are part of the Chinese culture, meaning that Chinese would often expect favours to be returned in the future, for something which in Western cultures would be considered a normal business dealing. He further noted “some foreign companies tried to ‘buy’ themselves guanxi by hiring people who presumably had guanxi and were then surprised that others demanded ‘favours’ in return”. Another banker added “as an employer, you never know which of your employees may ‘be indebted’ to somebody else and may strike a deal which is not in the interests of your company”.

One bank, which has a strategic investment in a Chinese bank, reported that it is facing certain difficulties in monitoring this investment. While the bank, like other bigger shareholders is being informed in board meetings, one banker admitted “we have no illusions in the sense that we could fully monitor our investment in [the Chinese bank], its performance, or risk situation”. The bank attributes its problems in monitoring its investment mainly to two factors. Firstly, the accounting system in Chinese banks is not yet up to Western standards and does not provide the information necessary to get a full picture of the performance and risk situation. Secondly, certain characteristics of the Chinese culture work against disclosing too much information to foreigners. Another manager commented, “many Chinese managers are still inclined to cover up problems”.

Another bank which closely cooperates with a Chinese bank explained that partnerships with Chinese partners have to work on an operational level; it is not enough just to cooperate on the top management level. One banker commented that in China, “partnerships need to be ‘lived’, they cannot be enforced upon from above”. In addition, according to the interviewee, “Chinese banks always look for the additional advantage they can get out of the partnership”. According to the banker, and in contrast to popular belief, Chinese banks often don’t think long term, but expect “immediate gratification”
from a partnership with a foreign bank. He further explained, many “Chinese don’t appreciate the ‘present value concept’”. Instead, they want to see the benefits from a partnership “here and today”. Thus, in order for a partnership to work, all areas of cooperation should be clearly defined, for example in terms of the client segment or the geographic area of cooperation. One example of a working cooperation between a foreign bank and a Chinese bank given by several interviewees is Dutch Rabobank’s partnership with a rural commercial bank in the area of agriculture banking.

Another banker stated that while cooperation with Chinese partners is sometimes difficult, a “change in culture” in many Chinese companies has already started. The banker described this as a “top down process” which is being pushed through by the top managers of several bigger Chinese banks, which are often graduates from universities in Western countries. However, the banker acknowledged that “it will take a generation of employees until this ‘change in culture’ will have reached the ‘bottom’ of the bank”.

While acknowledging possible difficulties when dealing with Chinese business partners, one manager stated that many foreign banks use these problems and differences in culture as an excuse for bad performances in the Chinese market. The manager commented, that often “lack of success in China cannot be attributed to the fact that China is ‘different’ or to the ‘otherness’ of China”. According to the manager, foreign banks that are successful in China succeed because they know how to run their business. “China is ‘different’ in many ways, but many foreign managers use those differences as excuses for bad decisions and bad performances”.

### 4.7.8 Commitment and support from headquarters

Three of the participating banks noted that lack of sufficient support or commitment from their head offices in Germany represents a challenge for their work in the Chinese market. All three of these banks either operate on the level of a rep. office or a foreign bank branch. One banker noted “the support and commitment of the top management in the home country is very important for foreign banks in China, it makes the day-to-day operations a lot easier”.

One example given are the extensive reporting requirements. Foreign banks in China have to provide the Chinese authorities with a wide range of data regarding their activities in the country. In order to prepare the required reports, a foreign bank’s presence in China often needs the assistance of the bank’s head office in its home country. This re-
quires the commitment of the necessary resources at the head office, for example from the accounting department or the tax office. In addition, the information required by the Chinese authorities can change from one month, week, or day to another, which is sometimes difficult to understand and appreciate for the supporting employees in the bank’s home country.

Another topic with regard to support and resource commitment in the relationship between a bank’s local presence in China and its head office is the issue of recruiting and retention of qualified employees. Since the personnel needs of foreign banks in China have led to a systematic rise in salaries across all functional areas (see for example Metcalfe 2008, and Section 4.7.2 of this study), several of the participating organisations had to commit additional resources to recruit or retain qualified Chinese employees. This is not always understood or appreciated by the banks’ head office, with the result that the necessary resources to recruit and keep qualified Chinese staff are not being committed. In addition, one banker reported, similar problems sometimes even exist with regard to expatriate employees, making it difficult for a foreign banks in China to hire and retain expatriate staff. He admitted, “the people ‘at home’ sometimes feel that the expats in China cost too much money” and “Sometimes expats face a certain level of jealousy from colleagues back home”.

Beside the resource commitment for specific China-related issues, several foreign banks in China are also affected by problems in other markets, which are not related to the business in China. One banker interviewed for this study mentioned two German banks active in China (and part of this study), which are considering scaling down or even closing their presence in China because the banks need their resources in their home market.

Another issue brought up by a participating bank was a lack of patience with regard to the bank’s investment in the Chinese market and the time it will take until the investment pays off. One banker admitted, “the problem is to make it clear to the people in the head office that operationally we are going to lose money [in China] in the first five years. I have been given a return on equity target of 15% [for the bank’s investment in a Chinese presence], which I will never be able to reach”.
4.8 Conclusion

This chapter has presented an analysis of the collected data with regard to the five research questions of this study. The following chapter will discuss the findings of Chapter 4 within the context of previous research presented in Chapter 2.
5 Conclusions and implications

5.1 Introduction

The purpose of this study is to investigate the market entry strategies of German banks and automotive financial institutions (AFIs) in the People’s Republic of China. The thesis has followed the structure shown below.

Chapter 1 introduced the background, main theme, structure, and justification of this research. In addition it briefly described the methodology, delimitations, and key assumptions of the study. Finally, Chapter 1 provided an overview of the development of the Chinese banking market and major laws and regulations affecting the entry of foreign financial services providers into the country as well as a brief overview of the German banking industry and the types of German banks taking part in this research.

Chapter 2 presented a comprehensive review of the extant theoretical and empirical literature with regard to the research problem, the market entry strategies of German financial services providers in China. Based on this two-part review, gaps in the literature and issues worth researching were identified and a conceptual framework was developed to guide the process of data collection and analysis, and to structure the findings of this study and put them into perspective with regard to the findings of previous research on similar or related issues.

Chapter 3 presented a description and justification of the research methodology applied in this study. In addition, Chapter 3 provided an outline of the research process including the procedures used for data collection and analysis, and a brief discussion of ethical considerations of the study.

Chapter 4 presented the findings of this study and analysed the data collected with regard to the five research questions of the study. In addition, Chapter 4 provided an overview of the characteristics of the sample organisations taking part in this research.

The final chapter, Chapter 5 will now discuss the conclusions and implications of the findings of this study with regard to each research question and within the context of the body of literature reviewed in Chapter 2.
The remainder of this chapter is organised as follows: After this introduction, the conclusions about Research Questions One, Two, Three, and Five will be presented separately. The conclusion about Research Question Four (which factors influence the choice of entry mode and market strategy) will be presented jointly with the Research Questions Two and Three (Sections 5.2.2 and 5.2.3), since these factors essentially point to the reasons, why the participating organizations chose their entry modes and market strategies in China. The structure of Chapter 5 with regard to the individual research questions is shown in Figure 5.1

**Figure 5.1: Structure of Chapter 5 with regard to individual research questions**

<table>
<thead>
<tr>
<th>Chapter section</th>
<th>Research question</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>5.2.1</strong></td>
<td>Research question 1: Motives and reasons of German banks and AFIs to enter the Chinese market</td>
</tr>
<tr>
<td><strong>5.2.2</strong></td>
<td>Research question 2: Choice of Market Entry Mode of German banks and AFIs in China</td>
</tr>
<tr>
<td><strong>5.2.4</strong></td>
<td>Research question 5: Challenges of German banks and AFIs in the Chinese market</td>
</tr>
<tr>
<td><strong>5.2.3</strong></td>
<td>Research question 3: Choice of Market Strategy (Activities) of German banks and AFIs in China</td>
</tr>
<tr>
<td><strong>Research question 4:</strong></td>
<td>Factors influencing the choice of entry mode and market strategy (activities)</td>
</tr>
</tbody>
</table>

Source: Developed for this research

Next, implications of the findings for policy and practice (Section 5.4) will be discussed followed by implications for theory and further research (Section 5.5). This is followed by a brief discussion of the limitations of the research findings (Section 5.6). The chapter concludes with a few summarising remarks (Section 5.6).
5.2 Conclusions about Research Questions 1 to 5

5.2.1 What are the motives of German banks and AFIs to enter the Chinese market?

With the first research question, this study investigated the motives which are driving the entry of German banks and AFIs into the Chinese market.

Participating German banks “follow their customers”. As discussed in Section 2.4.5, previous research has identified two major motives for banks to internationalise: (1) to follow existing home-country clients into a host country, and (2) to seek business opportunities among new host-country clients (Badulescu & Badulescu 2008). Moreover, several authors have suggested a shift in the strategies of foreign banks from the first motive to the second (Domanski 2005; Moreno and Villar 2005). As shown in Section 4.3, for the participating German banks, to “follow the customer” has been the most important motive to enter the Chinese market. Moreover, four of the participating Landesbanks and central cooperative banks entered the market to serve the clients of their associated savings and cooperative banks, which further underscores the importance of pre-existing client relationships as the major motive for the participating banks. In contrast, only two of the participating banks named the potential of the domestic Chinese market as their major motive to enter the country.

Several previous studies indicating that German banks “follow their customers” have done so based on finding a positive and significant correlation between foreign direct investment by German banks and economic integration between Germany and the host country (e.g. Wezel 2004; Buch 1999). Even if these and similar studies control for market size and other variables, they are often criticised for not being able to prove a causal relationship between bank internationalisation and economic integration. In addition, they do not show that German banks provide financial services only, or mostly, to the affiliates of their home country clients (Clarke, Cull, Martinez Peria & Sanchez 2003).

In this study, several of the participating German banks affirmed the causal relationship between the presence of German corporations in China and their own entry into the market. This is also apparent when looking at their client base. Five of the six German banks giving to “follow the customer” as their major motive to enter the Chinese market serve only or mostly the Chinese affiliates of their German clients. This confirms find-
Conclusions and implications

ings by Seth, Nolle and Mohanty (1998) analysing the lending patterns of foreign banks in the US. Out of six home countries, German banks were the only group of banks for which the authors can say that it is possible that they exclusively served home-country customers.

Finally, the importance of the existing home-country client relationships for the participating German banks is further amplified by the fact that two of the participating banks stated that they felt the need to establish a presence in China in order to protect their existing client relationships in Germany from solicitation by large international banks, which could approach their German clients in China.

Some previous studies suggest that while initially banks follow their customers abroad, after a while they may start to also increasingly serve host-country clients (Moreno and Villar 2005; Seth, Nolle and Mohanty 1998). In this study, two of the six banks citing to “follow their customers” reported that they also started to look for opportunities to take advantage of the potential of the host market and to actively develop business relations with Chinese clients. This may indicate a trend that other German banks which operate branches may follow in the future. However, half of the German banks “following their customers” only operate on the level of rep. offices and as such will not be able to expand their client base to Chinese customers unless they commit the resources necessary to set up a branch in China.

Previous research on the motives of foreign banks for entering the Chinese market is rare. Based on data from 1991 to 2008, a recent study by Song (2009) finds a significant positive correlation between the growth of FDI in China as well as import and export trade and the size of total assets of foreign banks in China, which the author interprets as indication that foreign banks followed their clients to China. Xu and Nellis (2008) indicate, that at least in an earlier stage, following the existing clients invested in China is the main approach for the foreign banks when entering the Chinese market. For the pre-WTO period of 1980 to 1993, Leung’s (1997) results are somewhat similar to this study’s, with “follow the customer” being the dominant motive, with the potential of the Chinese market being less important. Another pre-WTO study on foreign banks in Shanghai for the period of 1990 to 2001 by Leung and Young (2005) again yields similar results, with most foreign banks choosing not to undertake the additional investment which would allow them to compete with domestic banks in the RMB market in Shang-
Conclusions and implications

The drivers of bank internationalisation and foreign market entry have attracted considerable attention in the literature. As such, previous studies have examined various factors which could explain the results of this study with regard to motives of German banks for entering the Chinese market. One of them is bank size. German banks (and particularly the Landesbanks and central cooperative banks which reported to “follow their customers”) are relatively small (in total assets) compared to other internationally active banks. Among the top 20 biggest banks by asset size (per 2007/2008), there is only one German bank, but four banks from the UK, three from the US and France, and two each from Japan, Belgium, Switzerland and the Netherlands (The Guardian 2009). Previous research shows that bigger banks tend to be more internationally active. Several authors interpret size as an ownership advantage (theoretically based, for example, on the eclectic paradigm). This ownership advantage of size is seen as increasing the propensity of these institutions to internationalise and enter foreign markets (by resorting to both internal and external growth), and if they do so, to invest more resources and choose entry modes which require a higher resource commitment than smaller banks would be prepared to make (Leung & Young 2005; Buch & Lipponer 2004; Leung, Young & Rigby 2003; Di Antonio, Mariotti, and Piscitello 2002; Mutinelli and Piscitello 2001). In addition, three of the participating banks stated that their inability to reach a certain scale in their operations lowered their resource commitment, which kept them from applying a business model that goes beyond providing basic services and advice to their clients from Germany. In summary, it appears that the majority of the participating German banks are simply too small and lack the resources required to build the operations necessary to go beyond “following the customer”.

Motives and ownership of German banks. Secondly, the ownership structure of the participating German banks appears to be preventing some of these banks from committing the necessary resources in China to go beyond “following the customer”. Four of the six banks “following their customers” to China belong to the group of Landesbanks or central cooperative banks. Each of these banks is (at least to a large extent) owned by a group of small savings banks or cooperative banks in Germany. The Landesbanks are also essentially state-owned, either directly by one or more German states, or indirectly

hai, but deciding to just serve their home clients. However, in both studies only very few German banks were part of the sample.

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through groups of regional savings banks which are themselves owned by German municipalities. The business model of the share holding regional savings and cooperative banks usually focuses on retail banking and the provision of a limited range of services to SMEs in a specific geographic area of Germany. Thus, these small local retail banks use their affiliated Landesbank or central cooperative bank to provide services that go beyond their limited scope (see Section 1.7.2 on the types of German banks) based on a division-of-labour arrangement. As indicated by some of the participating banks, these shareholders are relatively risk averse. In addition they also lack the resources necessary to fund a stronger expansion into China. The same is true for the German states, which are the other shareholders of the Landesbanks. This ownership structure also does not allow these banks to raise additional equity via the issue of new shares.

**Motives and regulatory environment in China.** A third factor seems to be the regulatory environment in the Chinese banking market. As might be expected, previous literature suggests that a less liberal regulatory regime discourages banks from entering a foreign market (Cerutti, Dell’Ariccia & Martínez Pería 2005; Galindo, Micco & Serra 2003; Buch 2000). In this study, regulation or the regulatory environment was identified as the biggest challenge by the participating organisations for their activities in China. In light of the previous research, these results may indicate that the participating German banks feel discouraged by the regulatory barriers of the Chinese market from going beyond their existing customers and trying to take advantage of the potential of the Chinese market.

**Participating AFIs seek host market potential.** In contrast to the participating banks, for the AFIs taking part in this study, the market potential of the Chinese market is a major motive for entry. This comes as no surprise, since the obvious target segments of AFIs are retail clients (for car loans) and car dealerships (for dealership loans). Thus, the participating AFIs’ positive assessment of the potential of the Chinese market can well be explained by the predictions about the development of the Chinese car market in general. Mainly driven by strong GDP growth, increasing car ownership rates, and a growing middle class with an increasing disposable income, passenger car sales are expected to reach 6.7 million by 2010, representing an average annual growth rate of 14 per cent (KPMG 2007). All participating AFIs also consider additional services like leasing, fleet management, and car insurance, which are part of their usual product range in more developed markets, as a future market in China. Again, this assessment is in
line with predictions about the development of the Chinese market for auto related financial services (KPMG 2007).

Another major motive for the participating AFIs to enter the Chinese market is to promote the sales of cars and trucks, manufactured by the associated manufacturing joint ventures utilising financial services products. Again, this comes as no surprise as it is considered a major part of the automotive value chain (McAlinden and Andrea 2002).

5.2.2 Which market entry modes are being chosen by German banks and AFIs when entering the Chinese market and which factors are influencing their choices?

With Research Questions Two (“entry modes”) and Four (“factors”), this study sought to investigate the entry modes which are chosen by German banks and AFIs in China and the factors which influence these choices.

As discussed in Section 2.3.6, previous research has identified various factors influencing entry mode choices of foreign banks: the banks’ motives and client focus in the foreign market (Cerutti, Dell’Ariccia & Martínez Pería 2005; Konopielko 1999; Naaborg 2007), the banks’ size and international experience (Blandon 1998; Cerutti, Dell’Ariccia & Martínez Pería 2005; Di Antonio, Mariotti and Piscitello 2002; Ursacki and Vertisky 1992), regular constraints on certain entry modes imposed by the host country (Bâdulescu and Bâdulescu 2008; Cerutti, Dell’Ariccia & Martínez Pería 2005; Naaborg 2007; Konopielko 1999), economic and political risks associated with the host country (Cerutti, Dell’Ariccia & Martínez Pería 2005), and the host country’s market size and economic development (Cerutti, Dell’Ariccia & Martínez Pería 2005; Di Antonio, Mariotti, and Piscitello 2002; Slager 2004). The results of this study appear to basically confirm all of the above factors with the exception of the economic and political risks associated with the host country. All of these factors and their influence on the participating organisations’ choice of entry mode are discussed below.

Regulatory constraints. Regulation was the factor most cited by the participating organisations as having influenced their entry strategy choices. Some authors suggest that host country regulation can have an intended affect on entry mode choice, “steering” foreign banks toward one or the other entry mode preferred by the host country regulators (Bâdulescu and Bâdulescu 2008; Konopielko 1999). The Chinese regulators have voiced their intention to encourage foreign banks to set up locally incorporated subsidi-
aries or convert their existing branches into subsidiaries. To further encourage foreign banks to take the step of local incorporation, they also emphasise that locally incorporated entities of foreign banks will receive the same treatment as Chinese banks (CBRC 2007).

However, the findings of this study show that the majority of the participating German banks are discouraged by the regulatory environment in China from committing more resources and expanding their presences in the country. These results appear to be in line with Di Antonio, Mariotti, and Piscitello (2002) who find that in countries which impose strong regulatory constraints on foreign banks, Italian banks establish only representative offices. While all three participating AFIs are locally incorporated, only one of the participating German banks had followed the Chinese government’s encouragement to incorporate locally.

**Motive and client focus.** The findings of this study confirm existing literature with regard to the relationship of motives or client focus of foreign banks with their choice of entry mode. When following their customers, the participating banks tend to choose rep. offices and branches (Di Antonio, Mariotti and Piscitello 2002). When looking for new markets, especially in retail banking, the participating organisations tend to choose subsidiaries and joint ventures. Cerutti, Dell’Ariccia and Martínez Pería (2005) suggest that subsidiaries and joint ventures allow for easier penetration of the foreign market. Konopielko (1999) makes a similar argument by pointing out that these entry modes usually enable the organisation to build a branch network in the foreign market. In the case of China, it’s also a regulatory requirement. Only locally incorporated banks are allowed to serve Chinese individuals with RMB products, leaving foreign banks which want to tap into this market no choice but to set up a subsidiary, or form a joint venture with a Chinese partner or become an investor in a Chinese bank.

**Bank size and international experience.** This study’s findings also appear to confirm some previous studies with regard to the relationship between the size and international experience of foreign banks and their choice of entry mode. As found for foreign banks in Spain (Blandon 1998), and Korea and Japan (Ursacki and Vertisky 1992), as well as for Italian banks going abroad (Di Antonio, Mariotti and Piscitello 2002), the larger and more internationally experienced participating German banks tend to opt for entry modes which require larger commitments, while smaller and less internationally experi-
enced German banks tend to prefer rep. offices or branches for their activities in China (see Sections 4.4.1 and 4.4.2).

5.2.3 Which market strategies (activities) are being chosen by German banks and AFIs in China and which factors are influencing their choices?

With Research Question Three (“market strategies/activities”) and Four (“factors”) this study sought to investigate the activities or choice of market strategy applied by German banks and AFIs operating in China and the factors which influence these choices. As discussed in Section 2.4.7, in this study the market strategy includes the customer segment (corporations/individuals) and nationality of clients (foreign/Chinese) served by the bank or AFI, the scope of products and services being offered (industry or product specialist/universal banking services), the currency of products and services being offered (foreign/RMB), and the geographic reach or focus (nationwide/local market) of activities.

As discussed in Section 2.4.7, previous research on the activities of foreign banks in developing economies indicates that foreign banks tend to focus on large international and home-country clients, while more or less neglecting host-country SMEs and mass retail clients (for example Konopielko 1999; Berger, Klapper and Udell 2001; Beck and Martinez Peria 2008; Bădulescu and Bădulescu 2008). Of additional concern is that foreign banks may engage in “cherry picking” by only serving the most solvent borrowers and leave the more risky clients to local banks (de Haas and Naaborg 2006; Clarke et. al. 2003).

**Participating banks focus on large, non-Chinese corporate clients.** The results of this study appear to confirm previous findings with regard to the activities of foreign banks in developing markets. Overall, wholesale banking services for foreign corporate clients play a dominant role for the financial services providers in this study’s sample, with trade-related service, corporate finance and financial market products being the most important. Almost half of the participating banks only serve foreign clients in foreign currency. In line with previous research, home-country clients (German companies with a presence in and/or strong trade relations to China) dominate the client portfolios of these banks. Two more banks serve the same clientele with RMB products as well. Most participating banks avoid serving Chinese corporations. Only two banks actively
engage with selected Chinese corporations. In summary it seems justified to conclude that the German banks participating in this study are engaging in some form of “cherry picking” by focusing on large, international corporate clients and leaving the riskier Chinese corporations to local banks.

**Availability of reliable data on lending clients.** As discussed in Section 2.4.7, previous research suggests that the circumstances in many developing markets with regard to transparency and information availability influence the client choices of foreign banks. In transition economies, foreign banks often face a lack of historical financial company data, such as income statements and balance sheets to access a potential client’s credit worthiness. As a result foreign lenders prefer to focus on the more transparent large or listed corporate clients or companies from the banks’ home-countries, for which “hard” information is readily available. The more opaque SMEs are mostly left to local banks, which at least in theory should be better equipped to collect and interpret the more “soft” information available on these clients (Maurer 2008; Naaborg 2007; Berger, Klapper, Martinez Peria and Zaidi 2006). This lack of reliable data to assess the risk associated with a potential Chinese client is confirmed by participating organisations in this study. As a result, the participating banks which do serve Chinese corporate clients usually only lend to listed Chinese companies which have to fulfil rigorous accounting and reporting requirements.

**Reliance on existing client relationships.** Most of the participating German banks built their business in China on already existing client relationships or client referrals from their associated savings or cooperative banks. Thus another conclusion concerning the market strategy is that the participating German banks heavily rely on existing customer relationships. This is in line with previous findings regarding foreign banks in new markets (e.g. Konopielko 1999; Berger, Klapper and Udell 2001; Beck and Martinez Peria 2008; Bădulescu and Bădulescu 2008, Song 2009, Xu and Nellis 2008) and can be linked back to the dominating motive of the participating German banks, to “follow their customers” abroad (Section 5.2.1).

**Continuing neglect of mass retail clients on part of the banks.** This study’s findings with regard to retail banking services to Chinese individuals are less conclusive. Five of the participating organisations offer retail banking services to Chinese individuals. However, only one of these organisations is a regular bank (and not an AFI or product specialist) and this bank focuses only on very affluent Chinese individuals and does not
serve mass retail clients in China. Three of the five organisations are AFIs, and as such they are products specialists whose business model mainly rests on a two-product strategy, offering auto loans to new car buyers and inventory loans to car dealerships. Their presence in the Chinese market is strongly tied to their associated car manufacturers. Without the car manufacturers trying to promote their car sales in China, the participating AFIs would probably not have entered the Chinese market. In contrast, foreign banks don’t engage in auto loans to Chinese individuals on a large scale independently of car manufacturers (Metcalf 2008). Only one of the five participating organisations offering retail services to Chinese individuals has a clear focus on Chinese retail clients. However, this bank is also a product specialist essentially running on a one-product strategy which is based on special regulations and as such is not competing as a regular player in the Chinese retail banking market.

The reasons for the participating German banks not to engage in retail banking in China appear to be mostly associated with the regulatory environment, which requires local incorporation in order to serve Chinese individuals in RMB, and with the risks and costs associated with the necessary investment to incorporate locally and set up a branch network. Indeed, several of the participating banks did not even consider entering the retail banking market in China. This is in line with previous studies (e.g. Chen 2009; Bădulescu & Bădulescu 2008; Konopielko 1999), which find that the high cost of establishing retail banking services and the direct competition from local banks discouages foreign banks from doing so in developing markets. Another main factor discouraging foreign banks from engaging in retail banking in developing economies suggested in the literature is the low level of individual wealth in many emerging markets (Bădulescu & Bădulescu 2008; Konopielko 1999). The findings of this research suggest that this may not necessarily be the case in China. The successful, if limited, activities of the participating AFIs and one of the banks in the retail market seem to show that even in this customer segment, the potential is already there for foreign financial services providers to serve mass retail clients in China. In addition, recent studies predict a continuing strong increase in the number of affluent households in China (KPMG 2008a).

There is also some evidence that while foreign banks in developing markets start with serving larger corporations and home-country clients after entering a foreign market, over time they gradually broaden their focus and start to also serve host-country SMEs and even mass retail clients (de Haas and Naaborg 2006; Clarke et. al 2003; Carvalho
Conclusions and implications

2000). As the availability of “hard” data on Chinese SMEs improves and the Chinese middle class continues to grow, this could also be the case for the Chinese market. In line with previous studies by Achhorner et. al. (2006), Metcalfe (2008), and Chen (2009), almost all participating organisations expected continued strong growth in the financial services market in China. As such the development of market strategies of foreign banks in China over time is important and worthy of future investigation.

**Experience in Asia and asset size.** Previous research has emphasised the importance of a bank’s resources and its experience in culturally and/or geographically close markets as a good predictor for a bank’s commitment to a new market. For example, Leung and Young (2002) find that being part of an Asian network and the size of the parent bank significantly increase the likelihood of a foreign bank to also offer RMB products in China. The explanation given for this is that these foreign banks have a better understanding of the Chinese culture, economy and political situation, and this improves their ability to manage the credit risk associated with doing business with Chinese customers in local currency (Leung and Young 2002). The findings from the present study seem to confirm the importance of prior experience in other Asian markets for the commitment of the participating organisations in the Chinese market. The participating organisations which took the commitment necessary to be able to offer RMB products in China tend to operate in more Asian markets than those participants without an RMB licence. The participating organisations which also serve Chinese individuals tend to be active in even more Asian countries (see Section 4.2.4).

The results of this study with regard to size and resource commitment are less conclusive. While the biggest participant (in total asset size) clearly committed the most resources of all sample organisations, the rest of the sample does not show a clear trend concerning a relationship of a firm’s size and its resource commitment to its presence in China.

**Choice of location within China.** Previous studies have shown that geographic variances in the economic development and income distribution of a country play an important part in the location choice of foreign banks in emerging market economies (Beck and Martinez Peria 2008; Achhorner et. al. 2006).

As could be expected, the participating German banks and AFIs have made similar choices. Most of the participating organisations have located in the two most important
Conclusions and implications

metropolitan areas of the country, Beijing and Shanghai. The high concentration of economic activities in these areas, the large number of high-income individuals in the two cities, and the fact that they are the economic (Shanghai) and political (Beijing) centres of China, all contributed to the location choice of the participating organisations.

5.2.4 What are the challenges German banks and AFIs are facing in the Chinese market?

With the final question, Research Question Five, this study sought to identify and examine the challenges and hurdles German banks and AFIs are facing in the Chinese market. The findings seem to by and large confirm previous studies on the subject. However, some differences in the results are noteworthy.

**Regulations are biggest challenge.** Regulations or the regulatory environment remains the biggest challenge for the participating organisations in China. The results confirm previous research, both in regard to more **general** across-the-board topics like complexity, consistency, and clarity of regulations, a lack of coordination between the main regulation issuing bodies, and in regard to **specific** pieces of regulation (Metcalfe 2008, 2007; Miller and Holmes 2009; Leung and Chan, 2006; Leung and Young 2005).

**Discrimination based on size.** One particular issue brought up by several interviewees appears to not have been discussed before in the literature – that is, the perceived discrimination against foreign banks based on size. Several participating banks reported that the Chinese regulators, as well as the regulatory environment in general, favour bigger foreign banks over smaller ones. According to the interviewees, this is part of an active Chinese policy to encourage foreign banks to engage in the Chinese market, including incorporation in China which requires ample resources that only bigger banks command. This would also be in line with the CBRC’s encouragement of foreign banks to incorporate locally in China (CBRC 2007).

Recent findings by Metcalfe (2008, 2007) on the hurdles foreign banks have to overcome in China did not produce similar results. However, this can probably be attributed to differences in the samples of this research and Metcalfe’s studies. The sample banks in Metcalfe’s studies are not only mostly bigger than the participating German banks of this study, they are also more engaged in China, with most of them either already incorporated or intending to do so in the near future (Metcalfe 2008, 2007). In contrast, most of the German banks participating in this study only operate on the level of a rep. office.
Conclusions and implications

or branch without aspiring to incorporate locally. Thus it can be assumed that discrimi-
nation based on size was not an issue for the banks participating in Metcalfe’s study as
is was for the banks in this study.

**Recruiting and retention of qualified Chinese employees.** The second-biggest chal-
lenge for the participating organisations was the hiring and retention of qualified Chi-
nese employees. Again, these findings confirm the results of recent studies by Metcalfe
(2008, 2007) and KPMG (2008a). The increasing demand for qualified Chinese staff
has led to both significantly raising salaries and to higher turnover rates at the partici-
pating German banks. The participating German banks face an additional disadvantage
when it comes to hiring and retaining qualified staff. Again, because of their size and
limited engagement in China, most of them cannot offer their Chinese employees the
same promotional opportunities as many of their international competitors which are lo-
cally incorporated in China.

Beyond paying **competitive wages** and offering sufficient **promotional opportunities**, the participating organisations see only limited means at their disposal to try to retain their Chinese employees. These include offering **training opportunities**, creating a
“**positive working environment**”, shorter working **hours** than big international banks, offering **savings plans** which require a commitment of a couple of years, building **personal relationships** with their employees, and the inclusion in **international projects** or **overseas assignments** for more experienced employees. Some organisations also pointed to joint “**company trips**” or “**company outings**” and emphasised their im-
portance and huge popularity among Chinese employees.

In contrast to the banks, the participating AFIs did not report similar problems with re-
gard to hiring and retaining staff, although it was assumed that as financial services pro-
viders they are competing for the same employees. This is an unexpected finding and
worthy of further investigation. A possible explanation may be that the AFIs’ close rela-
tionship to the auto industry make them especially attractive to large number of poten-
tial employees.

**Competition from Chinese and foreign banks.** Competition represents another major
challenge for the participating organisations in China. Again, this confirms previous re-
search by Metcalfe (2008, 2007). The results of this study however present a more de-
tailed picture than previous studies, and also offer the opportunity to distinguish more
clearly between competition from Chinese banks and competition from foreign banks. Some participating organisations attempted to adjust their strategies to deal with the issue of competition, for example by actively taking selected “Chinese risks” into their loan portfolios, which many foreign banks still try to avoid, or by extending their product portfolio.

**Competing on quality, reliability and language.** Since current regulation largely prevents competition among banks in China based on pricing, the participating German banks try to compete mainly on three factors: (1) the quality of their services, (2) the reliability they have in the eyes of many of their clients in contrast to most Chinese banks, and (3) their German-speaking staff, which is important for many of their mostly German clients. This is in line with findings from Chen (2008), who found that foreign banks tend to focus on maintaining their existing client relationships by introducing more sophisticated products and services and try to avoid direct competition with Chinese banks by targeting niche markets or neglected entire client segments such as rural markets and local SMEs.

In contrast, the participating AFIs did not regard Chinese banks as their major competition. Interestingly, and possibly refuting the notion that Chinese banks still pay less attention to risk assessment in lending (e.g. Hansakul 2007; Bekier, Huang and Wilson 2005; Fu and Heffernan 2005), Chinese banks seem to have become very risk averse in auto financing, an attitude caused by heavy losses they sustained in this market in 2003 and 2004. In addition, Chinese banks still seem to have problems handling the operational side or the processing of “small loans”, a task that requires experience and is difficult to copy. Here, the participating AFIs expect stronger competition when experienced foreign banks become more active in this market segment and in turn develop their ability to handle the operational side of dealing with a large volume of small loans.

**Similar business models, same target segments.** With regard to competition from foreign banks, this study revealed that for the participating German banks, most competition from other foreign banks is actually coming from other German banks. In the light of this study’s results with regard to the participating banks’ market strategies, this should not be surprising. After all, most of the German banks taking part in this study apply a similar limited business model in China with a focus on German corporate clients and trade related services. However, a bigger engagement in the Chinese market does not guarantee less competition. While several informants emphasised the ad-
vantages of finding a niche in the Chinese financial services market, the findings on hand seem to indicate that many of the locally incorporated foreign banks also use similar business models and compete for the same market segments, with a strong focus on “low risk, high quality corporate clients” and affluent Chinese individuals.

**Lending and assessment of creditworthiness.** Issues surrounding lending in general and especially the assessment of creditworthiness pose another major challenge for the participating organisations. Some of these issues have been pointed out in other studies, for instance the lack of a comprehensive nationwide system of credit records (Qi 2010; Xu and Liu 2006; Chan, Fung and Liu 2007; Metcalfe 2007), or the limited knowledge foreign banks have of Chinese clients and the market conditions in general in comparison to Chinese banks (von Emloh and Wang 2004; Jiang et al. 2003). In addition, this study found that the participating organisations have no faith in the Chinese legal system to assist them when enforcing a legal claim or recovering a loan collateral. This mostly discourages these banks from lending to Chinese SMEs with their higher default probabilities. As such many of the participating organisations follow a risk avoidance strategy.

Another issue voiced by the participants in this study was the lack of transparency caused by the accounting and financial reporting of many Chinese companies, which just does not meet the standards necessary to assess these companies’ ability to meet their long-term loan obligations. As result, most of the participating German banks only engage in lending to listed Chinese corporations which have to comply with rigorous accounting and reporting requirements, or they refrain from lending to any Chinese corporations at all.

With regard to the Chinese banking system, previous research points to issues like flawed accounting systems and the lack of essential components of good corporate governance which still exist in many Chinese banks (Hansakul 2007; Bekier, Huang and Wilson 2005; Fu and Heffernan 2005; Jiang et. al. 2003). However, the results of this study indicate that the quality of the financial data provided by the banks’ clients presents an additional problem for banks active in China. Given the critical role of such data in the assessment of a clients’ creditworthiness, if the Chinese authorities want foreign banks to further engage into corporate lending to local clients, this hurdle which discourages foreign banks from taking more “Chinese risk” into their loan portfolio appears to be one of the issues they need to address.
Conclusions and implications

Limited sources of funding restrain foreign banks. Not surprisingly, and in line with previous studies by Metcalfe (2008), Hansakul (2007); Leung and Chan (2006); Bekier and Lam (2005), and Leung and Young (2005), funding is another major challenge for the participating organisations. Offshore funding is strongly limited by restrictions (or “quotas” as most informants call them) which have been in effect since 2008. Within China most of the participating organisations are severely restricted in their ability to collect deposits as a source of funding by their lack of an extensive “bricks and mortar” branch network. Consequently, for access to local currency the participants have to rely on the tightly controlled Chinese inter-bank market, which is dominated by the “big four” banks. As a result, both the participating organisations’ expansions of loans, as well as their profits, have been suffering.

Managing relationships with Chinese partners. The findings of this study also show that the management of partnerships and relations with their Chinese business partners is posing another challenge for the participating organisations. Based on the large body of literature in this area, this was an expected outcome (Soukhov 2001; Graham and Lam 2004; Guthrie 1998). The Chinese cultural phenomenon of guanxi is also a major issue for the participating organisations, and the results of this study confirm previous findings concerning problems that foreign companies may encounter when trying to build and develop guanxi with their Chinese partners. This includes the expectations on the side of the Chinese partner for “return favours” in what appear to be regular business dealings, the ethical problems related to providing certain favours, the danger of becoming entangled with corruption and bribery, and the difficulties of trying to “buy” guanxi by hiring employees who presumably possess guanxi.

Two findings seem especially noteworthy. With regard to the issue of “buying” guanxi the informants did not confirm the idea proposed in the literature (e.g. Alston 1989) that guanxi could be gained through the recruiting of people who possess it. In contrast, two interviewees pointed to the danger of hiring employees who, unknown to their employer, are “indebted” to somebody else within a “reciprocal relationship” and may return a personal favour in a way that actually hurts the interest of the employer. The other finding refers to the concept of taking a long-term perspective in developing relations with Chinese partners (Dunning and Kim 2007). In this study, the development of long-term relationships often did not appear to be overly important for the Chinese partners. Ra-
Conclusions and implications

ther, participants reported that Chinese partners often expected “immediate gratification” from a partnership with a foreign bank.

5.3 Implications for policy and practice

5.3.1 Implications for policy

Research on economic growth in developing countries consistently finds that economic development is positively and strongly related to efficient financial markets and legal systems in these economies. For the Chinese case this indicates that the country’s continued strong economic growth may depend on continued reform measures in the country’s banking sector (Berger, Hasan and Zhou 2009; Bonin and Huang 2002; Lardy 1998).

Nevertheless, China remains one of the most regulated economies in the world and the Chinese government continues to play a very active role in the country’s banking market, for example by influencing lending decisions (“policy lending”) to provide funding for government-supported projects and state-owned enterprises, or by appointing the management of state-owned banks (KPMG 2008a; Zou and Gao 2007; Farrell and Lund 2006; Li, Liu, Liu and Whitmore 2001). This active position provides the Chinese authorities with a lot of leverage to influence the future development of the Chinese banking market. Thus, it is justified to briefly discuss possible implications of this study’s findings for the country’s banking market policy.

While China’s gradual approach to banking reform is built on continuous reform and market deregulation (Dobson and Kashyap 2006), based on the findings of this research, four areas seem to stand out from a policy point of view. These are (in no particular order with regard to importance or priority):

- the needs of smaller foreign banks active in China,
- the shortage of qualified, English-speaking employees,
- the issue of refinancing or funding of foreign financial services providers, and
- the requirements foreign banks need to fulfil to locally incorporate in China.
Addressing the needs of smaller foreign banks. The China Banking Regulatory Commission has been encouraging foreign banks since 2007 to incorporate in China and expand their presence into the country’s second- and third-tier cities (CBRC 2007; Metcalfe 2008). However, the current regulatory environment in China, as well as the competitive situations in the Chinese banking market, appear to favour bigger banks (which can achieve a critical mass in their operations early on) over smaller foreign banks, which comprised the majority of this study’s sample organisations. If the Chinese authorities want smaller foreign banks to continue to play an active role in the future banking landscape of China, they should be aware of the situation of smaller foreign banks and possibly consider special regulations which cater to the needs of smaller banks and take into account their limited resources. One specific action which could improve the situation for smaller foreign banks would be the removal of capital requirements for banks which don’t seek local incorporation but focus on providing wholesale commercial banking services. The current requirement of RMB 200 million for the first branch presents an entry barrier that many smaller foreign banks will not be able to overcome. A removal of this specific capital requirement however would be within the norms of other major international financial centres like New York, London, Tokyo, and Hong Kong (American Chamber of Commerce 2008).

Addressing the talent shortage in the financial services industry. Chinese authorities and regulators should be aware that the shortage of qualified, English-speaking employees and the efforts undertaken to recruit, train, and retain employees pose a major challenge for the participating banks in this study. This confirms Metcalfe’s (2008) results, which suggest that the shortage of qualified people creates a “bottleneck” for the further growth of the banking industry in China in general (Metcalfe 2008). Thus, China should consider investing more in the education and qualification of employees both in terms of capacity and capability, not only on the entry or university level, but also on a more senior staff level.

Reconsidering limitations on refinancing and funding in RMB. Most of the participating organisations are strongly limited in their ability to collect saving deposits as a source of funding by their lack of a “bricks and mortar” branch network in China. This is not likely to change in the near future because of the high costs associated with setting up branches. At the same time, offshore funding for foreign banks and AFIs has been strongly limited by restrictions in effect since 2008, which leave only the tightly
controlled Chinese inter-bank market as the main source of local currency. The Chinese authorities should be aware that these constraints with regard to funding pose another major hurdle for foreign banks attempting to expand their business activities in China by including more Chinese clients by serving more second- and third-tier cities – both stated goals of the CBRC (CBRC 2007; Metcalfe 2007, 2008).

**Reconsidering requirements of local incorporation.** The nexus between banking sector reform in China and the entry of foreign banks into the country was not a focus of this research. However, not unexpectedly the regulatory environment remains a major factor influencing the market entry strategy choices of the participating organisations. The current regulatory environment in China clearly discourages foreign banks from committing more resources to their Chinese ventures. Again, this is especially an issue for smaller foreign banks with fewer resources on hand. It is particularly important with regard to the resources necessary to incorporate in China which is a precondition for entering the country’s retail banking market and for offering RMB products and services to Chinese retail clients. Incorporation in China is expensive for foreign banks. To incorporate in China, a foreign banks requires a minimum registered capital of RMB 1 billion and an additional RMB 100 million for each branch it opens. Changes to the regulatory requirements for local incorporation may encourage more foreign banks to take this step, which has been a stated goal of the Chinese authorities since 2007 (CBRC 2007).

### 5.3.2 Implications for practice

Many factors which were found to strongly influence the situation of foreign banks in China, for example the country’s regulatory environment, the competitive situation in the Chinese banking market, and the current global financial market crisis, are out of the hands of foreign banks’ managers.

Nevertheless, when extracting some “lessons learned” from this study’s results, three themes seem to stand out that should be of value to foreign financial services providers, especially smaller banks from Germany (for instance the Landesbanks and central cooperative banks), which may be considering entering the Chinese market or which are already active in China. These “lessons learned” from the findings of this study concern the following issues:

- the **business model** applied by the foreign banks (research questions 1 and 3),
Conclusions and implications

- the shortage of qualified, English-speaking Chinese employees (research questions 2 and 5), and
- the value of prior experience in geographically and culturally similar markets (research questions 2 to 5).

Reconsider limited business model applied in China. The results of this study show that the majority of the participating German banks more or less focus on the same product/client combination, by serving mostly German companies with a presence in China or by having strong trade relations with a Chinese partner with similar trade-related services and financial market products. Most of the participating German banks active in China also rely heavily on their existing customer relationships and build their business in China on already existing client relationships or client referrals from their associated savings or cooperative banks. As a consequence, in order to grow their business beyond their existing client base, these banks not only have to compete with Chinese banks and other foreign banks, which eye their attractive customer base of globally active German corporations and export-oriented SMEs, but also with other German banks that apply the same limited business model in China. As a result, German banks who are already active in China or who are planning to enter the country should reconsider their business model for the Chinese market.

Adjustments to their current strategies to build a more sustainable business model may include focusing on specialised products and services (“product specialist”) as has been successfully done by one of the smaller participating banks, or to start to also carefully take selected Chinese risk into their loan portfolio, a strategy which is also already employed by one of the participating banks. Both approaches would help German banks to increase their profit margins by partly moving their focus from traditional interest based banking products to more innovative, fee based products and services.

Another possible strategy could be to pool the resource investment and risks associated with local incorporation in China with other German banks by setting up a locally incorporated bank in China together. This could especially be an option for the German Landesbanks interested in the Chinese market, because these institutions already share a long history of cooperation on various levels.
Conclusions and implications

Finally, foreign banks, and especially smaller German banks should assess their options in the Chinese market in an open-minded manner and without any predisposition. This may include having to accept the possible outcome of such an analysis that at this point an entry into the Chinese market may not make sense for smaller banks that lack the resources required to serve Chinese individuals with RMB products. This is especially true for the essentially state-owned German Landesbanks, which in their foreign ventures sometimes do not seem to be driven by carefully assessed business opportunities, but by the political considerations and ambitions of their shareholding German states.

Address the shortage of qualified English-speaking staff, reconsider the use of expatriates. The results of this study have highlighted that the recruiting and retention of qualified Chinese employees remains one of the biggest challenges for most of the participating banks. This is particularly evident in terms of both rapidly increasing salaries as well as high staff turnover rates among Chinese employees of foreign banks. Again, this issue appears to be especially pressing for the smaller German banks with a limited engagement in China, because these institutions cannot offer their Chinese employees the same promotional and career opportunities as many of their international competitors, which are locally incorporated in China and have many more positions available.

While more company outings or international business trips may offer ways to increase employee engagement in the short-term, in the long-term many of the smaller German banks still lack the resources to compete with larger international banks for local talent. For these banks, a possible solution may be to go back to using more expatriate staff. While this might seem to go against the trend of using more and more local staff in international business ventures, it may very well make sense in the current situation in China. In the tight Chinese job market, employing more expatriates offers some clear advantages with regard to the recruiting process as well as the issue of employee qualifications. Since most of the smaller German banks only employ a limited number of people in China, the additional salary cost should be limited, while the banks will save time and resources in the recruitment process and employee training. Another source of recruiting for German banks could be Chinese immigrants living and working in Germany, as these employees would offer the advantage of being familiar with both, the German and the Chinese business culture and could facilitate business transactions with banking clients, as well as dealings with the Chinese authorities (Tung and Chung 2010).
**Utilise prior experience in other Asian markets.** This study did not investigate a possible causal relationship between prior experience in culturally or geographically close markets and success in China. However, for the participating organisations, the findings of this study show that those organisations which are active in more Asian markets tend to also have a stronger commitment in China. As discussed in Sections 4.4.3 and 5.2.2, the participant institutions which took the commitment necessary to acquire an RMB licence in China tend to operate in more Asian markets than those participants without an RMB licence. The participating organisations which also engage in business with Chinese individuals tend to be active in even more Asian countries. It does not seem too far-fetched to assume that indeed, experience in culturally similar and/or geographically close markets helps foreign organisations to better understand the Chinese culture, as well as the country’s economy and political conditions, which in turn improves their ability to manage the risks associated with doing business in China (Leung and Young 2002). Consequently, German banks should try to utilise their experiences in other Asian markets in their Chinese operations. This may again imply that bigger organisations which are active in more Asian markets are, in general better equipped to also be successful when entering the Chinese market. With regard to the previous recommendation, it would also fit with a strategy of using more experienced expatriate staff or Chinese immigrants in Germany in the banks’ Chinese operations.

**5.4 Implications for theory and further research**

This section will explore the implications of this study’s findings for theory as well as opportunities for further research based on the findings of this study.

**Application of eclectic and holistic approaches.** Based on the review of the extant theoretical literature on internationalisation and foreign market entry, it was concluded that the phenomena under investigation are too complex to be fully represented by a single theory or theoretical model. Thus, this study is not based on a single theory or model of internationalisation and foreign market entry. Instead, a simple conceptual framework was developed in Chapter 2 that was based mainly on previous empirical research and that facilitated the consideration and integration of the contributions of various perspectives. The results of the study appear to justify this approach, and as such one implication of this research for theory is to underscore the already existing trend in
Conclusions and implications

international business research for applying eclectic, more holistic approaches to the investigation of internationalisation and foreign market entry because they are better equipped to capture the complexity of the phenomena under investigation.

**Effects of corporate ownership structure and division of labour.** The main implication of this study (with regard to theory as well as further empirical research) appears to concern the effects of corporate ownership structure of internationalising foreign banks. The findings of this study suggest that certain characteristics of the German banking industry, particularly the ownership structures of the *Landesbanks* and central cooperative banks, as well as the division-of-labour process applied in both banking groups (see Section 1.7.2) are major factors influencing the internationalisation behaviour of *Landesbanks* and cooperative banks (see sections 4.3.1.2, 4.6.2, and 4.6.4 of Chapter 4 and 5.2.1 of Chapter 5).

The German *Landesbanks* are essentially state-owned institutions. Most of the *Landesbanks* are jointly owned by a group of regional savings banks and the German state in which the *Landesbank* resides. The central cooperative banks are jointly owned by a group of regional cooperative banks.

Both the regional savings banks as well as the regional cooperative banks work together with their *Landesbanks* or central cooperative banks in a division-of-labour process, an arrangement in which the regional savings banks and cooperative banks usually cater for retail clients and SMEs, while the *Landesbanks* and central cooperative banks focus on larger corporations, and providing more complex and international services. In addition, they function as product specialists for the clients of their shareholding savings banks or cooperative banks.

The findings of this study suggest that based on these characteristics, the savings banks and cooperative banks strongly influence the internationalisation and foreign market entry of their *Landesbanks* and central cooperative banks. The first area of influence regards the motives for entering the Chinese market. Since the regional savings banks and cooperative banks lack the resources to enter the Chinese market themselves, they have an interest in having their *Landesbanks* or cooperative banks having a presence in China because these institutions act as outlets and agents for the savings and cooperative banks by serving their German clients in China.
Conclusions and implications

On the other hand, the regional savings and cooperative banks do not want their *Landesbanks* and central cooperative banks to take the risk of the investment required to become locally incorporated in China. This, however, strongly limits the range of activities these banks can engage in in China.

These effects of *ownership structure* and particularly the influence of owners or shareholders on the internationalisation and market entry of banks has yet received only very little attention, both in theoretical literature and in empirical research.

One starting point for new research could come from the wide range of research conducted on the conflicts resulting from separation of ownership and control, and concepts of the theoretical work on the principal-agent relationship (e.g. Meyer 2004). Both may offer useful ideas which could be combined with existing internationalisation frameworks. Moreover, the internationalisation and market entry of banks from other countries like Italy, France, or the Netherlands, where cooperative banks or savings banks also play a significant role, could be investigated with a focus on the effects of ownership structure.

**Protection of existing client relationships.** Another issue worthy of further investigation appears to be the motives of some *Landesbanks*/central cooperative banks to enter the Chinese market in order to protect existing clients' relationships from being lured away by large international banks, which could not only approach a German client in China, but ultimately once a business relationship is established there, could approach them in Germany itself. This applies to the *Landesbanks*/central cooperative banks’ own clients, but also to the clients of their associated savings and cooperative banks as well. This proactive internationalisation behaviour for the defensive goal of protecting an existing client relationship is a concept that has not received a lot of attention yet and would be worthy of further inquiry.

Some additional topics for further research can be drawn from the *factors* which have been identified in this research as influences on the market entry strategies of the organisations taking part in this research (research question 4) as well as from the *challenges* found to plague the participating financial service providers (research question 5). China only formally fulfilled its WTO commitment with regards to the banking market by December 2006, when it lifted the remaining geographic restrictions as well as all non-prudential restrictions on banking services provided by foreign banks. As such it ap-
Conclusions and implications

pears to be especially interesting on how some of these factors and challenges will affect the entry and performance of foreign banks in the long term.

- One issue to be investigated could be the long-term effects of the remaining strong regulatory constraints on foreign banks active in China, which discouraged some of the participating German banks from committing more resources to their presence in China. Possible foci of inquiry could be the effects on entry modes, activities, and performance of foreign banks in China as well as the effectiveness of the imposed regulations with regard to the goals and objectives put forward by the Chinese authorities. From a theoretical point of view, it would be interesting to analyse, how regulatory constraints could be integrated into, or modelled by, those existing theories and frameworks which are often applied to the issues of internationalisation and foreign market entry (for example by integrating the cost and uncertainty of the negotiation process foreign banks have to go through when entering a highly regulated market like China).

- Another issue whose long-term effects could be investigated is the shortage of qualified, English-speaking Chinese employees in China’s financial service industry, something found in this study as well as in previous research by Metcalfe (2008; 2007). Further research should investigate both the effects of such a shortage at the level of the individual bank as well as the development of the Chinese banking industry in general. A possible sub-issue worthy of investigation could be the use of Chinese immigrants working and living in the banks’ home countries as a potential source of recruiting for these banks when entering the Chinese market, as these employees may offer the advantage of being familiar with both the home and the host country culture (e.g. Tung and Chung 2010).

Finally, in order to be able to generalise findings it would be useful to investigate the entry strategies of foreign banks in China based on quantitative research methods once the number of foreign banks in the country has increased to a point where statistical analysis can be sufficiently applied.
Conclusions and implications

5.5 Limitations of this study

The limitations of this study’s research methodology were discussed in Section 3.2.3 of Chapter 3. This section now discusses some additional limitations which apply to this research and its findings.

This research seeks to investigate the complex phenomenon of market entry strategies of German financial services providers entering the Peoples’ Republic of China. It takes advantage of some characteristics offered by qualitative research and the case study methodology, but is also limited by this approach. Based on the research problem, case study was chosen as the research method, because it offers an in-depth, multifaceted research approach, because it facilitates the investigation of “why” and “how” questions, and because it permits follow-up questions to be asked when new issues arise during the course of the research. In addition, case study research is flexible and often develops as it proceeds, which is especially helpful when dealing with complex and dynamic research subjects like the ones investigated here (Orum, Feagin, and Sjoberg 1991; Yin 2003; Nykiel 2007).

However, this qualitative methodology and the unique situational context with regard to the host country, China, and the home country, Germany, impose several limitations on the study, especially in terms of generalisation and transferability of its results. The recent opening of the Chinese banking system in December 2006, the country’s strong economic growth and growing middle class, the changing regulatory environment and requirements all contribute to a unique situational context in the host market of this study which has to be considered when interpreting the study’s findings. Similarly, some characteristics of the participating organisations, for instance the ownership structure and relatively small size of several of the participating German banks, have to be taken into account when interpreting the results of this study. Finally, the data collection for this research took place in March and April 2008, when the global financial crisis had already began, but its full consequences, especially for several of participating organisations, were not yet apparent. Since then, one of the participating organisations has announced that it will close its Chinese operations. Another, as was expected, has been acquired by another German bank which is also active in China. These changes reflect one of the general limitations associated with cross-sectional studies which only collect
Conclusions and implications

data at one point in time: as situations change, future research may be required to assess the changing nature of the research topic.

5.6 Concluding remarks

Despite the economic difficulties of many banks caused by the financial market crisis of 2007/2008 and the various challenges they face, large internationally active banks in particular appear to continue to embrace the Chinese market (Metcalf 2010). The situation for German banks has to be evaluated separately. The global players among the German banks will probably continue and gradually expand their activities in China. The smaller \textit{Landesbanks} and cooperative banks, with their limited resources and limited business models, may have to individually reconsider their presence in China. The future of the \textit{Landesbanks} appears particularly to remain in question. Their strategies and role in Germany’s financial system have been controversially discussed for years now, with many questioning the need for more than one or two independent \textit{Landesbanks} and subsequent calls for further integration – a discussion that has further been fuelled by the huge losses experienced by almost all \textit{Landesbanks} during the recent financial crises (DBRS 2010; Schrooten 2009). Until the long-term future of the \textit{Landesbanks} has been decided, these institutions will find it difficult to expand beyond their current limited presences in China.
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Appendix

Appendix

Appendix A- Information sheet for interviewees
A Study of Market Entry Strategies of Foreign Banks in China

My name is Friedemann Mrochen and I am a Doctor of Business Administration candidate at Southern Cross University, Australia. As part of my doctoral studies, I am conducting research on the Market Entry Strategies of foreign banks in China. The supervisor of this research is Dr Carmen Cox of the Graduate College of Management at Southern Cross University (see below for contact details).

The banking sector in China is currently undergoing a transformation process. The ongoing development and economic growth of China, its emerging middle class and the WTO-entry driven deregulation of the banking sector all contribute to this dramatic transformation of the market for financial services in China.

The purpose of this study is to gain a thorough understanding of the motives and goals of foreign banks entering the Chinese market for retail and corporate banking services; of how foreign banks choose and develop their market entry strategies in China; and which internal and external factors they are considering in the decision making process.

You are invited to take part in this research by agreeing to participate in an interview, the details of which are provided below.

Interview procedures

The interview will mainly consist of open questions and will focus on three key topics:

- The motives/reasons of your organization to enter the Chinese market and your organization’s subsequent objectives and goals for its business venture in China.
- Your organization’s choice of market entry mode (defined by the form of representation, the form of incorporation and the form of co-operation with a local partner) and the internal and external factors influencing these choices.
- The choice of “competitive strategy” (defined by the currency of the business conducted, the nationality of the clients, the customer segments, the geographic markets and the product scope) and the internal and external factors influencing your organisation’s choices.

Each interview will take approximately 90 minutes of your time should you agree to participate, and will take place in your office or any other venue deciding on what is most suitable for you. Participation is purely voluntary and no financial remuneration or incentive will be offered for taking part in this research. There are no travel expenses, nor are there any costs associated with participation in this research apart from your valuable time.

Responsibilities of the Researcher

To ensure the confidentiality of the information provided by you during the interview, your name and other identifying information will not be attached to data collected. Your name will only be used to enable an appointment to be made to conduct the interview. Your participation in this study is on a voluntary basis.
As an interviewee, you will be asked to sign an informed consent form, in which you give your permission that the information collected in the interview may be used in this study, without identifying your or your organization's name. All signed consent forms will be held in safe storage at the University for a period of five years before being destroyed. You are free to withdraw your consent and to discontinue participation at any time.

The research findings may be submitted for publication. Unless agreed on otherwise, all data collected is anonymous and confidential. Other than your role or position within the organization, no personal data will be used in this research. All information collected will be presented as overall data. In the final research report, the participating organizations will only be referred to as cases with numbers. The results of the research will be made available to interested parties in final thesis format through Southern Cross University’s library.

Responsibilities of the Participant and Possible Risks

The only requirement of you as part of this research, should you agree to participate, is a commitment of time and willingness to share your opinions and experience about the research topic. There are no foreseeable risks or discomforts involved for you in this research.

Inquiries

This form is yours to keep for future reference. If you have any questions, please feel free to contact us any time:

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The ethical aspects of this study have been approved by the Southern Cross University Human Research Ethics Committee. The Approval Number is ECN-08-015. If you have any complaints or reservations about any ethical aspect of your participation in this research, you may contact the Committee through the Ethics Complaints Officer:

Ms Sue Kelly  
Ethics Complaints Officer and Secretary  
HREC  
Southern Cross University  
PO Box 157  
Lismore, NSW, 2480  
Telephone (02) 6626-9139 or fax (02) 6626-9145  
Email: sue.kelly@scu.edu.au

All complaints, in the first instance, should be in writing to the above address. All complaints are investigated fully and according to due process under the National Statement and this University. Any complaint you make will be treated in confidence and you will be informed of the outcome.
Appendix B - Standard interview protocol (German)
A study of Market Entry Strategies of foreign Banks in China

Interviewleitfaden

(1) Überblick über das China-Engagement Ihres Hauses:

- Zeitpunkt des Markteintritt / wesentliche Veränderungen seitdem
- Anzahl der Filialen / Repräsentanzen
- Geographische Regionen
- Geschäftsfelder (kurzer Überblick)

(2) Motive / Gründe für das Engagement in China

(a) zum Zeitpunkt des Markteintritt

(b) heute

z.B.:

- Follow the customer
- Marktpotential in China
- Special skill-based
- Resource-based
- Strategisch
- WTO-Beitritt / Marktoffnung
- zufällig

(3) Ziele für das Engagement in China

(a) zum Zeitpunkt des Markteintritt

(b) heute

- kurzfristig
- mittelfristig
- langfristig
(4) Wahl des Markteintrittsmodus in China

- **Art der Repräsentanz:** Representative office / Filiale
- **Rechtsform:** ausländische Rechtsform / Chinesische Rechtsform
- **Kooperation:** Kapitalbeteiligung / vertragl. Kooperation

Kriterien bei Partnerwahl / Zusammenarbeit mit lokalem Partner:
- Profil / Stärken des Partners
- Kontrolle über Management
- Schutz des Investments
- Exit option
- Umsetzung des eigenen Geschäftsmodells

(a) interne Einflußfaktoren (auf die Wahl des Markteintrittsmodus)

(b) externe Einflußfaktoren (auf die Wahl des Markteintrittsmodus)

(5) Wahl der Marktstrategie

- **Währung:** Devisen / RmB
- **Nationalität der Kunden:** ausländisch / Chinesisch
- **Kundensegmente:** Firmenkunden / Privatkunden
- **Geographische Abdeckung:** ein lokaler Markt / mehrere lokale Märkte
- **Produktpalette:** Spezialist (Produkt-/Segment-) / „Universalbank“

(a) interne Einflußfaktoren (auf die Wahl der Marktstrategie)

(b) externe Einflußfaktoren (auf die Wahl der Marktstrategie)
(6) Herausforderungen des China-Geschäfts

(a) zum Zeitpunkt des Markteintritts

(b) heute

z.B.:

- Konkurrenz durch Chinesische Banken
- Konkurrenz durch ausländische Banken
- Zusammenarbeit / Kooperationen mit lokalen Partnern
- Banking Regulation / CBRC
- Chinesisches Rechnungswesen / Accounting framework
- Personalbeschäftigung / Recruiting von qualifizierten Mitarbeitern
- Rechtssicherheit
- Politische Stabilität
- Infrastruktur / IT
- andere Markteintrittbarrieren

(7) Zukünftige Entwicklung des China-Geschäfts

(a) Banking in China – allgemein –:

(b) eigenes Engagement:

z.B.:

- Stabilität / abwarten
- organisches Wachstum
- Neue Lizenzen / Segmente / Produkte / geographische Regionen
- eigene Neugründung
- Partnerschaft mit joint stock commercial bank
- Partnerschaft mit „Big four“
- Partnerschaft mit ausländischem Institut
- Exit
Appendix

Appendix C - Informed consent form
Informed Consent to participate in the following research project

This consent form is based on Guidelines from the National Statement on Ethical Conduct Involving Human Participants as issued by the NHMRC.

**Name of Project:** Market Entry Strategies of Foreign Banks in China

**Researchers:**

- Dr Carmen Cox  
  Senior Lecturer  
  Southern Cross University  
  PO Box 42 Tweed Heads NSW 2485 Australia  
  Telephone: (61-7) 5506 9321  
  E-Mail: carmen.cox@scu.edu.au

- Friedemann Mrochen  
  Diplom-Kaufmann  
  Southern Cross University / International Office  
  PO Box 42 Tweed Heads NSW 2485 Australia  
  Telephone: 061(0)42052 1175  
  E-Mail: fmrochen@hotmail.com

☐ I have been provided with information at my level of comprehension about the purpose, methods, demands, risks, inconveniences, and possible outcomes of this research (including any likelihood and form of publication of results).

☐ I agree to participate in the above research project. I have read and understand the details contained in the Information Sheet. I have had the opportunity to ask questions about the study and I am satisfied with the answers received.

☐ I agree to an interview and to my interview being recorded on audiotape.

OR

☐ I do not agree to my interview being audio-taped and prefer the researcher to take hand written notes.

☐ I understand that if I withdraw from participation in this research, that any tapes or handwritten notes about my contribution will be destroyed.

☐ I understand that any personal information which may identify me will be de-identified at the time of analysis of any data. Therefore, I, or information I have provided, cannot be linked to my person or company. (Privacy Act 1988)

☐ I understand that neither my name nor any identifying information will be disclosed or published, except with my permission.
☐ I understand that all information gathered in this research is confidential. It is kept securely and confidentially for 5 years, at the University.

☐ I understand that I am free to discontinue participation at any time. I have been informed that prior to data analysis, any data that has been gathered before withdrawal of this consent will be destroyed.

☐ I am aware that I can contact the Supervisor or other researchers at any time with further inquiries, if necessary.

☐ I would like to receive a summarised copy of the research results when the project is finalised. Please send a copy to me via the following email address: ____________________________________________

The ethical aspects of this study have been approved by the Southern Cross University Human Research Ethics Committee (HREC). The Approval Number is ECN-08-015.

If you have any complaints or reservations about any ethical aspect of your participation in this research, you may contact the Committee through the Ethics Complaints Officer:

Ms Sue Kelly
Ethics Complaints Officer and Secretary
HREC
Southern Cross University
PO Box 157
Lismore, NSW, 2480
Telephone (02) 6626-9139 or fax (02) 6626-9145
Email: sue.kelly@scu.edu.au

All complaints, in the first instance, should be in writing to the above address. All complaints are investigated fully and according to due process under the National Statement on Ethical Conduct in Research Involving Humans and this University. Any complaint you make will be treated in confidence and you will be informed of the outcome.

☐ I understand that I will be given a copy of this consent form for my records. The researcher will also keep a copy in safe storage at the University.

I have read the information above and agree to participate in this study. I am over the age of 18 years.

Name of Participant: ____________________________________________________________

Signature of Participant: __________________________ Date: ______________________

I certify that the terms of the Consent Form have been verbally explained to the participant and that the participant appears to understand the terms prior to signing the form. Proper arrangements have been made for an interpreter where English is not the participant's first language.

Name & Contact Detail of Witness: ________________________________________________

Signature of Witness: __________________________________________________________

Date: ______________________

NOTE:
The witness should be independent of the research, where possible. If this is not possible at the place of consent, please inform the researcher and state a reason below.
Reason: ........................................................................................................................................
........................................................................................................................................
........................................................................................................................................

Name and signature of the researcher: ................................................................................
........................................................................................................................................

Date: ......................................................................................................................................