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Determinants of Foreign Entry Mode Choice in China's Banking Sector: Institutions and Resources

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Abstract

This paper examines the determinants of foreign entry mode choice in China's banking sector with a focus on strategic investment and wholly-owned subsidiaries. A conceptual framework that integrates the institution-based view and resource-based view is developed to analyze what determines foreign entry mode choice in China's banking sector. On the institution side, this paper finds that regulation/deregulation of host country on foreign financial institutions, especially the regulation on business scope and entry requirements, affect foreign entry mode choice. On the resource side, strategic investment provides foreign financial institutions access to location-specific resources, especially customer information, and then the wholly-owned subsidiaries of financial institutions would like to utilize the location-specific resources to do their own business.

Keywords: *Institutions-based view, resources-based view, strategic investment, wholly-owned subsidiary, customer information*

1. Introduction

China's accession to the World Trade Organization (WTO) in December 2001 was highlighted by the promise to open the formerly tightly closed banking system, where foreign financial institutions were guaranteed phased access to the Chinese market with the elimination of all restrictions on their business activities within five years. Moreover, China's economy has been growing about 10% per year in real terms over the last decade, and is projected by some to become the world's largest economy in the coming decades [1]. This rapid growth and large economy would bring large banking market opportunity, especially the bank lending [2]. All these factors attract foreign financial institutions to enter into China from 2001.With the gradually deregulated banking sector and huge banking market opportunity; many foreign financial institutions adopt wholly-owned subsidiaries and strategic investment to enter into China. And this paper would examine what determines their foreign entry mode choice in China's banking sector.

The China Security Regulatory Commission (CSRC) defined strategic investment as a certain scale and long-term investment in strategic acquisitions in its regulation "Management Approach of Foreign Investors' Strategic Investment in Listed Companies" at the end of 2005, applying Merger & Acquisition (M & A) terminology to strategic investment. This paper confines foreign strategic investment in China's banking sector to foreign financial institutions acquiring a minority equity stake in Chinese banks and committing to holding the stake for some period, typically a minimum of three years.

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Several theories can be used to explain foreign entry modes choice such as internalization theory [3-4]; eclectic theory [4]; comparative advantage theory [5-6]; resource-based view [7-10]; institution-based view [8-16]. In these theories, comparative advantage theory can't explain why one form of entry mode is preferred over another [4]. Eclectic theory doesn't provide a unified perspective in the explanation and prediction of entry modes choice [17], and it also doesn't explain why two firms in the same line of business and with similar ownership, internalization, and location advantages would not necessarily choose the same entry mode in the same foreign market [18]. Furthermore, extant eclectic theory ignores the impact of broad product characteristics, home country factors, and boundary variables on choice of entry mode [19]. For both internalization theory and eclectic theory, it's also difficult to generate testable hypothesis [4].

The resource-based view has not looked beyond the properties of resources and resource markets to explain enduring firm heterogeneity [20]. In particular, it has not examined the social context within which resource selection decisions are embedded [21]. Therefore, the integrated approach between resource-based view and institution-based view has been identified as the insightful theories when probing into emerging economies [22], especially in explaining entry modes in emerging countries or transition countries [8-10, 13]. As far as we know, no paper has combined institution-based view and resource-based view to explain the determinants of foreign entry mode choice in banking sector, especially on foreign entry into China's banking sector.

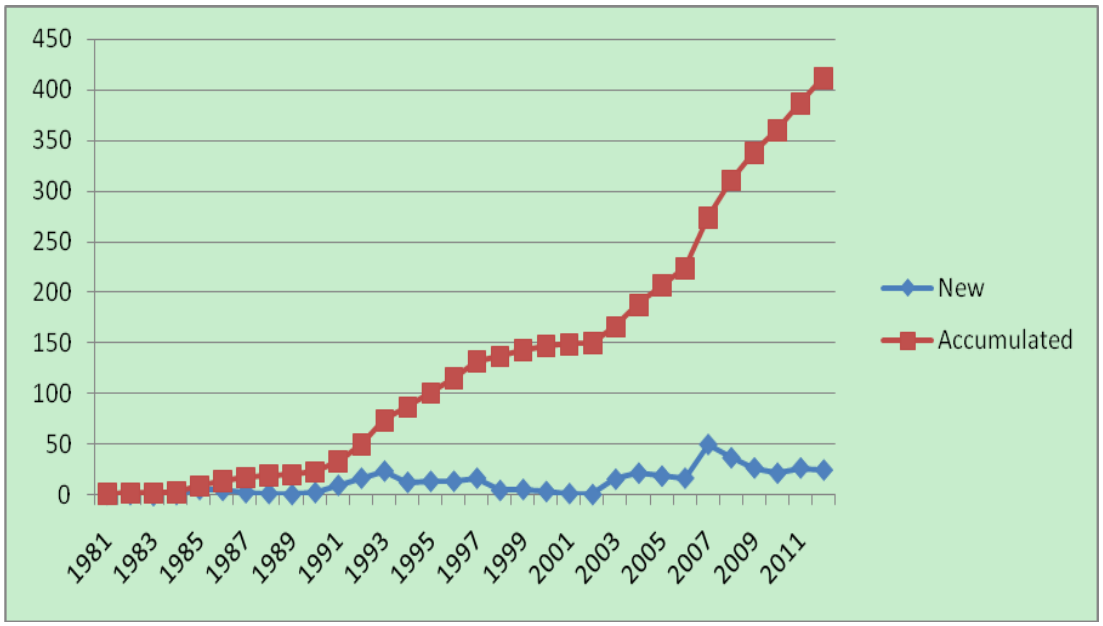
Here, this study attempts to make two contributions to the entry mode literature in banking. First, given the obvious importance of entry issues in international business, it is important to examine whether institution-based view and resource-based view are applicable in certain countries, industries, and time periods [23], especially in China's banking sector. Hence, this study examines the determinants of foreign entry mode choice in China's banking sector over 2001-2012 through following the work by [8-13], which examines whether the institutions and resources determine the foreign entry mode choice. Second, regarding banking sector, previous studies usually argue the entry modes choice between branches and subsidiaries [24-25]. As far as we know, few of them discuss the entry mode choice between wholly-owned subsidiary and strategic investment. This paper attempts to examine choice between wholly-owned subsidiaries and strategic investment in China's banking sector using institution-based view and resource-based view.

The reminders of the paper are as follows. Section 2 introduces the foreign entry history and modes in China's banking sector. Hypothesis about institutions, resources and foreign entry modes are developed in section 3. Section 4 argues the determinants of foreign entry mode choice in China's banking sector. Section 5 concludes.

2. Background Information

Since 1980, the development trend of foreign financial institutions in China's banking sector can be seen from Figure 1. In 1981, Nanyang Commercial Bank established a branch in Shenzhen, becoming the first foreign financial institutions doing business in China since 1949. Foreign financial institutions can only engage in exchange business in firms with three kinds of capital and foreign individuals. In the early 1990s, it was the fastest-growing period in foreign trade and foreign direct investment. The big demand for foreign financing is a good opportunity for the development of foreign financial institutions. In the aftermath of Asian financial crisis, foreign financial institutions became more cautious in expanding their business in the Asia-Pacific region, and foreign financial institutions' business in China's banking sector also slowed down. From 1998 to 2001, only 15 new branches and sub-branches were established in China (2006 ACFB). On 11 December 2001, China gained

accession to the WTO. The gradual deregulation on foreign financial institutions enabled a rapid expansion of their business. In the five years following the WTO accession, the branches, sub-branches, and subsidiary of foreign financial institutions expanded from 147 in 2001 to 291 in 2006.



Source: Complied by the author according to the 2006 Report of the Almanac of China Finance and Banking and the 2012 Annual Report of CBRC.
Note: The foreign banks include the branches, sub-branches, foreign-owned subsidiaries.

Figure 1. Foreign Financial Institutions in China over 1980-2012

From 1994, foreign financial institutions can establish their wholly-owned subsidiaries, but it can't do the RMB business to Chinese firms and individuals. However, from December 11, 2006, the wholly-owned subsidiaries can do business to Chinese individuals, and are regulated in the same way as domestic banks. At the end of 2009, foreign financial institutions establish 33 wholly-owned subsidiaries (CBRC, 2009 Annual Report). In fact, strategic investment can be established from 2001[1], but the regulation on strategic investment is promulgated on December 8, 2003 by China Banking Regulatory Commission (CBRC). At the end of 2006, 29 foreign financial institutions strategically invested a total of US$19.0 billion in 21 Chinese banks (CBRC, 2007 Report).

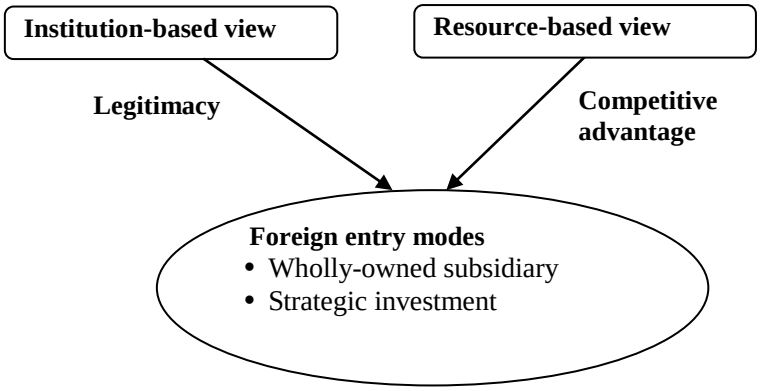
3. Institutions, Resources, and Entry Mode Choice

Institutions are typically defined as the 'rules of the game in a society' [26], which include formal rules and informal constraints [10]. Institutional-based view [27-29] examines the role of social influence and pressures for legitimacy in shaping organizations' actions [20]. When firms entry into a foreign market, institutions of both home and host country would influence the international strategies of firms, especially the foreign entry mode choice into emerging countries [9-10].

[1] See the presentation of Vice Chairman of China Banking Regulatory Commission on 2005 China Forum, http://www.gov.cn/gzdt/2005-11/02/content_89553.htm

Because resources are both heterogeneous across firms and imperfectly mobile [30-31], the resource-based view [30, 32-34] examines the resources and capabilities of firms that enable them to generate a sustainable competitive advantage [20, 30], which has significantly influenced recent international business literature [35]. Regarding foreign entry modes, the resource-based view explains the differences in entry mode choice observed across firms in an industry [19].

Institution influences the way firms manage their resources [10], and the resources of firms affect the strategy [33], especially the international growth strategy [35]. For example, industry-specific regulations and conditions for tenders to exploit natural resources influence investors' strategies and the acceleration of their commitment [36]. Regarding foreign entry mode choice, the resource-based view incorporating the institution-based view provides a research framework, which can be seen from Figure 2.



Source: Compiled by the author.

Figure 2. Conceptual Framework of Institutions and Resources

3.1. Institution-based View and Entry Modes

The central premise of institutional-based view is that firms adopt structures and practices that are "isomorphic" to those of the other firm as a result of their quest to attain legitimacy [16]. Researchers have identified several factors that give rise to isomorphic pressures. North (1990)[26], for example, suggests that there are two dimensions of institutions. The formal institution refers to the laws and regulations, and the informal institution refers to customs, norms, and cultures. Firms choose a particular form of structure and practice either because it would receive formal institution or informal institution as is necessary due to their reliance on resources from these environments or because it is taken for granted that doing so is the proper and legitimacy way to organize [37-38].

Foreign entry mode choice reflects the extent to which the foreign firms conform to the regulation of the host country environment [16]. The elements of the regulation include laws and rules that construct and constitute the grounds of organizational and industry action as well as ensure stability and order in societies [26, 28]. These laws and rules relate to the legal legitimacy that whether foreign firms can choose certain entry mode or not in host country. Hence, the foremost concern of a firm when entering a foreign market is to conform to the host country regulation. If the host country wants to encourage foreign firms adopt certain entry mode, foreign firms can get more benefits when adopting the entry mode instead of other entry modes.

Regarding the banking sector, beyond the simple binary determinant of whether foreign entry is allowed or not, the extant literature shows that the regulation more generally affects

bank entry mode choice [39-40]. In the empirical study on the question of regulatory barriers to banking merger and acquisitions activity, Buch and DeLong (2004)[39] test a sample of over 2300 international commercial bank mergers and find strong evidence that regulation affects international mergers decisions. When the host country promulgates less restrictive regulation on certain entry mode, foreign financial institutions would like to adopt the entry mode to enter a foreign market. From 2001, with China's accession to the WTO, the restrictions on certain entry mode are eliminated within five years. With the deregulation on certain entry modes, foreign financial institutions would like to adopt these entry modes to enter into China's banking sector. Therefore, the hypothesis is as follows:

Hypothesis 1a: *More deregulation of host country on strategic investment, the more likely foreign financial institution chooses strategic investment to enter into China's banking sector.*

Hypothesis 1b: *More deregulation of host country on wholly-owned subsidiaries, the more likely foreign financial institution chooses wholly-owned subsidiaries to enter into China's banking sector.*

3.2. Resource-based View and Entry Modes

The resource-based view provides a tool to analyze how firm resource endowments generate competitive advantage [30]. This paper uses the resource-based view to analyze how different resource endowments lead firms to pursue alternative strategies to attain competitive advantages in foreign locations and grow international operations [41].The augmentation of resources is one important way to contribute to the resource endowments and it can create new resources, and establish a link between firms' resource endowments and their likely path of international growth [8, 35, 41-42]. Therefore, the augmentation of resources is core to the international strategy of multinational enterprises [41].

One type of resources which can contribute to resource augmentation is the location-specific resources. Location-specific resources include local organizationally embedded resources such as distribution networks and brand names, and local market embedded resources, such as local market experience and managerial knowledge. The nature of firms' existing resources determines whether they need to engage in such resource augmentation when investing abroad [42-43]. Since firms may be restricted in their structural and experiential resources to operate in a foreign market [8], and if their core competences are also based on location-specific resources, they need to augment the location-specific resources to overcome foreignness of liability and maintain competitive advantage in the host country.

Thus, when the development of location-specific resources is more important, firms more likely choose collaborative entry modes [44]. Strategic investments provide access to complementary location-specific resources. Strategic investments in local partners can increase the shared resources which include technologies, as well as distribution networks and managerial knowledge on the local environments [41]. Moreover, it can increase the upside benefits because the foreign firms can accrue their partner's customer base. Past research also suggests that different forms of experience are best exploited by using modes of entry to undertake strategic investment if and where the investor lacks location-specific resources [45].

Regarding the banking sector, if foreign financial institutions would like to augment location-specific resources, such as local customer base, well-developed distribution networks, and local marketing experience, strategic alliances provide access to them. In China's banking sector, before 2001, foreign financial institutions don't have the experience on doing RMB business to Chinese firms and individuals. Thus, strategic alliances with Chinese banks can benefit foreign financial institutions on how to do business with Chinese

firms and individuals. Therefore, the hypothesis about resource augmentation and foreign entry mode choice is as follows:

Hypothesis 2a: *The more likely foreign financial institutions augment location-specific resources, the more likely foreign financial institutions choose strategic investment in China's banking sector.*

These location-specific resources can help foreign financial institutions to overcome the foreignness of liability when operating in the host country. If the location-specific resources are mainly on how to do business with Chinese firms, the branches of foreign financial institutions can utilize these resources since branches can do RMB business to Chinese firms. If the location-specific resources are mainly on how to do business with Chinese firms and/or individuals, the wholly-owned subsidiaries of foreign financial institutions can utilize these resources since the wholly-owned subsidiaries can do RMB business to Chinese firms and individuals. Therefore, when foreign banks choose strategic investment and augment the location-specific resources, foreign banks also would like to exploit the location-specific resources to attain competitive advantage by their own organizations, such as wholly-owned subsidiaries. So, the hypothesis is as follows:

Hypothesis 2b*: In China's banking sector, the more likely foreign financial institutions adopt strategic investment, more likely foreign financial institutions adopt the wholly-owned subsidiaries.*

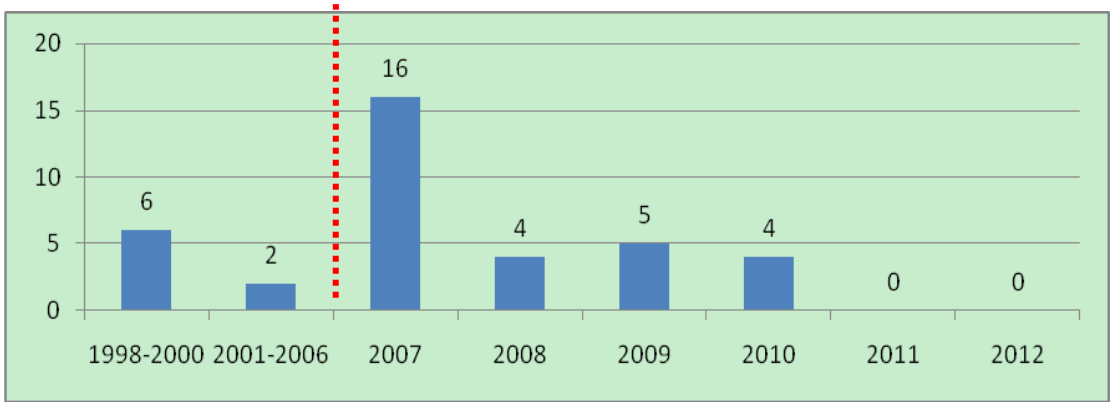
4. Determinants of Foreign Entry Modes Choice in China's Banking Sector

Foreign entry information is got from CBRC Annual Report, the Almanac of China Finance and Banking (ACFB), Quarter Statistics of The People's Bank of China (PBC). Regulation and resource information is got from the official website of CBRC, PBC, The Wall Street Journal, The New York Times, Financial Times, Bloomberger, some Chinese magazines, and two literatures [46-47].

Before 2001, the business scope of wholly-owned subsidiaries is very limited; also the scale of foreign financial institutions is very small. In addition, strategic investment in Chinese banks is not allowed before 2001. However, from 2001, foreign banks can adopt different entry modes into China's banking sector, and the restriction on business scope is eliminated. Therefore, this study focuses on the foreign entry modes over 2001-2012.

4.1. Deregulation and Wholly-owned Subsidiary

After December 11, 2006, the foreign wholly-owned subsidiaries in China's banking sector can do the RMB business to Chinese individuals, but the branches of foreign financial institutions just can receive a time deposit of not less than RMB 1 million each sum from a Chinese individual. For foreign financial institutions, a wholly-owned subsidiary is a good choice when they want to do the RMB business to Chinese individuals. Thus, when deregulation on business scope of wholly-owned subsidiaries is promulgated at December 11, 2006, 16 wholly-owned subsidiaries are set up in 2007, 4 in 2008, 5 in 2009, and the number of 2007 is more than that of previous 16 years, which can be seen from Figure 3. The dotted line means the deregulation on wholly-owned subsidiaries at December 11, 2006.



Source: Complied by the author according to the 2007-2012 Annual Report of CBRC, the Almanac of China Finance and Banking, and the 2009 report on "Foreign Banks in China" of PricewaterhouseCoopers.

Figure 3. Wholly-owned Subsidiaries in China's Banking

Table 1. Changes on Number of Wholly-owned Subsidiaries after the 2006 Regulation

Period	Number of foreign wholly-owned subsidiaries
Pre5: 5 years before 2006 regulation (2001-2006)	2
Post5: 5 years after the 2006 regulation（2007-2012）	29
Difference	27
Pre3: 3 years before 2006 regulation (2003-2006)	2
Post3: 3years after the 2006 regulation（2007-2009）	25
Difference	23

Source: Complied by the author according to the 2007-2012 Annual Report of CBRC, the Almanac of China Finance and Banking, and the 2009 report on "Foreign Banks in China" of PricewaterhouseCoopers.

Note: Number refers to the number of wholly-owned subsidiaries of foreign financial institutions.

Table 1 lists the changes on number of wholly-owned subsidiaries after the regulation initiated at December 2006. The number of 5 years before 2006 regulation is 2, but the number of post 5 years of the 2006 regulation is 29, these results show that the deregulation on foreign wholly-owned subsidiaries obviously encourages foreign banks establish wholly-owned subsidiaries. The deregulations on wholly-owned subsidiaries in China's banking sector highly affect foreign institutions' entry mode choice, which supports hypothesis 1a.

4.2. Deregulation and Strategic Investment

Although foreign financial institutions can adopt strategic investment in Chinese banks from 2001, the activities are subject to approval of cases, and the proportion of single investor investment should not exceed 15% and all investors should not exceed 20%.So, there is just Bank of Shanghai and Shanghai Pudong Development introduces foreign strategic investment over 2001-2003. However, on August 25, 2003, the Chairman of CBRC, Mingkang Liu, publicly encourage foreign strategic investments at the "Meeting of top managers of foreign financial institutions in China". Later, CBRC promulgated a regulation on foreign strategic investments which give a clear requirement on qualifications of foreign banks and the equity scope foreign bank can control.

Because of these encouragements, many foreign financial institutions undertake strategic investment in Chinese banks after 2003, which is shown in Table 2. In 2004, 4 Chinese banks introduced foreign strategic investment; in 2005, 10 Chinese banks introduced foreign strategic investment; in 2006, 7 Chinese banks introduced foreign strategic investment. The time distribution shows that the deregulation on strategic investments lead foreign financial institutions to undertake foreign strategic investments. Therefore, the deregulations on strategic investment in China's banking sector highly affect foreign institutions' entry mode choice, which supports hypothesis 1b.

Table 2. Time Distribution of Foreign Strategic Investment in Chinese Banks

Year	*N*	Percent (%)	Bank name
2001	1	3.8	Bank of Shanghai (CCB)
2003	2	7.7	Shanghai Pudong Development (JOCB); China Industrial Bank (JOCB)
2004	4	15.4	Bank of Communication (SOCB); Shenzhen Development Bank (JOCB); China Mingseng Bank (JOCB);Qilu Bank (CCB)
2005	10	38.5	Xian City Commercial Bank (CCB);Bank of Hangzhou (CCB);Huaxia Bank (JOCB); Bank of Beijing (CCB); China Bohai Bank (JOCB); Bank of China (SOCB); China Construction Bank (SOCB); Bank of Tianjin (CCB); Bank of Nanjing (CCB); Nanchong Commercial Bank (CCB)
2006	7	26.9	Industrial& Commercial Bank of China (SOCB); Shanghai Rural Commercial Bank (RCB);China CITIC Bank (JOCB); Hangzhou United Rural Cooperative Bank (RCB); Bank of Ningbo (CCB); Guangdong Development Bank (JOCB); Bank of Chongqing (CCB)
2007	1	3.8	Bank of Qingdao(CCB)
2008	1	3.8	China Evergrowing Bank (JOCB)
Total	26	100.0	

Source: Compiled by the author according to the Zhu *et al.* (2008)[46] and García-Herrero & Santabárbara (2008) [47], and some public information.

4.3. Resource Augmentation and Strategic Investment

Through establishing strategic alliances with Chinese banks, foreign financial institutions can access to the local customer base and use the huge branch networks of Chinese banks (Hope & Hu, 2005; Hope *et al.*, 2006). Moreover, they can not only cut down on the time, effort and money needed to build a network of branches and attract customers, but also learn about the market and gain experience that can be applied to building their own brands and doing their own business in China[2], which can also be seen from the interview with David Marshall by The New York Times, a banking analyst with Fitch Ratings in Hong Kong.

"I think their real interest is using the partner bank in China to distribute financial products and services that would be very difficult for them to do on their own, If you view thestake as the cost of obtaining access to the client base, it could be worthwhile in the long term as long as those joint ventures turn out to be profitable."

Several strategic investment cases can explain their motivation on augmenting location-specific resources more clearly. For example, the Bank of Communications and HSBC have set up a credit card unit, which would sell credit cards under the HSBC brand, which means that HSBC is expanding its customer base through local partners[3]. Another example,

[2]Some news have confirmed that foreign banks can get the local resources about customer base and branch networks through equity strategic alliances, such as "The New York Times, 2005.9.21, China's troubled banks lure investors; McKinsey Quarterly, November, 2005, Competing for China's credit card market; Financial Times, 2009.7.1, Exit the dragon".

[3]The news "The New York Times, 2004.11.5, HSBC and Partner Offer Credit Card in China" also confirms that

Industrial and Commercial Bank of China Limited (ICBC) will market and issue cards with an American Express logo. ICBC would provide American Express with customer support, and customers will be able to use the cards at any of the merchants in ICBC's existing network[4]. Moreover, the cooperation on credit card between Citigroup and Shanghai Pudong Development Bank[5] can also interpret the aims that foreign banks undertake strategic investments to use Chinese banks' resource. Taken together, strategic investments provide foreign banks access to augment location-specific resources.

4.4. Strategic Investment and Wholly-owned Subsidiary

Table 3 lists the entry modes of foreign financial institutions which undertake strategic investment over 2001-2012. These foreign strategic investors are divided into two groups, group 1includes commercial banks and investment banks, and group 2includes the investment firms, insurance firms, and other financial service firms.

Table 3. Entry Mode of Foreign Strategic Investors over 2001-2012

Type	Year of initial strategic investment	Strategic investors	Wholly-owned subsidiary established during 2007-2012
Group 1: Commercial banks and investment banks	2001, 2004	HSBC	Y
	2001	Shanghai Commercial Bank	N
	2002, 2005	Citigroup	Y
	2004, 2005	Hang Seng Bank	Y
	2004, 2005	Commonwealth Bank of Australia	Y
	2005	BNP Paribas	Y
	2005	Bank of Nova Scotia	N
	2005	ING	Y
	2005	Bank of America	N
	2005	United Bank of Switzerland	Y
	2005	Bank of Tokyo-Mitsubishi UFJ	Y
	2005	Royal Bank of Scotland Group	Y
	2005, 2008	Standard Chartered	Y
	2005	Deutsche Bank	Y
	2005, 2006	ANZ Banking Group	Y
	2006	OCBC	Y
	2006	Rabobank	Y
	2006	BBVA	N
	2007	Dah Sing Bank	Y
	2007	Intesa Sanpaolo	N
Total		**20**	**15**
Group2: Other	2003	Shanghai Commercial Bank	N
	2004	Newbridge Capital	N

HSBC can use the customer base of Bank of Communications through equity strategic alliances.

[4]The news "The New York Times, 2004.March.30, American Express to Issue Cards in China" also confirms that American Express can use the customer base of ICBC through equity strategic alliances.

[5]The news "The New York Times, 2005.9.21, China's troubled banks lure investors" also confirms that Citigroup can use the customer base of Shanghai Pudong Development Bank through equity strategic alliances.

financial service firms	2005	Sal Oppenheim	N
	2006	Goldman Sachs	N
	2006	Allianz	N
	2006	American Express	N
Total		**6**	**0**

Source:Compiled by the author according to the Zhu et al. (2008) [46] and García-Herrero & Santabárbara (2008) [47], and some public information.
Note:(1) Y: foreign financial institutions have the entry mode; N: foreign financial institutions don't have the entry mode. (2) Asian Development Bank, International Finance Corporation, Government of Singapore Investment, and Temasek Holdings are the official financial institutions or sovereign financial institutions, this study excludes them. (3) Date is the time when foreign financial institutions establish strategic alliances with Chinese banks, and two dates mean that they establish strategic alliances with two Chinese banks.

The number of financial institutions in group 1 is 20, and the number in group 2 is 6, which indicates that most of the financial institutions entry into China's banking sector is commercial banks and investment banks. Among the 20 financial institutions in group 1, 15 establish wholly-owned subsidiaries which show that 75% of the commercial banks and investment banks want to do business in China's banking sector. Through the strategic investments, these banks can learn the local market experience and knowledge and get access to local customer base, and then these can be utilized by their own organizations.

Among the 6 foreign financial institutions in group 2, no one establish subsidiaries in China's banking sector, which indicates that the main goal of investment firms and insurance firms are not to learn Chinese bank experience. Taken together, if the main goal of foreign financial institutions' strategic investments is to augment the specific resources about Chinese banking, foreign institutions are more likely to choose wholly-owned subsidiaries to utilize these resources.

5. Conclusions

This study finds that the institution-based view and resource-based view can be applied to explain the foreign entry mode choice in China's banking sector, and next step of my research is to examine these views in other countries' banking sector. The encouragement of CBRC and the deregulation on business scope encourages foreign financial institutions to adopt the equity strategic alliances and wholly-owned subsidiaries respectively. In order to pursue the location-specific resources, foreign financial institutions choose strategic alliances. And the wholly-owned subsidiaries and branches can use the location-specific resources to do their own business.

However, this study just uses the interview results of some magazines, so the further research of this study is to conduct the questionnaire or interview to get more data to support the hypothesis. This study just identifies one type resource, in fact, the firm-specific resources are also very important to the entry mode choice, so the further research of this study is to explore the relationship between firm-specific resources and foreign entry modes choice.

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