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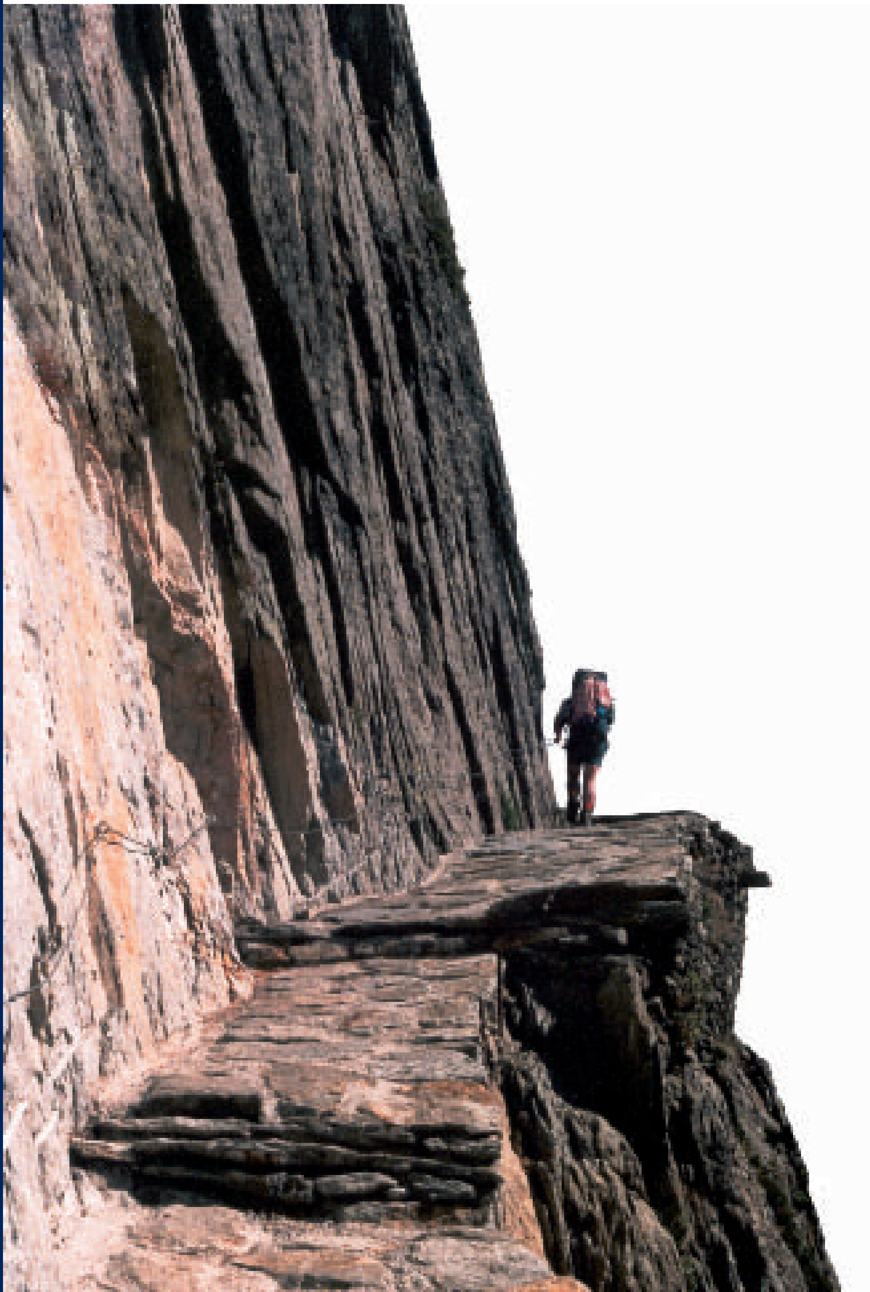
Banking Across Borders



Banking Across Borders

Internationalization of the World´s Largest Banks between 1980 and 2000

Contents

This booklet summarizes the main findings of the PhD study "Banking Across Borders". The complete study can be accessed at the website of Erasmus Research Institute of Managements (ERIM), http://www.erim.eur.nl/

1 Executive Summary

- Since the early 1980s banks internationalized on an unprecedented scale. To understand whether international expansion has affected the banks´ operations, and identify if additional performance and shareholder return was created by internationalization, this study analyzes the internationalization strategies and financial performance of the world's largest banks from eight countries between 1980 and 2000. This amounts to the study of a total of 44 banks.

- In the 1980s the overall degree of internationalization for the whole sample basically did not change much. In the 1990s, the degree of internationalization systematically increased, but the increase was concentrated with a small number of banks. For the bank sample as a whole, internationalization has not led to higher profitability levels. Even though the banks in the sample have been amongst the largest and leading internationalisers, most have not been in a situation to profit from this strategic choice.

- The largest banks, however, have not pursued uniform internationalization strategies. Retreating as well increasingly internationalstrategies could be observed. In the 1980-2000 period, around one quarter of the banks faced a stagnent level of internationalization, one quarter retreated, while one quarter slowly and one quarter strongly internationalized.

Shifting incentives to internationalize

- This study established a relationship between incentives to internationalize and the degree of internationalization. Following the client as a commonly known incentive to internationalize in service sectors, had explanatory power in the 1990s but not in the 1980s. No relationship with foreign direct investments was found. Net interest margins were a determining factor for banks to internationalize in the 1980s. In the 1990s this shifted towards fee income.

- Financial development was found to be positively related to the degree of internationalization for continental European banks, but negatively related to the United States, Japan, and the United Kingdom, the countries with the world's largest financial centers and securities markets. A higher degree of market concentration proved to be positively related to the degree of internationalization. Furthermore individual banks' degree of internationalization tended to be sensitive to the overall degree of internationalization of the whole sector, which is an indication of herding behavior amongst banks. Incentives such as profitability, capitalization and efficiency also explained the degree of internationalization. These incentives tended to explain internationalization better for the 1990s than in the 1980s.

Results from internationalization on average disappointing

- Between 1980 and 2000, the banks in the sample showed on average lower profitability on foreign banking activities than on domestic banking activities. They reported a decrease in total profitability when their degree of internationalization was higher, and also showed higher variability of profitability. If banks had intended to increase their profitability by serving new foreign banking markets and clients, or profit from geographical diversification, then on average they did not succeed.

- Banks with different internationalization strategies realized different returns for shareholders. Banks that either strongly or moderately increased their internationalization activities showed the lowest shareholder returns. On the other hand, banks that retreated from internationalization activities and (re)focused on their domestic banking business generated the highest shareholder returns. But banks with established internationalization strategies, showing a long term commitment to their international banking activities, generated the highest shareholder return.

- Similarly, shareholders valued large foreign acquisitions and foreign divestitures differently. Large changes in the degree of internationalization led to additional shareholder return. With a decrease in internationalisation additional shareholder return increased over time. With an increase in internationalization additional shareholder return decreased over time. The return-risk ratio improved most with large decreases in the degree of internationalization.

Continuing trends?

- Although this study covers the 1980-2000 period, some trends identified might still apply for the present and the future. First, banks who have accelerated their internationalization activities either have to find the right configuration to make internationalization a relative profitable activity, or will have to divest activities because it has not found an opportunity for sustainable foreign profitability and refocus on domestic activities. Generating relatively stable income from foreign retail banking or private banking increases the probability that the bank remains highly internationalized, potential for (further) domestic deregulation and growth reduces the probability.

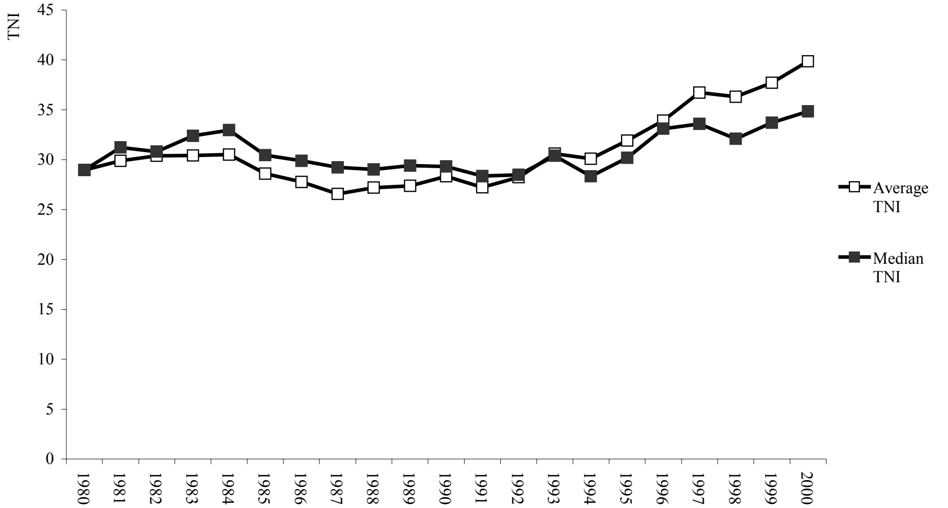
  Similarly, banks that retreated from internationalization can either maintain or further decrease internationalization activities, or increase them again: *re-internationalization*. Some banks have begun with re-internationalization since 2000, but generating sustainable foreign profitability is generally difficult to realize.

2 Internationalization patterns

The world's largest banks pursued different internationalization strategies between 1980 and 2000. Banks retreated as well as increased their internationalization activities. Roughly one quarter of the banks remained internationalized, one quarter retreated, while one quarter slowly and one quarter strongly internationalized.

The overall picture has been that in the 1980s the degree of internationalization for the largest banks in the world basically did not change (Figure 1). In the 1990s, the degree of internationalization systematically increased. But as the difference between average and median TNI indicates, the increase was concentrated with a small number of banks.

Figure 1. *Internationalization of banks, 1980-2000*



If banks in a country are considered as separate groups, then the development of internationalization activities of banks has differed between countries. There is a certain country-of-origin effect in banking. At the beginning of the 1980s, American and British banks showed the highest degree of internationalization. During the 1980s, the degree of internationalization decreased systematically for American banks, while this applied to British banks from the mid-1980s. The ascent of Japanese banks in the late 1980s in the international banking arena filled a relative void created by American and British banks in the 1980s.

Insert 1: About the research

This study adopted several research stages. First, a broad and representative sample of banks was selected. The 3 to 5 largest banks by assets with substantial international activites were chosen for the United States, the United Kingdom, Germany, France, Spain, Switzerland, the Netherlands and Japan. In 1995 this sample amounted to 34 banks; mergers and acquisitions increased the sample to 44 banks. As a group, these banks command over 48% of total global assets of banks between 1980 and 2000.

The internationalization of banks was investigated between 1980 and 2000. This long period was chosen to take full advantage of the disclosed geographical information, especially for American and British banks. Also, 1980 as a starting year is a natural demarcation point in the internationalization strategies of banks. In particular, the emerging market loans crises from 1981 onwards initiated for many banks a decade of reorientation on the role of their international activities. Arguably, the strategic reorientation in the 1980s also has substantially influenced internationalization activities of banks in the 1990s. An assumption when using a long time period is that banks and their managers have a long term memory: what the bank did in 1980 has relevance for their activities in 1990 or even later. A long time period is not uncommon in management studies - well known examples are "In Search of Excellence" by Peters and Waterman (1982) or "Built to Last" by Collinas and Portas (1993) – but longitudinal studies covering most leading companies of one sector are relatively rare.

Next, a database was developed for this study, collecting internationalization data for different indicators. For each bank the degree of internationalization was calculated which yielded an internationalization index for each bank (see next insert). This provided the basis for developing a strategic typology of internationalization. Different phases of expansion, restructuring and retreat were combined with a scan of client-arena-products targeted by the bank during these periods. A choice was made not to look at intended or announced strategies but at realized strategies, compiling information from newspapers, annual reports and other sources. This led to the identification of five different types of realized internationalization strategies: *Moderate*, *Accelerating*, *Established*, *Retreating* and *Imploding*.

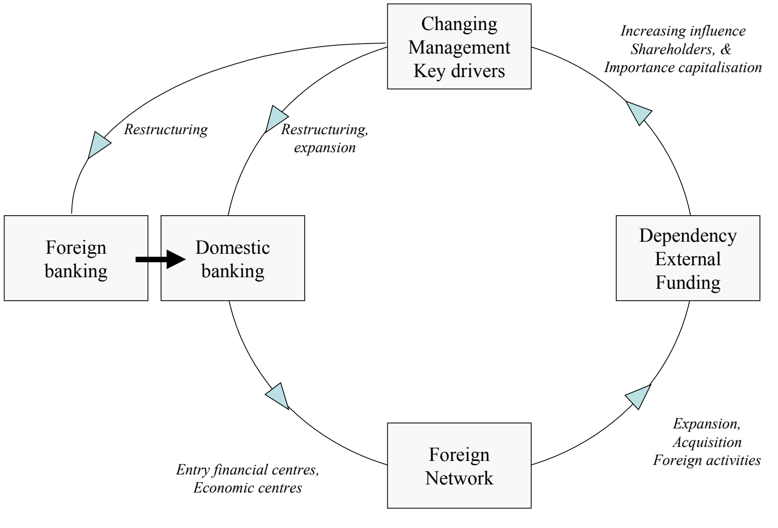
The types of realized internationalization strategies were then used in the next research phase, focussing on the effectiveness of internationalization. First, it was investigated which incentives are relevant for the internationalization of banks. With a pooled data regression model, several tests were performed, varying the time period, grouping the data per country or per realized strategy. Performance was addressed by first looking at the available data: difference in foreign and domestic profitability was calculated, based on the available data from annual reports. Alternative tests were set up to determine a broader relationship between performance and the degree of internationalization. Finally, integration was pursued by determining the relationship between incentives to internationalize, performance and shareholder return for the five different types of realized internationalization strategies.

The internationalization activities of Japanese banks increased until the early 1990s, their descent followed from the mid 1990s and marks the influence of a crisis in the domestic market. Continental European banks showed the strongest increase in degree of internationalization between 1980 and 2000; the largest banks from the Netherlands, Germany, Spain, France and Switzerland first steadily in the 1980s and then accelerating their degree of internationalization since the mid-1990s.

Internationalization cycle

The case studies suggest the following stylized internationalization cycle: starting in the 1970s, bank internationalization originally consisted of setting up banking activities in financial centers and economic centers. Part of this was related to incentives such as "follow-the-client" or aimed at increasing overall profitability. Additionally, restructuring and expansion in the domestic markets might have been cumbersome for some and impossible for other banks, further stimulating internationalization. Regulatory ideosyncracies in the home market might be one explanation for this, but also the existence of a home bias 'inertia': restructuring the domestic retail networks in the early 1980s might have been more difficult with vested interests in the home country such as labor unions. In particular, banks in smaller countries had to expand abroad for fear of anti-trust regulation at home.

Figure 2. *Stylized Internationalization patterns of banks*



For most banks during the 1980s, international expansion supported their domestic strategies and was relatively small compared to the home country. So banks did not have to attract additional capital. When banks initiated larger acquisitions in the late 1980s and 1990s, external capital became more important as a source of financing. (Domestic and

Insert 2: The degree of internationalization

There are different approaches to measure a banks' degree of internationalization. Estimating the degree of internationalization of a firm or a bank is to some extent arbitrary. An initial approach could be to construct a single item indicator; however the use of a single item indicator increases the potential error of measurement because it might be more prone to external shocks. An alternate approach is to combine several indicators into one index.

This study applies three single item indicators, which are combined in a composite index to analyze the degree of internationalization of a bank, the Transnationality Index (TNI). The TNI is one of the most cited indicators for internationalization. The index is expressed as a percentage and calculated as an unweighted average of 1) the foreign assets to total assets ratio, 2) the foreign gross income to total gross income ratio and 3) the foreign employment to total employment ratio.

The TNI by definition moves between 0 and 100. An internationalization index that incorporates income, staff and assets captures a richer picture of the bank's foreign activities than that which would be captured by income, staff and assets separately. Another attractive characteristic is that the TNI dampens the effect of finance companies or off-shore funding constructions. A substantial amount of foreign (relative to total) assets can a priori be expected to be located in tax havens or countries with lenient fiscal regimes. Such reported assets would, however, be accompanied by low number of employees. Combining both employees and assets in the TNI would then create a more balanced view. The same argument also applies to investment banking activities that are concentrated in financial centers outside the home country; these activities tend to generate a relatively high degree of income with few employees.

A disadvantage of the TNI might be that the construction of such an index cannot take account of the effects of technological change. Changes in technology can for example raise productivity and increase the assets or income per employee.I If these changes are distributed evenly over the total bank organization then its effect on the TNI is probably limited. If the ratio of foreign assets per foreign employee increases in the same amount as the ratio of domestic assets per domestic employee, then technological change has no effect on the TNI. From the mid 1990s however technological advances have had other geographic distribution effects. For example, the development of "internet" banks like ING Direct implies that the share of foreign assets and foreign income increases while staff and operations working for the internet bank basically remain at home. This might potentially depress the true extent of internationalization measured by the TNI.

foreign) shareholders not only provided additional capital to expand. They also followed management more closely, and pressed for changes when expected results were not delivered. An increasing shareholder role and foreign profitability that was below expectations, led bank managemers to change objectives in the mid 1990s: profitability should be internally generated, the domestic base strengthened and foreign activities divested if they did not contribute satisfactorily to total profitability.

Realized internationalization strategies

An analysis of banks' internationalization activities clustered per country is too coarse. For example, Chase Manhattan and Bank of America retreated from internationalization activities in the 1980s, while Citicorp and J.P.Morgan remained committed to international banking activities. To analyze the pattern of realized internationalization strategies, the internationalization activities of 44 banks were reviewed individually to determine commonalities in realized strategies. The degree of internationalization was measured per bank. In combination with the internationalization patterns, several phases in realized internationalization activities were identified. Similarities in these sequences over time for different banks wwere then used to identify five different realized internationalization strategies:

- *Accelerating internationalization*
  Banks initially develop internationalization activities by setting up branches in major economic and financial centers. As a next step international activities are expanded by increasingly large foreign bank acquisitions. Finally, the bank has to restructure, to consolidate the large foreign acquisitions and to regain or increase its profitability.

- *Moderate internationalization*
  Banks with *Moderate* internationalization strategies consider internationalization as a support activity of the total bank organization. They develop a foreign branch network and bank activities in major foreign economic and financial centers; acquisitions and establishment of other international bank activities are a reaction to the internationalization activities of other banks, especially banks with *Accelerating* strategies. Ultimately, restructuring also sets in to consolidate activities and (re)gain profitability.

- *Imploding internationalization*
  A fast increase of internationalization activities is often implemented to uphold or increase the bank's relative position compared to other competitors. Because the bank is unable to directly control the large increase in international activities, prolonged financial crises occur. Finally, internationalization activities are divested to raise capital; bank managers (under pressure of regulators) refocus their activities on the domestic banking market.

Insert 3: The degree of internationalization (TNI) of the world's largest banks

Country	Bank	TNI		
		1980	1990	2000
France	Agricole	2.3	4.0	17.9
	BNP	27.6	30.5	47.7
	Credit Lyonnais	11.3	32.5	25.1
	Paribas	28.1	39.4	-
	Societe Generale	29.2	27.4	34.9
Germany	Bayerische Hypobank	4.8	4.4	-
	Bayerische Vereinsbank	4.9	6.5	-
	HypoVereinsbank	-	-	36.1
	Commerzbank	14.8	17.8	26.4
	Deutsche Bank	9.3	23.6	59.0
	Dresdner Bank	8.3	8.4	32.5
	Westdeutsche Landesbank	8.6	12.3	41.2
Spain	BBVA	na	11.5	56.0
	BCH	na	-	-
	Santander	na	29.3	59.5
	Argentaria	na	-	
Switzerland	Credit Suisse	26.7	47.5	69.3
	SBC	41.2	38.6	-
	UBS	27.9	37.8	65.5
UK	Barclays	51.5	44.3	28.5
	HSBC	.	44.4	56.4
	LloydsTSB	40.9	18.9	15.1
	Midland Bank	21.4	14.2	.
	National Westminster	34.7	29.2	24.2
	Standard Chartered	72.6	77.0	79.7
Netherlands	ABN	30.5	-	-
	ABN/Amro	-	32.7	72.0
	Amro	13.5	-	-
	Fortis (bank)	-	28.8	33.6
	ING (bank)	11.0	16.8	61.6
	Rabobank	na	14.5	20.2
USA	Bank of America	48.3	21.8	7.6
	Chase Manhattan	51.7	31.9	28.0
	Chemical Banking	38.4	15.3	-
	Citicorp	53.6	41.3	46.1
	J.P. Morgan	47.7	41.7	-
	Manufacturers Hanovers	54.6	38.6	-
Japan	Dai Ichi Kangyo	29.0	39.6	19.1
	IBJ	12.1	26.3	28.6
	Mitsubishi Bank	31.5	33.5	-
	Sumitomo Bank	36.4	35.0	20.5
	Tokyo-Mitsubishi	-	-	40.6
	Bank of Tokyo	31.4	31.3	-

-: bank not in sample. na: not available.

- *Retreating internationalization*
  After a foreign financial or economic crisis, banks reassess their foreign activities and shift their focus from international activities to domestic activities. Foreign activities are divested to raise capital and/or domestic banking activities are expanded. Both effects combined lower the degree of internationalization.

- *Established internationalization*
  Banks with an already high degree of internationalization at the start of the period have been historically committed to international activities. They usually build up international activities over a long period.

The five types represent the internationalization of all banks in the sample, and are clustered in table 1. Apart from Credit Lyonnais and Midland, representing *Imploding* internationalization, the four other models of internationalization are evenly spread between the firms. Insert 4 summarizes the stylised characteristics of the five realized internationalization strategies.

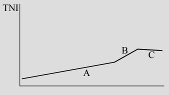
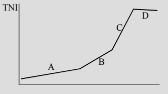
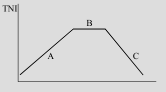
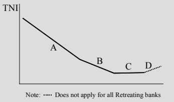
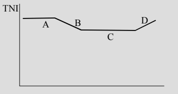
Table 1. *Banks and their model of internationalization*

Accelerating	Moderate	Imploding	Retreating	Established
• HypoVereins bank	• Argentaria	• Midland	• Manufacturers Hanovers	• Tokyo-Mitsubishi
• BCH	• Amro	• Crédit Lyonnais	• Chemical Banking	• ABN
• ING bank	• Fortis		• Mitsubishi Bank	• HSBC
• ABN/Amro	• Bayerische Hypobank		• Bank of America	• Tokyo
• NMB Bank	• Vereinsbank		• Barclays	• SBC
• BBV	• Agricole		• Chase Manhattan	• J.P. Morgan
• Paribas	• Commerzbank		• Dai Ichi Kangyo	• BNP
• Credit Suisse	• IBJ		• Lloyds TSB	• Citicorp
• Deutsche Bank	• Rabobank		• National Westminster	• Société Générale
• Dresdner Bank			• Sumitomo Bank	• Standard Chartered
• Santander				
• UBS				
• WestLB				

Financial systems and internationalization of banks

Financial systems, financial development and internationalization are intertwined. In general three different financial systems can be identified: bank oriented, market oriented and government/institution directed financial systems. With market oriented financial systems (for example the United States or the United Kingdom), the allocation process is mainly determined by market prices, and a substantial part of the banks´ main activities,

Insert 4: Realized internationalization strategies

	Moderate	Accelerating	Imploding	Retreating	Established
Description	Banks with generally stable growth of internationalization patterns, consistently increasing their TNI over time, with a short periods of acceleration.	Banks who start internationalization at a moderate pace, increasing the degree of internationalization in one or more step, after which a period of consolidation sets in.	A strong rise and decline of internationalization activities in a short period, where the decline is forced by financial distress.	Bank who have built up their foreign activities in an earlier period, the decline is triggered by a crisis, foreign activities are disinvested, domestic activities are increased.	Banks who have built up their foreign activities in earlier period and continue their commitment to international activities.
Patterns	 A. Expanding branch network in main financial, economic and off shore centers. B. Broad expansion, mainly by acquisitions, to maintain relative position to *Accelerating*/established banks C. Consolidation or restructuring: shedding activities acquired in B., resuming stable growth.	 A. Expanding branch network in main financial, economic and off shore centers. B. Broad expansion, mainly by acquisitions, relatively smooth integration except capital market activities C. Focused expansion, a number of relatively large acquisitions D. Consolidation or restructuring: integration activities in organization, focus on internal growth, divestments	 A. Expanding branch network in main financial, economic and off shore centers, acquisition of branch retail networks, to maintain relative position to *Accelerating*, Established banks B. Restructuring: stop loss making activities and streamline organization C. Exit: divestment of foreign activities, focus on domestic activities, combined with capital injection	 Note: ----- Does not apply for all Retreating banks A. Focus and exit: divestment of foreign activities, focus on domestic activities, forced by financial distress B. Consolidation: share of TNI further decreases because of further domestic expansion C. Balanced growth: Re-orientation role of foreign activities relative to larger domestic base D. Renewed expansion: selective foreign investments, supporting domestic activities	 A. Balanced growth of foreign and domestic banking activities B. Increase in domestic activities, or selective foreign disinvestments, either first mover or reaction to domestic consolidation C. Balanced growth D. Increase in foreign activities, focused on regions/activities
Banks	-Amro, Fortis, Rabobank -Bayerische Hypobank, Vereinsbank, Commerzbank Crédit Agricole -Argentaria -IBJ	-NMB Bank, ING Bank, ABN Amro -Paribas -Deutsche Bank, Dresdner Bank, Westdeutsche LB -Santander, BBV -UBS, Credit Suisse	-Crédit Lyonnais -Midland Bank	-Manufacturers Hanover, Chemical Banking, Bank of America, Chase Manhattan -Mitsubishi Bank, Dai Ichi Kangyo, Sumitomo Bank -Barclays, Lloyds TSB, National Westminster	-ABN -Tokyo-Mitsubishi, Bank of Tokyo -HSBC, Standard Chartered -SBC -J.P. Morgan, Citicorp -BNP, Société Générale

is performed by capital markets. With bank-oriented financial systems (for example Germany or France), the price process still is important, but the bank itself also plays an important part in the allocation process. Finally, in government/institution-oriented systems (such as Japan), banks can be instrumental in achieving the government's objectives.

Within the framework of internationalization, results of the study however suggest the existence of basically two different financial systems: continental European banks versus the United States, the United Kingdom and Japan. This grouping is based on three strategic characterics (Table 2). The classification of banks in different strategic types showed that there is a relatively large concentration of British and American banks, representing the market based system, in the *Retreating* and *Established* strategy types. On the other hand, European continental banks were relatively well represented in the *Moderate* and *Accelerating* strategy types, representing the bank based system. Japanese banks were evenly distributed over most categories.

Table 2. *Difference in financial development and internationalization*

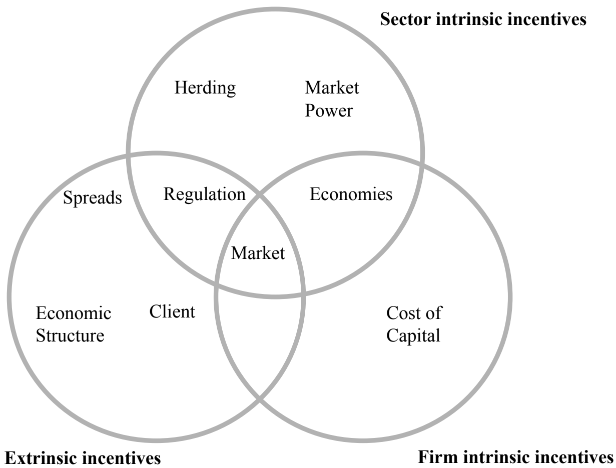
United Kingdom, United States, Japan	Continental Europe
• Relatively many *Retreating* internationalization strategies	• Relatively many *Accelerating* internationalization strategies
• Home of the world's largest financial centers	• Regional financial centers
• Negative relationship between financial development indicators and internationalization of banks.	• Negative relationship between financial development indicators and internationalization of banks.

When considering internationalization, market oriented versus bank oriented financial systems might not be a useful distinction: the relationship between financial development indicators and TNI pointed into another direction. For the continental European banks, strong relationships between financial development indicators and TNI were found. These relationships broke down for the United States, Japan, and the United Kingdom, all in a similar fashion. These three countries share a number of similarities: they have or have had leading financial bank systems in the world and they have the largest financial centers. The United States and Japan share additional similarities, such as in the regulatory system (the Japanese regulatory system was initially designed by the Americans) and the low degree of banking concentration.

3 Why banks internationalize

Since the early 1980s, nearly half the world´s largest banks have established significant international operations by setting up branches, engaging in joint ventures or acquiring foreign activities. To understand *why* banks have internationalized, this study first investigated the relationship between incentives to internationalize and the degree of internationalization of banks. A review of existing research identified three groups of incentives to internationalize: *Extrinsic*, *Bank intrinsic*, and *Sector intrinsic* incentives (Figure 3).

Figure 3. *Investigated incentives to internationalize*



Extrinsic incentives to internationalize stress the relationships with host governments, and its effects on host economies. These incentives relate to “following clients” strategies to foreign export markets and differences between countries in net interest margins, economic growth, financial development and regulation. *Bank intrinsic* incentives to internationalize center on minimizing costs, maximizing efficiency and optimizing competitiveness. Hypothesized intrinsic incentives in this study relate to economies, profitability and capitalization as incentives to internationalize. Finally, *Sector intrinsic incentives* represent common ground between extrinsic motives and intrinsic motives such as the relative position a bank wants to attain relative to competitors, achieved by market power.

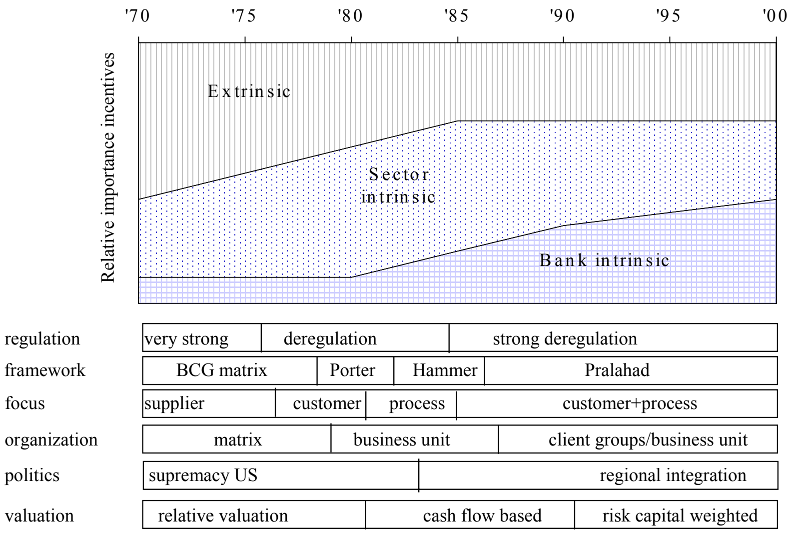
Main findings

The relationship between incentives to internationalize and the degree of internationalization was investigated using a pooled regression analysis for the 44 banks in the 1980-2000 period. The main findings are:

- Banks following their clients abroad were more motivated by their clients' exports than by the foreign direct investment of their clients.
- Net interest margins were a determining factor to internationalize in the 1980s, shifting towards fee income in the 1990s.
- Financial development was found to be positively related to the degree of internationalization for continental European banks, but negatively related to the United States, Japan, and the United Kingdom, the countries with the world's largest financial centers and securities markets.
- A higher degree of market concentration was positively related to the degree of internationalization; furthermore individual bank tended to be sensitive to the overall degree of internationalization.
- Profitability, capitalization and efficiency also explained the degree of internationalization. Their explanatory power tended to be higher in the 1990s than in the 1980s, and was higher for banks that followed *Retreating* or *Established* internationalization strategies, than for *Moderate* or *Accelerating* strategies.

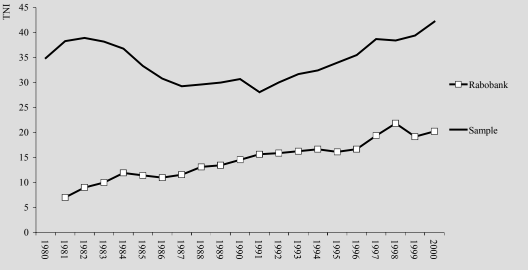
Shifting importance of incentives to internationalize
Estimations of the relationship between incentives and the degree of internationalization for different periods indicated that shifts in importance have taken place between 1980 and 2000. In Figure 4, a likely shift between incentives over time is shown, as well as possible explanations.

Figure 4. *Relative importance of incentives and possible explanations*



Insert 5. Rabobank: moderate internationalization strategy

Dutch based Rabobank is a diversified financial services organization with a cooperative status. Founded in 1972, the bank has a strong domestic base, and builds on its agricultural roots in its foreign expansion strategies.



The Rabobank is representative for banks with a moderate internationalization strategy: to a large degree, internationalization is considered as a support activity of the total bank organization.

- *1980s: broad international expansion.* Foreign activities to serve its domestic clients formed the core of its internationalization strategy in the 1970s and 1980s. To join the international capital market operations, Rabobank set up activities in London and New York. Rabobank actively participated in consortium banks and alliances, with UNICO as a linking pin within this strategy.
- *1990-1995: broad domestic and international expansion.* In the 1990s, the bank moved towards a bankassurance model acquiring insurer Interpolis and asset manager Robeco. It was the basis for a three pillar strategy: in the home market, Rabobank built its organization into a broad financial service provider, strengthening the retail, corporate finance and asset management side, remaining loyal to the legacy of earlier decades. Rabobank strengthened ties with existing UNICO partners, especially German DG bank and Spanish bank Banco Popular.
- *1996-1998: increased international expansion.* The rising costs of the foreign branch network forced a reorientation, and in 1996 the bank decided to provide corporate, investment and private banking services to clients in the agricultural, pharmaceutical and food industries in the major regions, initiating a string of acquisitions worldwide. Somewhat more opportunistic, its London branch was heavily upgraded in 1997 into an investment banking department, trying to reap the fruits of booming securities markets. Investment banking was scaled down in 1999 after disappointing results.
- *1999-2000: Restructuring.* However, Rabobank suffered a string of setbacks forcing it to reconsider its strategy: two announced large scale mergers fell through and its investment banking activities delivered poor results. In 1998 Rabobank unsuccessfully contemplated a full-fledged merger with Achmea. An alternative, to combine the investment banking activities with DG Bank in a joint venture, fell through. Also, the domestic cost efficiency was lagging in comparison with other competitors. These events signalled a period where management reconsidered the bank's strategy, and in anticipation of a new direction cost cutting measures were announced.

Extrinsic incentives (such as "follow your client" or spreads) may have been declining in importance over a longer period. While they did explain internationalization well in the 1970s, their explanatory power decreased, especially in the 1990s. On the other hand, *Bank intrinsic* incentives (capitalization, performance) might have increased substantially in importance. The Basle Accord marked the development towards a regulatory framework where banks had to be adequately capitalized; growing dependence on capital markets meant that banks increasingly focused on performance as a driver for shareholder performance. *Sector intrinsic* incentives to internationalize, such as herding, might have played an important role in the 1970s and 1980s. The increasing role of *Bank intrinsic* incentives meant that herding as an incentive shifted from an organizational level to a product-client level. Fewer banks in the 1990s set themselves goals in terms of asset size or market share compared to competitors, but this might well have taken place in specific markets for specific clients.

The incentives: an elaboration
The seven major incentives to internationalize can be discussed in more detail.

1. *Follow your client*

   The traditional incentives to internationalize, where banks follow their clients abroad, were not confirmed in this study. The estimated relationship between exports and the degree of internationalization was positive, but the coefficient showed no statistical significance. The model was also re-estimated per country. For most countries a negative relationship between exports and TNI was found between 1980 and 1989, on average changing to a positive relationship between 1990 and 2000. Trade as an incentive to internationalize has been one of the traditional explanations in internationalization theories. It could be that this 'traditional' explanation had some weight prior to 1980, but it lost its explanatory power in the 1980s as banks began to develop internationalization strategies for other reasons. Export became important again in the 1990s when regional integration such as the European Union led to a further intensification of trade relationships.

   A relationship between outward foreign direct investments (FDI) and TNI, also a traditional incentive to internationalize, was not confirmed for the total sample. Re-estimating per country, even negative relationships between FDI and TNI were found. If the regression results of exports are compared to FDI, then exports have more explanatory power for the degree of internationalization than FDI. In other words, (stable) trade relationships were more important incentives for banks to internationalize than the (more volatile) foreign direct investments of firms.

2. *Increase earnings*

   Two other variables to measure the relationship between the degree of internationalization and extrinsic incentives were the bank's net interest margin and fee income, i.e. non interest income as share of gross income. Fee income has been especially relevant to internationalization activities of banks in financial centers, where investments banks were set up or acquired. A low net interest margin as an incentive to internationalize was confirmed for the 1980-1989 period but rejected for 1990-2000 while a higher degree of domestic fee income as an incentive to internationalize was rejected for the 1980-1989 period and supported for 1990-2000. This might suggest that fee income has taken over the role of net interest margin as incentive to internationalize: the decline of net interest margin in the 1980s positively influenced the degree of internationalization, while fee income in the 1990s was positively related to the degree of internationalization. This finding supports the increased role of (foreign) investment banking activities of banks, especially in the 1990s.

3. *Exploit financial and economic developments of the home country*
The financial structure and financial development of countries influence the internationalization of banks. While the level in GDP per capita in the home country is positively related to the degree of internationalization, the growth in GDP in the home country on the other hand is negatively related to the degree of internationalization. This paradox can be explained since relatively richer countries (with a high GDP per capita) tend to have banks with a higher degree of internationalization, *unless* there are domestic economic growth opportunities.

The relationships between TNI and the home country's bank assets, GDP per capita, and market capitalization were expected to be positive, and have been confirmed for France, Germany, Spain, Switzerland and the Netherlands. On the other hand, relationships between financial development of a country and the degree of internationalization were rejected for American, British and Japanese banks. These countries have in common that they harbor the largest financial centers: the natural domestic base for generating fee income might explain the negative relationship between market capitalization and TNI.

4. *Regulation*
To assess the effect of changes in regulation on the degree of internationalization of banks, changes in TNI before and after major regulatory events were calculated. These events included the liberalization or deregulation of major financial markets, the implementation of the Basle capital adequacy rules and the American regulation for foreign banking activities. In general, mixed results were found. There was no relationship visible in changes in the TNI of banks (in the country of regulatory change) before and after major financial deregulation events such as the liberalization of financial markets in the United Kingdom in 1986 or France. Similar, the implementation of the Basle capital adequacy rules for all countries in the sample effective in 1993 showed no specific change in the TNI for banks in the country before and after the implementation.

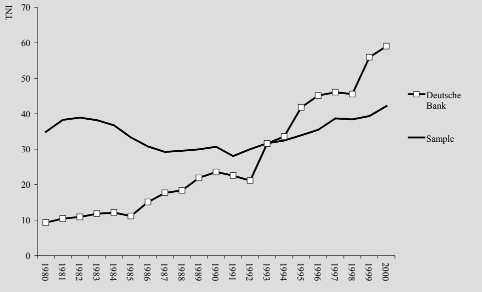
5. *Market concentration*
   A higher degree of market concentration in the home country is positively related to the degree of internationalization. Expected limited domestic growth opportunities in terms of banking market share are supported as an incentive to internationalize. Market concentration was also found to have a negative relationship with GDP Growth or GDP per capita. This indicates that market concentration in itself is an independent incentive to internationalize, and not directly tied to the size of the economy.

6. *Herding*
   The degree of internationalization of the total sample, approximating a herding effect, also had a positive relationship with the degree of internationalization. When banks were clustered by realized internationalization strategy and country, herding was also observed. Japanese, American and British banks have tended to show *Established* and *Retreating* internationalization strategies between 1980 and 2000; German, Dutch, Swiss and Spanish banks were inclined to have *Moderate* and *Accelerating* internationalization strategies. French banks could not easily be clustered in one of the categories. With the exception of Japan, this clustering could also be interpreted as a dichotomy between bank-oriented and market-oriented financial systems. Banks in market-oriented financial systems (the United States and the United Kingdom) tended to develop *Established* and *Retreating* internationalization strategies; continental European banks on the other hand leaned towards *Moderate* and *Accelerating* international expansion strategies.

7. *Efficiency, profitability*
   For the whole sample, support was found for bank intrinsic incentives to internationalize: efficient banks (i.e. with a lower cost to income ratio) show a higher degree of internationalization, and so do banks that have a higher profitability and are better capitalized. Cost-to-income, capitalization and profitability are variables that a bank can influence; they tended to have more explanatory power in the 1990s than in the 1980s. When the relationship between incentives and the degree of internationalization was grouped per realized strategy type, an observation was that cost-to-income, capitalization and profitability had more explanatory power for banks with *Established* and *Retreating* internationalization strategies, than for banks with *Moderate* and *Accelerating* internationalization strategies.

Insert 6. Deutsche Bank: accelerating internationalization strategy

Deutsche Bank fits the stereotype of the European bank in search of a truly global strategy. As one of Europe's largest banks, it has focused on developing a retail bank presence in Europe in the 1980s, shifting to acquiring a leading position in worldwide investments banking in the 1990s.



Initially, Deutsche Bank's *Accelerating* internationalization strategy began by setting up branches in major economic and financial centers. Next, international activities were expanded by increasingly large foreign bank acquisitions. Finally, a restructuring period set in, consolidating the large foreign acquisitions and regain profitability.

- *1970s-1985: Entry in international banking markets.* Throughout the 1970s, Deutsche Bank systematically set up its branch network world wide. This development was largely over in the early 1980s but Deutsche Bank continued to open branches or convert representative offices to branches, though not with the intensity of the “flag-planting competition” of British banks.
- *1986-1998: Broad international expansion.* In 1986, Deutsche Bank started a reorganization to increase its market position in securities trading, increase its presence in other high-growth international markets and strengthen bank’s position in retail banking. Retail banking networks were acquired in Italy (1986 and 1993), Spain (1993) and Belgium (1998). It was unsuccessful in acquiring a retail network in France, and decided in 1999 to set up 15 branches for wealthy customers. The growth in the capital markets was primarily accomplished in two large steps: the acquisition of Morgan Grenfell in 1989, and the acquisition of Bankers Trust in 1998. Subsequently, the bank’s headquarters for its investment banking activities were transferred to Morgan Grenfell in London. Deutsche Bank’s aim was to also to become a sizeable participant in the wholesale banking activities in the United States. This was achieved with the sale of Bankers Trust to Deutsche Bank in 1998.
- *1999-2000: Restructuring*. Increasing its German market shae was a permanent issue for Deutsche Bank in the 1990s. It unsuccessfully negotiated a merger with domestic competitor Dresdner Bank in 1999, failing to agree on integrating their investment banking activities. The restructuring of domestic operations had to be done alone, and Deutsche Bank created "Deutsche Bank 24", its retail banking unit, by combining retail and direct bank activities (clicks and bricks) in 1999. After restructuring, profitability increased in 2000, and the bank moved away from the concept that retail banking was a costly but necessary burden for the bank.

4 Performance and shareholder value

Have banks become more profitable through internationalization, and have shareholders gained by it? To get an answer to this question, the relationship between the degree of internationalization and performance was analyzed. Performance was analyzed from the perspective of the bank and from the perspective of the shareholder. The main findings are:

- The banks studied showed on average a lower profitability on foreign banking activities than on domestic banking activities, and reported a decrease in total profitability when their degree of internationalization was higher.

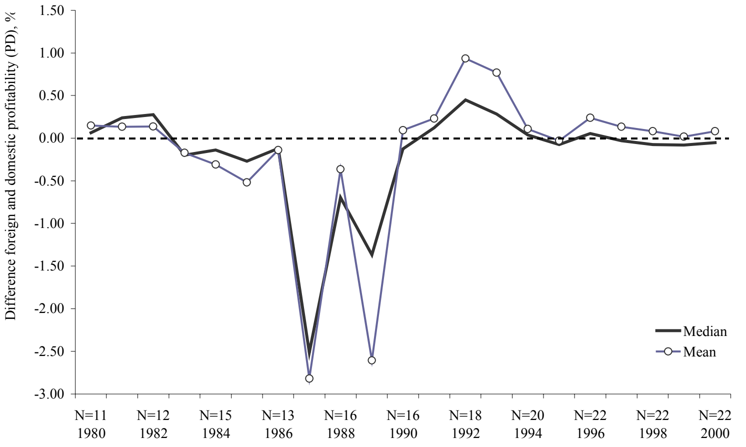
- Similarly, the banks also showed higher variability of profitability with an increase in internationalization. If banks had intended to increase their profitability by serving new foreign banking markets and clients, or profit from geographical diversification, then on average they seem not to have succeeded.

- The study identified bank performance as a major driver for shareholder return. Since internationalization leads to lower performance, more internationalization indirectly has lowered shareholder return. Banks with *Accelerating* internationalization strategies and *Moderate* shareholder return showed the lowest shareholder return between 1980 and 2000. Banks with *Retreating* internationalization strategies on the other hand created the highest shareholder return, as well as banks with long *Established* international banking activities.

No additional performance by foreign activities

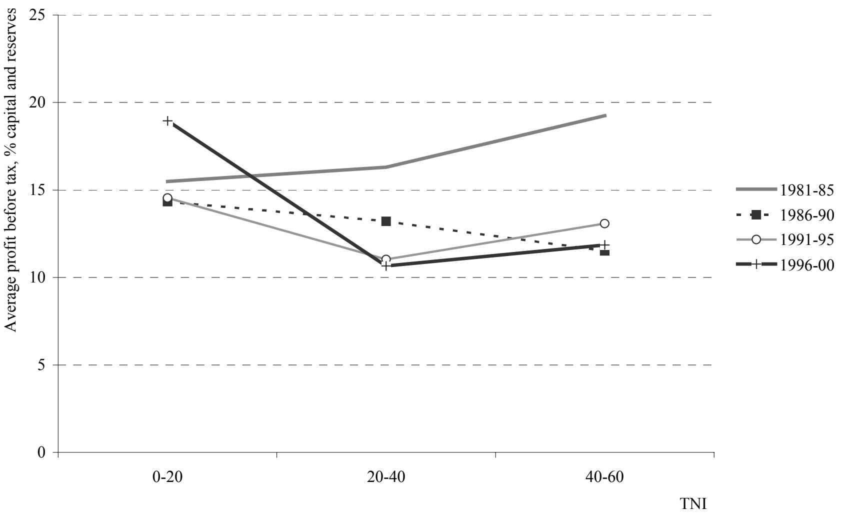
In the first analysis existing annual report data was used to examine the relationship between the degree of internationalization and profitability, measured as profit before tax as a percentage of assets. Between 25% of the banks in 1980 and 50% in 2000 reported on foreign and domestic profitability and assets, so the results do not apply for the whole sample. The difference in reported domestic and foreign performance was calculated, showing that profitability of foreign activities on average has been lower than profitability of domestic activities. This negative difference in profitability is mainly concentrated between 1983 and 1990, indicating that the years of entry and exit matter to total profitability.

Figure 5: *Difference between foreign and domestic profitability (profit before tax as % total assets)*



To establish analyses that applied to the whole sample, the relationship between total profitability, measured as profit before tax as a percentage of capital and reserves, and the degree of internationalization was examined. For most banks and most time periods, there is a negative relationship between total profitability and the degree of internationalization.

Figure 6. *Relationship between profitability and the degree of internationalization, for different periods.*



An exception was between 1981 and 1985 when there existed a positive linear relationship between profitability and TNI; 1986-1990 showed on the other hand an opposite relationship. Between 1991 and 2000 the linear relationship between profitability and TNI broke down: profitability decreased with an increase in TNI and subsequently increased again with further increases in TNI, resembling a weak V-shaped form.

Another analysis estimated realized foreign and domestic profitability for each individual bank, based on the accounting definition that asset weighted foreign and domestic profitability adds up to total profitability, where profitability is profit before tax as a percentage of total assets. Using foreign and domestic asset weights and benchmark profitability for foreign and domestic profitability, the estimated differences between foreign and domestic profitability were calculated. Here, the estimated difference in foreign and domestic profitability for the whole sample became systematically negative.

The different analyses therefore support the conclusion that foreign profitability on average has been lower than domestic profitability for banks in the sample between 1980 and 2000. An objection usually raised by banks in their annual reports is that for reported figures, the allocation of foreign and domestic profitability is to some extent arbitrary because some financial services generated are consumed in more than one place. Examining the relation between the degree of internationalization and total profitability took this objection into consideration, but here too an overall negative relationship between the degree of internationalization and total profitability was found.

Variability of profitability increases with internationalization

While internationalization might not on average improve overall profitability, another argument would be that internationalization leads to more stable profitability through geographical diversification. This effect was examined by calculating variability of profitability, measured as the five year standard deviation of profit before tax as a percentage of capital and reserves. A finding was that variability of profitability increased with a higher degree of internationalization. This suggests that the banks in the sample were on average not able to generate additional profitability (reaping internalization advantages) and neither to generate more stable earnings (profit from geographical diversification).

Similarly, another hypothesis was that geographical diversification advantages should allow a bank to generate more stable results and improve its return-to-risk ratio, i.e average profitability (return) as a ratio of the standard deviation of profitability (risk). Having established that foreign activities do not structurally generate more return, the burden of proof lies with the reduction of risk. However, no relationship exists between TNI and risk. Combining the results for risk and return, internationalization in general is negatively related to the level of the return-risk ratio.

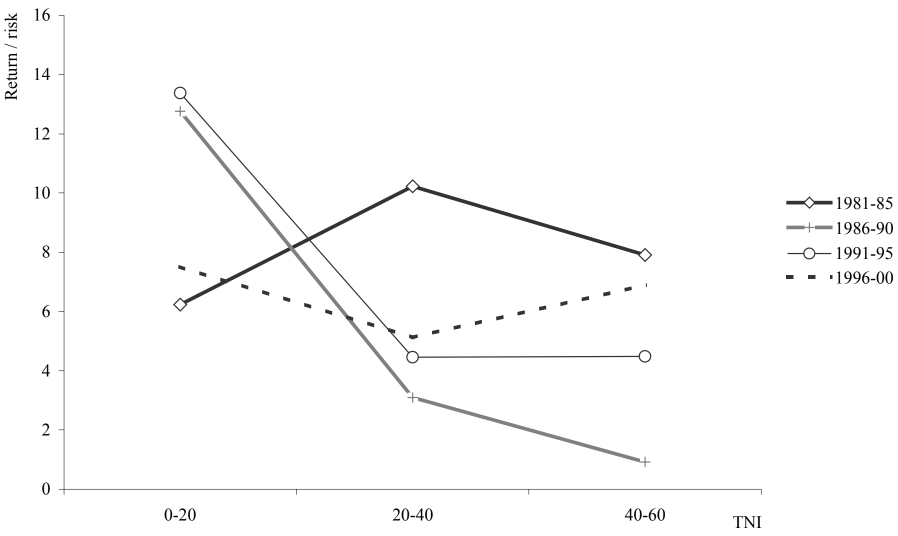
Insert 7. HSBC: established internationalization strategy

HSBC began its internationalization strategy as a HongKong based bank with close ties to the United Kingdom. Expanding in several countries, the bank moved its headquarters to the United Kingdom in 1991 by acquiring Midland Bank. Its worldwide presence as a large diversified banking organization was enhanced in the 1990s by buying banking activities in Brazil and in the United States.

HSBC, a bank with an *Established* internationalization strategy, has historically upheld a high degree of internationalization. Historically committed to international activities, HSBC has built up international activities over a long period.

- *1980-1992: Broad expansion.* In the late 1970s and into the 1980s, China began to open up for foreign business. The bank bought operations in the United States (notably Marine Midland) and Canada, initially to capitalize on business between China and the United States and Canada, much of which was transacted through Hong Kong since China lacked financial infrastructure until the 1980s. HSBC was located in HongKong, uncertainty about its return to China led HSBC to gain a major foothold in the United Kingdom. In 1987, pressed to reduce its independence on Hong Kong, it took an equity stake in Midland. Midland bank was purchased in 1992 and – as part of the agreement to buy Midland - in 1993 HSBC formed HSBC holdings, transferring its headquarters from Hong Kong to London.
- *1993-2000: Broad expansion*. The strategy of HSBC in the mid 1990s has been to build the world's biggest financial services group, presenting itself as a contender of Citigroup. HSBC took a different approach to investment banking than competitors like J.P. Morgan, and Deutsche Bank, building a far more modest investment banking unit, emulating Barclays Capital Market activities. HSBC began to expand further in Asia, expanding in Malaysia and China. In 1997 it expanded in South America, buying banks in Argentina, Brazil, Mexico and Peru. In 1999 it bought a controlling stake in South Korea's government-owned Seoulbank. It also bought Republic New York and Safra Republic Holdings, doubling HSBC's private banking business and adding 426 branches in New York State. In 2000, HSBC bought Credit Commercial de France for 11 billion euros, adding 1 million French customers and completing Europe's largest ever cross-border banking acquisition. Also in 2000, HSBC formed a 1 billion US dollar joint venture with US securities firm Merrill Lynch to offer online brokerage services to wealthy clients.

Figure 7: *Relationship between return/risk of profitability and internationalization.*



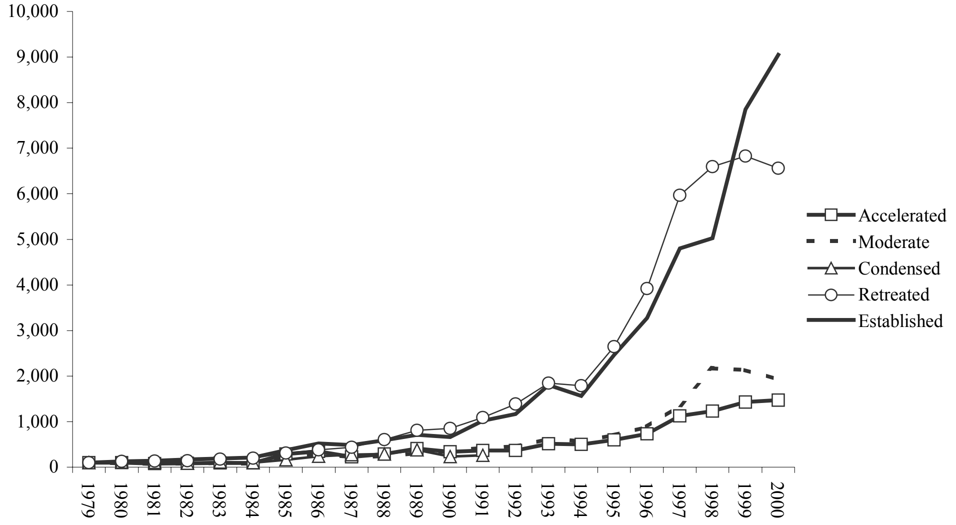
Shareholder return

To analyze the relationship between total shareholder return (TSR) and degree of internationalization (TNI) for the whole sample, a simple model was developed and estimated. TNI, and change in TNI were found to have a positive relationship with shareholder return in line with the hypothesis, especially between 1990 and 2000. But the estimates are in general non-significant.

Shareholders clearly attached different valuations for different realized internationalization strategies. *Retreating* and *Established* banks generated the highest total shareholder return, whether this is measured in absolute returns or adjusted for country averages. These groups include relatively many American and British banks. *Moderate* and *Accelerating* banks generated the least shareholder return, in spite of *Accelerating* banks having attracted relatively large amounts of capital to fund their (foreign) activities. The high TSR for *Retreating* banks supports research that for example shareholders in the United States experienced negative abnormal returns when foreign acquisitions were announced; with this type of realized internationalization strategy on average more foreign divestments than acquisitions have been announced.

Additional analyses considered the relationship between risk, return and the degree of internationalization. No support was found that the level of internationalization is a predictor for out- or underperformance in the consecutive periods. In general, a higher degree of internationalization is negatively related to additional shareholder return, albeit non significant. On the other hand, performance had significant explanatory power for shareholder return.

Figure 8: *Total shareholder return for different internationalization strategies*



Note: Total return in US dollar, rebased at 31 december 1979=100, return weighted by market value in US dollar
Source: Datastream, own calculations

When TNI decreased, a finding was that the bank share's return/risk profile improved. The return to risk ratio was calculated as annualized TSR (return) as a ratio of annualized standard deviation of TSR (risk). Similar to the previous analyses for return and risk, the results are not statistically significant though. It was also considered what the impact of large changes in TNI was on risk and return. Changes were defined as large when TNI increased or decreased with more than 10% compared to a year earlier; these large changes have always been caused by a large acquisition or divestiture. Banks who decreased their TNI with more than 10% generated on average more shareholder return in the years after the change, while the risk steadily declined after an initial increase. The return-risk ratio of banks with decreasing TNI's improved the most in the years shortly after the change in TNI.

When banks increased their internationalization activities and raised TNI with more than 10%, shareholder return was relatively high in the years of the TNI change, steadily decreasing in the years afterwards but still remaining positive. The volatility of the shareholder return increased in the year of change, remaining at broadly the same level for the subsequent years. On average, the return-risk ratio of the banks with a large increase in foreign banking activities improved slightly.

5 The future of international banking

This study has primarily provided a contemporary analysis of realized internationalization strategies of banks in the 1980–2000 period. In this section possible implications for internationalization of banks in the near future are considered: can something be said of future internationalization developments, and what consequences might this have for shareholders? Three future developments are considered. First, which banks are most likely to gain in the near future from internationalization? Next, what effects would the further European integration have on the internationalization of banks. Finally, what role will financial systems play?

Future internationalization

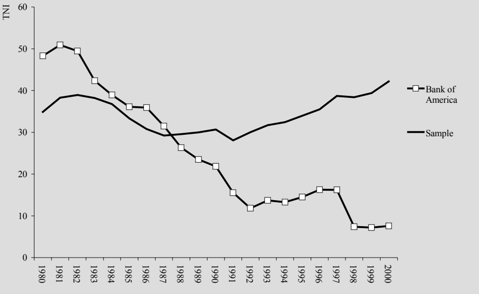
Internationalization activities of banks changed considerably between 1980 and 2000. In 1980, American and English banks were at the helm of internationalization. Japanese banks dominated the international scene in 1990. By 2000 many European banks had raised internationalization to new, unprecedented heights, perhaps only matched by the internationalization of banks in the colonial system at the start of the 20th century. The average degree of internationalization for the sample did increase, but not dramatically: the degree of internationalization (measured by TNI) moved around 30% in the 1980s, and increased to 40% at the end of the 1990s.

There are similarities observable between the early 1980s and the late 1990s. In the early 1980s, American and English banks had to make strategic choices with regard to their internationalization activities just as Dutch, German, Spanish and Swiss banks had to reconsider the role of their foreign banking activities at the end of the 1990s. In the early 1980s, banks were confronted with the decline of a smooth source of foreign income, the LDC loans; by the late 1990s banks were confronted with the decline of stockmarkets reducing both fee income and the attractiveness of the stock markets as a source of foreign acquisition financing. A large number of banks in the sample undertook some form of restructuring in 1999 and 2000, and continued this in the years after. While the decrease in stock markets from 2000 onwards might be alleviated, other triggers of strategic change are bound to follow, such as financial crises.

Ultimately, internationalization of banks has been a mixed blessing for shareholders over a longer period. Banks with long established foreign bank activities (the *Established* banks) generated in the long run as a group the highest shareholder return, similar to banks who substantially decreased the role of foreign bank activities (the *Retreating* banks). On the other hand, banks who either increased their internationalization activities steadily (the *Moderate* banks) or with increasing pace (the *Accelerating* banks) have generated the lowest shareholder return.

Insert 8. Bank of America: retreating internationalization strategy

The initially California based Bank of America was in the 1970s a bank with a large worldwide presence. In 20 years, the bank transformed into broad financial service provider, with a predominant domestic focus caused by foreign divestitures and large domestic mergers with Nationsbank (1998) and recently FleetBoston (2003).



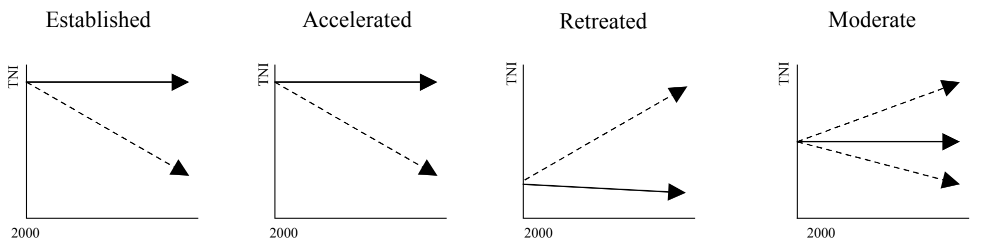
The internationalization strategy of Bank of America has been *retreating*: after the foreign loan crises in the emerging markets in the early 1980s, the bank reassessed its foreign activities and shifed its focus from international activities to domestic activities. Foreign activities were divested to raise capital and/or domestic banking activities expanded, lowering the degree of internationalization.

- *1980 Financial crisis*. The asset seeking strategy of the 1970s and early 1980s had major flaws: operating expenses were hard to control, management had difficulties coping with the organization, and the foreign expansion turned out to be over-ambitious, having lent considerably to LDC's.
- *1980s. Foreign retreat, domestic restructuring*. Large losses between 1985 and 1987 forced a restructuring program with three goals. First, the retail and commercial banking units were strengthened, since BankAmerica had an extensive distribution network. Second, poorly performing lending activities were divested or cut back. Third, international activities were cut back. The number of European staff decreased from 7,500 to 1,700 in 1994, the number of Latin American countries it was active in decreased from 20 to 6. After cutting costs and restructuring bad loans, the bank returned to profit in 1988 and steadily increased its financial performance.
- *1992-2003: Increasing domestic expansion*. In 1990 the operations of Bank of America were expanded into seven other states by acquiring thrifts. In acquiring Security Pacific, Bank of America increased its position in California, increasing total assets by 56%. The bank acquired additional banks and mortgage businesses, and in 1994 Continental Bank was bought. Bank of America and Nationsbank announced their merger in 1998.

2000 renewed international orientation? The Russian crisis, and the merger activities between Nationsbank and BankAmerica led the bank in early 1999 to restructure its foreign activities, selling its private banking operations in Europe and Asia to UBS, and its consumer banking business in Asia to ABN Amro. Simultaneously, it announced that it planned to expand its securities activities in at home as well as in the United Kingdom, attempting to build it up internally.

From the shareholder point of view, which banks' internationalization strategies are best positioned for the near future? Specifically, *Accelerating* banks have increased their foreign bank activities at the end of the 1990s to such an extent that these banks have become comparable in their degree of internationalization to *Established* banks throughout the 1980s and 1990s. Given the relative successful (shareholder) performance of *Established* banks, what banks with *Accelerating* strategies are likely to emulate the success of *Established* banks? To answer these questions the possible future courses of realized internationalization strategies (*Moderate, Established, Accelerating, Retreating*)[1] are projected in Figure 9. For example, *Established* banks have a relatively high degree of internationalization; the solid line in the figure projects the current degree of internationalization into the future, assuming no fundamental change in the role of foreign activities in the bank. On the other hand, the dotted arrow shows a possible change in the degree of internationalization.

Figure 9. *Future directions of internationalization*



Note: degree of internationalization, assumption is stability from end of 2000 onwards

possible change in degree of internationalization

If past experience provides any guidance, then an investment in banks with realized *Established* and *Accelerating* strategies for the coming decade might be worthwhile, while investments in banks with *Retreating* and *Moderate* strategies should be considered with more caution.

- *Established internationalization strategies*
  Established banks (such as Citicorp, HSBC) have found a durable balance in the 1980s and 1990s between foreign and domestic bank activities. These banks have in common that their foreign bank activities are broadly based, branching out in investment banking, corporate finance as well as retail banking (consumer finance)

[1] The realized *Imploding* internationalization strategies are ignored here, this strategic type applies to only two

and asset management. Also, their foreign activities are geographically well diversified. *Established* banks have to maintain the right configuration to keep internationalization a relative profitable activity, or the bank might divest activities that do not contribute to the total profitability of the bank.

- *Accelerating internationalization strategies*
  Accelerating banks (examples are Deutsche Bank, ABN Amro, Credit Suisse, UBS, Santander) have increased their internationalization activities significantly during the 1990s and are at a position in the early years of the new millennium similar to *Established* and *Retreating* banks in the early 1980s. Either they have to find the right configuration to make internationalization a relative profitable activity, or the bank will divest activities because it has not found an opportunity for sustainable foreign profitability and refocus on domestic activities. In other words, *Accelerating* banks have to determine whether they soon will reach the stage of *Established* banks, or they have to reconsider their portfolio of foreign activities and become *Retreating* banks. In the past, both scenarios were rewarded by shareholders. This suggests a paradox: banks with *Accelerating* internationalization strategies have on average delivered the least shareholder return in the past but are best positioned to generate the most shareholder return in the near future.

  The strategic choice banks with *Accelerating* strategies have between developing either *Established* or *Retreating* strategies leads to the question which banks with *Accelerating* strategies have characteristics more similar to banks with *Established* strategies or more similar to *Retreating* strategies. In other words, what banks with *Accelerating* strategies are likely to evolve into *Retreating* strategies and what banks are likely to develop *Established* strategies?

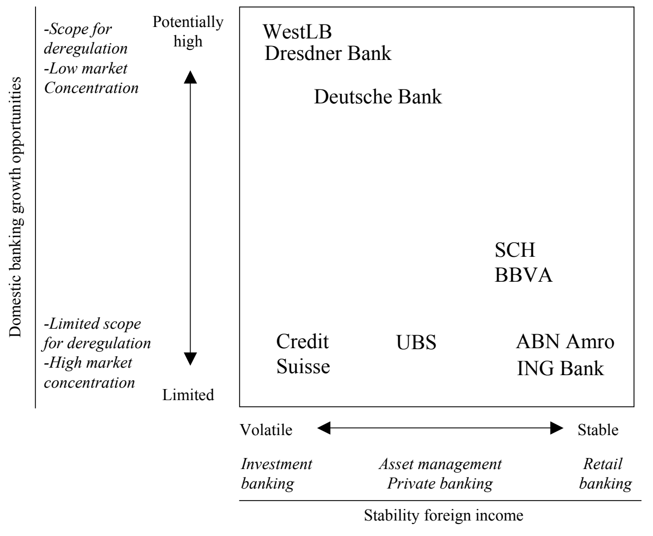
  Naturally any future scenario is highly conjectural but to answer this, two criterions are introduced. The case studies first indicate that when domestic growth opportunities increase, banks favor domestic growth over foreign bank growth. For most banks, the first priority is to maintain the (relative) domestic market position, as well as seizing the best opportunities to achieve profitability growth or efficiencies. Expansion of domestic banking markets (mostly triggered by regulatory changes) led to a decrease in internationalization of banks; this applied for American banks, English banks and also Japanese banks. Naturally, this criterion does not apply for banks with small and/or highly concentrated domestic banking markets, such as the Netherlands and Switzerland. Future domestic growth opportunities are however relevant for French and German banks where de-mutualization, and (further) abolishment of separation between different banking types in the country might be future events.

  Second, all major retreats from internationalization have been triggered by a financial crisis. While the timing of financial crises cannot be predicted as such, the banks that retreated the strongest or earliest were on average banks with large capital

banks and is therefore difficult to generalize.

market/investment banking operations. In short, banks with more stable foreign funding bases such as foreign retail banks or banks with more stable foreign fee income base such as asset management and private banking are probably more likely to whither economic and financial adverse conditions than banks with volatile foreign activities in capital market/investment banking. This will be used as the second criterion; both criterions suggest the following categorization of future development (Figure 10).

Figure 10. *Accelerating banks' sensitivity to domestic market developments, stability of foreign income*



German banks with *Accelerating* strategies (Dresdner Bank, WestDeutsche Landesbank and Deutsche Bank) are more likely to retreat from foreign bank activities and eventually develop *Retreating* internationalization strategies. Their potential domestic growth opportunities are relatively large; when regulation permits these banks might prefer domestic banking growth opportunities over foreign banking growth opportunities. Also, these banks are more sensitive to external shocks such as financial crises due to their high dependency on (foreign) capital market activities. On the other hand, the Swiss, Dutch and Spanish banks have no domestic growth opportunities; the Dutch banks ING and ABN Amro have acquired large stable funding bases (retail banking operations) outside the Netherlands. Credit Suisse and UBS have not acquired retail networks outside Switzerland; UBS has created a relatively stable source of foreign income through asset management and private banking while Credit Suisse has more focused on expanding in investment banking. In other words, ING, ABN Amro, UBS, Santander and BBVA may be the banks who have developed and expanded internationalization activities closest to banks with *Established* internationalization strategies.

- *Retreating internationalization strategies*
  Similar to *Accelerating* banks, Banks with *Retreating* internationalization have two strategic alternatives: either to maintain or further decrease internationalization activities, or to increase them again (*re-internationalization)*. Lloyds TSB, Barclays and JP Morgan Chase have re-internationalized or planned to do so. Lloyds TSB has publicly contemplated increasing their internationalization activities in 2000, while Barclays has re-internationalized in Spain but on a more subdued scale than its European and American expansion activities in the 1980s. Chase decreased its foreign bank activities since the mid 1980s but effectively re-internationalized when it acquired J.P. Morgan in 2000 which had more than half its operations outside the United States. Royal Bank of Scotland also (re-) internationalized by acquiring National Westminster. National Westminster decreased its foreign bank activities in the 1990s; after the acquisition in March 2000 Royal Bank of Scotland developed a specialized internationalization strategy, expanding its United States retail branch network with a series of modest acquisitions and developing foreign distribution channels for motor insurance activities.

  The re-internationalization of Barclays or J.P.MorganChase is probably not a repetition of the internationalization activities in the 1980s. Compared to earlier periods, the banks have shown a strong focus on domestic banking activities. Also, bank capital has become scarcer than in the 1980s. At the end of 2003 the proposed structure and implementation of Basle II introduced a more sophisticated regulatory framework for banks and their capital. Whichever structure or implementation route is chosen, the allocation of capital to foreign bank activities is bound to be more closely monitored and evaluated than in the 1980s. Some internationalization incentives remain the same; the announced re-internationalization of Lloyds TSB could be interpreted as seeking growth opportunies after domestic expansion activities failed, when Lloyds TSB was not allowed to acquire Abbey National in 2000. The other *Retreating* banks have not re-internationalized; Bank of America autonomously expanded investment banking operations in London but substantially reduced the relative role of its foreign operations when it acquired FleetBoston in 2003. For the retreated Japanese banks, the climate for re-internationalization has become more favorable but the banks have largely been engaged in domestic mergers to absorb the large write off of bad loans, increase profitability and regain solvency.

- *Moderate internationalization strategies*
  Finally, question marks surround the future shareholder returns of *Moderate* banks: they have the widest range of strategic options available to them, and are probably the most diverse bank group of realized strategies. However, most of the *Moderate* banks have as yet sought to increase their degree of internationalization. Fortis for example

has essentially stayed focused on the Benelux and Spain, consolidating and integrating its bank operations and striving for autonomous growth. Credit Agricole on the other boosted its foreign activities since its acquisition of wholesale bank Indosuez in 1994 but strengthened its domestic focus by acquiring Credit Agricole in 2002.

What road leads to a sustainable and equal profitability development of foreign and domestic banking activities? The next table summarizes the hypothesized changes in realized internationalization strategies for the near future. The number of banks with *Established* strategies will increase, so will the number of banks with *Retreating* internationalization strategies.

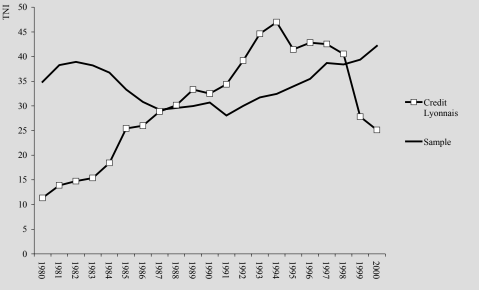
Table 3. *Possible changes in future internationalization of banks*

Change to	Change from: Established	Accelerating	Retreating	Moderate
Established	Tokyo-Mitsubishi HSBC Standard Chartered Citicorp BNP Paribas Societé Générale	ABN Amro ING Bank UBS Santander(1) BBVA		
Accelerating				
Retreating		Credit Suisse Deutsche Bank Dresdner Bank West LB HypoVereinsBank	Bank of America Mizuho(3) Lloyds TSB(4)	
Moderate			JPMorgan Chase Barclays Royal Bank of Scotland(5)	Fortis Rabobank Commerzbank Crédit Agricole

Note 1: The bank has been renamed SCH. Note 2: Credit Suisse could also be classified as retreating.
Note 3: Mizuho incorporates IBJ and Dai Ichi Kangyo. Note 4: Lloyds TSB announced a re-internationalization in 2000, this has not materialized between 2000 and 2003. Note 5: Royal Bank of Scotland acquired National Westminster in 2000, and continued its foreign banking activities.

Insert 9: Credit Lyonnais: imploding internationalization strategy

Crédit Lyonnais, a state owned bank, dramatically increased its internationalization efforts in the 1980s, aiming to become the largest diversified European bank and overtaking Deutsche Bank's role. A financial crisis eventually emerged because of poor management. The bank restructured with state aid, and eventually was acquired by Credit Agricole.



Credit Lyonnais experienced an *Imploding* internationalization strategy. After a financial crisis in the early 1990s, the bank reassessed its foreign activities and had to shift its focus from international activities to domestic activities. Foreign activities were divested to raise capital, lowering the degree of internationalization.

- *1980-1984: Broad international expansion.* The internationalization of Crédit Lyonnais was well underway since the 1970s, establishing a network in Latin America, Africa and for a short while the Middle East. Branches in the major financial centers were created, and capital market activities expanded.
- *1985-1993: Increased international expansion.* Crédit Lyonnais embraced a universal banking concept: while the bank aimed for an important role in the financing as well as control of industrial companies. It believed in the need to be present in European countries, either through internal growth or by buying foreign banks. The expansion of Crédit Lyonnais was directed by government; the bank expanded abroad to assist state-owned industrial firms as they sought to compete outside France. It acquired a score of banks and industrial holdings between 1989 and 1992 in Europe; this aggressive strategy proved to be a risky one after the economic slowdown in 1992. Industrial holdings and property loans generated heavy losses. Insufficiently controlled subsidiaries caused serious setbacks both in France and abroad. After a change of management, staff was cut, operations streamlined and assets sold. Mounting heavy losses forced the French government to rescue the bank, first in early 1994 and then in April 1995.
- *1994-2000: Restructuring, refocus and international exit.* The government provided financial assistance which probably worsened the situation, and the bank ran into further trouble in 1996. A financial restructuring plan was finally agreed on with the French government and approved by the European Commission in 1998. This plan included scheduling major sales of foreign assets as well as the privatization of the bank by October 1999. The public offering of shares took place in 1999, with Crédit Agricole controlling a 10% equity stake.

Regional integration: extension of the home market?

A large degree of foreign activities of European banks (as well as American banks) have taken place within European banking markets. Another implication to consider is then the consequence of regional integration such as the European Union, representing an economic and political extension of the home market and a regional uniformization of the regulatory regime. The European integration process accelerated in two periods, between 1988 and 1991 (in preparation of the Single Market) and between 1996 and 1999 (in preparation of the Eurozone). The economic integration programs liberalized capital markets, and the introduction of the Euro led to a convergence of monetary policies between the major EU countries. With European integration, will the extension of the home market imply similar high profitability as domestically, or should expansion in the Eurozone still be considered internationalization to a foreign country, with lower foreign performance than domestic as this study found?

Banks have dealt with European integration in several ways: pan-European strategies were formulated by National Westminster, Barclays, Deutsche Bank and Crédit Lyonnais in the 1980s. They built up a branch network in the major European cities, and acquired retail or private banks in European countries, mainly in Germany, France and Spain. In the 1990s, a new concept was introduced: the "second home market" in Europe. These were acquisitions of foreign banking activities with the expected benefits enjoyed domestically (such as a large depositor base). Banks who followed this strategy were ING with its 1997 acquisition of Belgian BBL or HSBC who acquired French CCF in 2000. If banks view Europe as an extension of their home market, then the findings of this study would suggest that this extension in general lowers overall profitability. Is this finding also valid for European banks internationalizing in the (integrated) European banking market?

Supporting the assumption that European integration extends the concept of home market are convergence of net interest margins in the Eurozone, the structural removal of regulatory barriers, and reduction of fluctuations in GDP growth because economic cycles in the Eurozone converge. These developments have in common that differences between "domestic" and "foreign" economies within the Eurozone decrease.

Outwardly, one might interpret the process of European integration for the banking markets as following the path taken by American banks since the mid 1990s, where ongoing deregulation of interstate banking has led to a natural extension of the home market. Deregulation of interstate banking in basically has created new markets with similar customers, introducing opportunities for increased efficiency and higher profitability. However, European integration cannot be compared to the banking deregulation in the United States.

There are two arguments that do not support the concept of an extension of the home market within Europe. First, potential efficiency advantages may be difficult to exploit. Consolidation of the banking market moves at different paces in different countries; European labor market are considered to be rigid implying that part of the cost-to-income ratio levels for banks in a country are structural, especially for labor intensive retail banking. In other words, efficiencies might be difficult to gain by foreign banking acquisitions in Europe. Second, fiscal policies with regard to savings and pensions are not harmonized. They determine to a large extent the growth of the savings pool and the opportunities to be had. A scenario could be that further European banking consolidation follows along these lines: Capital market activities in Europe are to a large extent consolidated; dominated by a few American and European banks for the region, with complementary dominant positions for country based banks. Consolidation in the European banking market is then directed at acquiring foreign retail banks. Capital markets are less influenced by local tastes than retail banks, whether this is by a branch network or a virtual network.

Financial systems and internationalization
Finally, what role do (changing) financial systems play in future internationalization of banks? On the basis of the relationship between internationalization of banks and financial development indicators, two country groups could be established: continental European countries and countries with the largest financial centers (the United States, the United Kingdom, and Japan). Table 4 shows the two groups.

Table 4. *Financial systems and realized internationalization strategies*

	United States	United Kingdom	Japan	France	Germany	Netherlands	Spain	Switzerland
Accelerating				Paribas	Deutsche Bank Dresdner Bank Hypo-Vereinsbank Westdeutsche Landesbank	ING Bank ABN Amro NMB Bank	BCH BBV Santander	Credit Suisse UBS
Moderate			IBJ	Agricole	Vereinsbank Commerzbank Bayerische Hypobank	Rabobank Fortis Amro	Argentaria	
Imploding		Midland		Credit Lyonnais				
Retreating	Chemical Banking Manufacturers Hanovers Bank of America Chase Manhattan	Barclays Lloyds TSB National Westminster	Mitsubishi Bank Dai Ichi Kangyo Sumitomo Bank					
Established	J.P.Morgan Citicorp	Standard Chartered HSBC	Tokyo-Mitsubishi Tokyo	BNP Societe Generale		ABN		SBC

Continental Europe

Largest financial centers/ capital markets

By and large, American, British and Japaneses banks tend to have banks with predominantly *Retreating* and *Established* strategies. On the other hand, continental European banks have shown predominantly *Moderate* and *Accelerating* banks. This does however not imply that *Retreating* and *Established* strategies are specific to market oriented financial systems (Japan is here the exception), or that *Moderate* and *Accelerating* are specific to bank oriented systems (the Netherlands and Switzerland are classified as market based).

Two parallel developments might take place that have similar consequences and are bound to interact closely in the near future. Viewed from top down, for most European countries the integration of the capital markets may eventually emulate characteristics of the United Kingdom, the United States and Japan, countries where the banks in the sample showed *Retreating* and *Established* internationalization strategies. Viewed from bottom up, banks who accelerated their internationalization activities are likely to enter a re-orientation phase to developed either *Established* or *Retreated* internationalization strategies.

The study has also found implications for the role of changing financial systems, but more on an individual bank level. An example in this case is Deutsche bank. Its expansion in the 1990s in capital market activities in the United States and the United Kingdom was financed by equity issues. The bank increased its dependency on shareholders, and in the process positioned itself to American and Swiss competitors. Transparence and comparability with other banks was improved by separating the differing characteristic of a German bank, its industrial shareholdings, were eventually moved towards a different holding, clearly indicating that these were for sale. In other words, internationalization might create its own momentum to change bank based systems to market based systems.

There is also a cross over from bank oriented systems to market oriented systems though. American banks have moved from a specialized bank model in the 1970s to a European universal banking model in the 1980s and 1990s; and started to move towards the bank assurance model in the late 1990s, with the Travelers-Citicorp merger. If this trend were to be followed by more banks, it might support the earlier implication that domestic growth opportunities for American banks are further enlarged, shifting focus further from international to domestic activities, reducing the degree of internationalization.

Banking Across Borders

Since the 1980s, many of the largest banks in the world have increased their foreign activities dramatically. Currently, international capital and banking markets are more intertwined than ever, making a correct assessment of the costs and benefits of internationalization a serious matter for bank management, regulators as well as shareholders. This study contributes to a better understanding of the internationalization of banks. The study appraises to what extent banks internationalized because of internal, institutional or sectoral incentives. The internationalization strategies of the world's largest banks in eight countries between 1980 and 2000 are described and analyzed. These banks have dominated the internationalization of banking. Strategic commonalities and differences are identified on the basis of a strategic typology developed for this study.

The central research question deals with the effectiveness of internationalization. Using a self constructed internationalization database, differences are estimated between foreign and domestic performance, and the effects on shareholder return. A higher degree of internationalization has on average not contributed to bank performance. Similarly, most shareholders have not gained by more internationalization.

The study also tries to address the future outlook for international banking - how will the internationalization of banks proceed? The potential for further financial deregulation in the home country, uncertainty on the international regulatory regime, and the business mix of the bank are likely drivers for the bank's future internationalization strategy and profitability enhancement.

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