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Organizational forms of foreign direct investment in banking sector of Serbia[3]

Abstract: Globalization and liberalization of financial markets led to a dramatic increase in the presence of foreign banks in many countries, especially in transitional ones. For small open economies, without adequate sources of domestic savings, foreign direct investment and a healthy financial system that has capacity to support these investments are of vital importance for creating preconditions for future economic growth. In the last decade foreign direct investment in banking sector of Serbia, have changed the banking landscape and triggered important changes in the banking system structure. This paper presents the discussion about the organizational forms of banks related to the entry of new banking capital in the form of foreign direct investments. There are many reasons and theories related to the internationalization of banking sector. Following the decision to entry a new foreign market, each bank must choose organizational form. Throughout history, there have been various solutions that have been applied by banks in terms of their organizational form for the expansion. Usually three factors are considering when determining form of organizing. First factor is type and volume of bank business operations, second is the need for employing resources, and the third is regulatory framework. In economic theory, banks can be organized as correspondent banking, representative offices, agencies, subsidiaries and branches, while in Serbia this choice is narrowed.

Key words: foreign direct investments, banking, organizational form.

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1. Introduction

During the 1990s foreign direct investment (FDI) became a largest source of external finance for many small open economies, developing countries without adequate sources of domestic savings. With delay of one decade to other transitional countries, Serbia started to be net recipient of foreign direct investment. Process of internationalization as a part of economic globalization brought foreign direct investments into Serbian banking and financial market. This inflow did not just bring growth, development and new capital, but also new technologies, marketing, staff training, management and organizational skills in banking sector. The stimulus in the form of mentioned new resources in the banking sector is often reflected in the real sector of economy. Nevertheless, a financial system needs to be stable, strong and has to have capacity to support inflows. This way it can create a desirable environment for investment in the economy of a country.

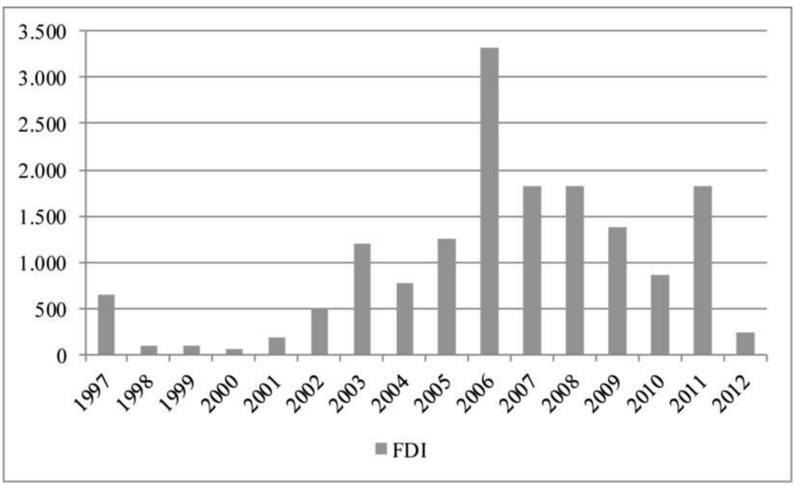
In practice and in literature two terms – choice of organizational form and a mode of entering into new market – are often misinterpret and are often used interchangeably. Organizational form involves the legal form of the business, and in the theory can be in the form of agencies, representative offices, branches and subsidiaries. Of course, organizational form mostly depends on host country regulation. The modalities are related to the type of investment and ownership. Banks may enter into new markets in the form of Greenfield "*de novo*" investments and or by merging or acquiring a domestic bank. Another alternative to these modalities are joint ventures.

This paper analyses the organizational forms of foreign direct investments of the banking sector in Serbia. After this introduction, second part explains purpose of foreign direct investments in banking for the community and also elaborates advantages and disadvantages of foreign direct investments. Third part discusses about organizational forms in banking sector. Last part in the form of concluding observations, summarizes the results of the research.

2. Foreign direct investment in banking sector

Since the 1990s there has been a tendency in the world towards the change of capital flows, i.e. its redirection from developed countries towards markets of developing countries (primarily towards China), and somewhat towards countries in transition (primarily Russia) (Ljumović, Jovanović, 2010). However recent economic crisis changed the patterns of FDI inflows. During the 2012 inflow to transitional countries declined by 9% compared to previous year. Also the structure of these inflows changed. Flows to South-East Europe almost halved, while those to Commonwealth of Independent States (CIS) countries remained relatively resilient (WIR, 2013). However, the projections and expectations for foreign direct investments in developing and transitional countries are showing that it is expected that these investments will still remain to be a very significant channel for economy financing. According to UNCTAD statistics, total capital influx through foreign direct investments in transition countries increased in the period 1990-2012 from negligible 0.03% to 6.5%. In Serbia total foreign direct investment inflow reached peak in pre-crisis period in 2006, while during the recent financial crisis the amount decreased drastically (Figure 1).

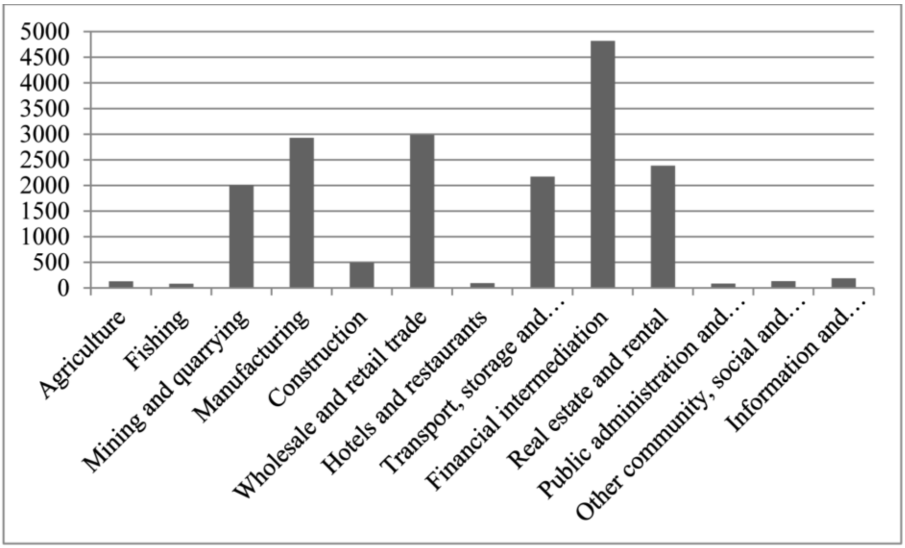
Figure 1. Total FDI in Serbia (in millions of Euros)



Source: National Bank of Serbia.

Majority of foreign direct investments in period 2004-2012 were focused towards financial intermediation and mostly to banks. Figure 2 represents cumulative FDI in Serbia in period 2004-20012 by industry, where certain industries with small share were left out from the graph. Figure 2 shows that financial intermediation had the highest inflow of FDI related to other presented industries. The largest FDI in banking in Serbia were Intesa Saopaolo (508 million euro), OTP bank (166 million euro) and Alpha bank (152 million euro).

Figure 2. FDI in Serbia, cumulative 2004-2012 by industry (mill euros)



Source: National Bank of Serbia.

Table 1 shows the list of all FDI in banking sector of Serbia in the period 2001-2013 with year and mode of entry presented. If a bank entered via acquisition acquired entity is stated. Also, there are comments if another organizational change happened. 21 FDI from 11 countries happened in this period, where Greece and Austria were majority contributors, followed by France and Italy. Banks entered Serbian banking market through FDI by buying existing bank or as a Greenfield investment. This was determined by the regulatory policy of monetary authorities, since the regulation in the period 2002-2008 allowed the entry of foreign banks only through merger or acquisition of domestic banks. Seven banks entered the banking market via Greenfield: Raiffeisen, Societe Generale, Alpha bank, Unicredit bank, Procredit, Moscow bank (from 13 September Moscow bank changed name into VTB bank), and Opportunity bank. Other banks entered the market by acquiring one or more domestic banks. Many of foreign banks that operate in Serbia now have internationalized their business not only in Serbia, but also in surrounding countries. For instance, National Bank of Greece bought Finansbank in Turkey, in Serbia Vojvodjanska banka, in Romania Banca Romaneasca, and a bank in Bulgaria. Eurobank bought in Turkey Tekfenbank, in Bulgaria DZI Bank and in Serbia Postbank and Naconalna Štedionica bank. (UNCTAD, 2008, p. 32, according to Jovanović – Obradović (2013), p. 46).

Table 1. List of FDI in banking sector of Serbia

Country		Bank name	Year of entrance	Mode of entrance	Former entity	Comment
Austria	1	Erste bank	2005	Acquisition	Novosadska bank	
	2	Hypo Alpe-Adria-bank	2002	Acquisition	Depozitno kreditna bank	
	3	Raiffeisen	2001	Greenfield	/	
Belgium	4	KBC bank	2007	Acquisition	A bank	
France	5	Credit Agricole	2005	Acquisition	Meridian bank	
	6	Findomestic BNP Paribas Group	2006	Acquisition	Nova bank	
	7	Société Gen	1991	Greenfield	/	
Greece	8	Alpha bank	2002	Greenfield	/	later acquired Jubank in the process of privatization
	9	Eurobank EFG	2003	Acquisition	Postbank	later acquired Nacionalna stedionica in the process of privatization
	10	Piraeus bank	2005	Acquisition	Atlas bank	

Country		Bank name	Year of entrance	Mode of entrance	Former entity	Comment
Greece	11	NBG – Vojvodjanska bank	2006	Acquisition	Vojvodjanska bank	
Italy	12	Banca Intesa	2005	Acquisition	Delta bank	
	13	Unicredit Bank	2001	Greenfield	/	former HVB bank
Cyprus	14	Marfin Bank	2006	Acquisition	Centrobank	
Hungary	15	OTP bank	2007	Acquisition	Niška, Kulsa and Zepter bank	
Germany	16	ProCredit	2001	Greenfield	/	former Microfnance bank
Russia	17	Moscow bank	2008	Greenfield	/	
	18	VolksBank – Sberbank	2012	Acquisition		2003 Volks bank acquired Trust bank
USA	19	Opportunity bank	2002	Greenfield		
Slovenia	20	KBM	2010	Acquisition	Credy bank	
	21	NLB	2004	Acquisition	Continental bank	In 2008 merged with NLB NHB bank

Source: Ljumović (2011) and official web pages of mentioned banks.

2.1. FDI in Serbia – theorethical perspective

In order to analyse FDI in Serbia from theoretical perspective, we will use Dunning OLI model (for detail on this look in Marinković et al, 2011, pp. 507-508). Dunning (2008, pp. 68-78 and 157-183) observes FDI in relation to their purpose in the community and proposes the classification of investments as natural resource seeking, market seeking, efficiency seeking, strategic asset seeking and other motives (escape, support and passive investments).

Foreign direct investments in form of *natural resource seeking* are concentrated on the extraction of raw materials from the host country and their sales in the global market. *Market seeking investments* are those that have invested in creating products and services exclusively and specifically for the market in which the company invested. In the case of market seeking investments, parent company estimates that the only cost-effective or possible way is to physically be present in the market. It is more cost effective to be a part of the local market, than to export or give licenses and franchises to domestic producers. Looking at the historical horizon of occurrence the main reason for this type of market entry is the ban on the import of foreign products. *Efficiency seeking investments* are restructuring or expansion of existing businesses in order to take advantage of global competitive advantages of the investing company. In contrast to the market seeking investments, investing company supplies resources to its affiliation including human, organizational and technology, but directs the company towards international way of doing business. Efficiency seeking investments can arise only in cases where there is free trade between countries. Investments in EU accessing countries had these characteristics to a large extent. The growth rates of the accession countries are at twice the EU average and low wages, below the EU average, even when adjusted for differences in productivity have undoubtedly been attractive. The main idea behind *strategic assets seeking* investments is the significance of the so-called "specific assets". Investor takes control over the local company in order to approach and use certain values that cannot be obtained in the home market. Usually this is done in order to promote long-term strategic objectives, especially that of sustaining or advancing global competitiveness.

For the Serbian banking market FDI had mixture characteristic of the market seeking and efficiency seeking investments. Market orientation was manifested as a desire to corner the market and attract a significant number of clients. The entry of foreign banks was limited to the establishment of the subsidiary as a separate legal entity (in the EU on the basis of a single passport banks that have a license to work in one country can operate without restrictions throughout the EU) and this type of limit set by the central bank is considered as limiting factor. On the other hand, the banks established by non-residents have contributed to improving the efficiency of purchased banks, investing in new technologies, information systems and human resources.

2.2. FDI pro et contra

With respect to stability of financial markets in transition countries, foreign direct investment have a positive influence not only on stability of financial markets, but also on the integration of local markets into global, allowing access to cheaper funds from the global market through the home bank. In the beginning of market liberalization, developing countries are scarce in the capital because their economy and population were exhausted for years. These countries need capital which will create opportunities for further allocation of funds from the domestic market. Increasing the volume of international monetary flows as a direct result of globalization significantly improves the allocation of worldwide savings. It is well known that over the past 20 years the inflow of capital in various forms of foreign direct investment in transition economies was large (for details look in Ljumović and Jovanović, 2010). In conditions of meagre savings base in developing and transitional countries, these countries have to get engage in the process of globalization in order to be able to use the surpluses generated at the global level.

Beside all the positive facts related to FDI, there are certain problems that may emerge. There is a real possibility that there is a discrepancy between the interests of the foreign acquirer and the financial regulatory authorities of the host country. Every coin has two sides and on one side there is a stable financial system and capital inflows that are essential for economic growth so the state must be focused on long-term investments and long-term growth and stability. On the other hand banks are usually oriented to global risks and the higher level of profit. Asian crisis is a good example, because the volume of long-term investments that would ensure continual growth was not sufficient. At the beginning of the crisis a large amount of short-term speculative capital was very quickly withdrawn from the market, leaving it without a source of liquidity.

Another problem can occur in the form of conflicting supervisory coordination between the host and the home country of acquirer. When a large part of the banking sector in foreign ownership (this is the case in almost all transition countries) the stability of the financial sector depends on efficiency and knowledge of foreign bank management. Also the inadequacy or lack of transparency in reporting, the loss of information on the domestic financial system and legislation can be a problem and an obstacle for foreign direct investment (Ljumović, 2011).

3. Organizational forms in banking

As we could see from the previous section there are many reasons and theories related to the FDI in banking. Following the decision to the entry new market each bank must choose organizational form and entry strategy. Throughout history there have been various solutions that banks applied in terms of their organizational form of the expansion, where each structure gives different advantages and disadvantages. However not all forms are available at global level and much depends on the particular host nation regulations, since in some countries particular organizational forms may be prohibited. From most simple and less foreign involved the organizational form in banking are: correspondent banking, representative offices, agencies, branches and subsidiaries (Curry at al, 2003, p. 39).

First and foremost solution is correspondent relationships between banks. According to its structure this is not a type of foreign direct investment, but we will elaborate it because of the chronology and its current importance. These reciprocal relations are established between the two banks in order to meet the needs of international trade in goods and services, payments and capital flows. One bank in favour of another bank conducts finance transactions and other activities, and thus to another bank that is not present in this market carries out its obligations and obligations of its customers. A correspondent bank can conduct business transactions, accept deposits and gather documents on behalf of the other financial institution, depending on the home country regulative. These banks are usually used by domestic banks in order to service transactions originating in foreign countries and act as a domestic bank's agent abroad, because domestic bank may have limited access to foreign financial markets, and cannot service its client accounts without opening up a branch in another country. Actual thing about correspondent banking is that it plays an important role in the processing of payment transactions in euro, as it ensures payments flow between credit institutions, as well as allowing indirect access to payment systems, thereby representing an important link in the payment chain (ECB, 2013). European Central Bank is conducting surveys on correspondent banking business since 1999 in order to monitor its importance, size and development. The participants in survey are the largest banks in terms of general business size (balance sheet, staff numbers and the size of the branch network) that are very active in providing payment services. The results of the eighth correspondent banking survey (2013) confirmed that correspondent banking remains an important channel for effecting payments in euro where both the number and value of payments processed by correspondent banks were very large. For instance, the total daily turnover of euro transactions settled through correspondent banking arrangements averaged more than €1.1 trillion (ECB, 2013). Prior to the establishment of correspondent relations it is important to gather reliable, accurate and complete information about the corresponding bank, in order to find appropriate partners. This is exactly the reason why the British banks were not able to establish a correspondent relationship in the early stages of multinational banking. Poorly developed financial markets and the lack of respectable institutions reliable for establishing these relations were the main limiting factor. Therefore, new organizational forms emerge, where physical presence is necessary.

Representative offices have limited function and can engage in only a small number of activities. The important role of these organizational forms and the most common purpose of establishing them is collecting information for the parent bank and its customers. Often, representative offices are formed before establishment of branches in order to test the market and assess the real advantages and disadvantages. Law on Banks (Official Gazette 107/ 05, Article 2 , paragraph 4) defines representative offices in Serbia as an organisational part of a bank abroad or a foreign bank in the Republic of Serbia, without legal personality, which does not carry out activities that may be carried out by a bank, but activities related to market research and which represents the bank and/or the foreign bank it constitutes part of. According to the newest data from NBS, in Februar 2013 there were 7 representative offices operating in Serbia: Akb "Euroaxis Banka", Moskva, Atlas Banka Ad Podgorica, Bank of Cyprus Public Company Limited, Citibank N.A., South Dakota, Commerzbank AG., Frankfurt/Main, Deutsche Bank Aktiengesellschaft, Frankfurt/Main and Halk Bank Ad Skopje (source: http://www.nbs.rs/internet/cirilica/50/50_2/index.html).

Agencies are more complex but still relatively modest organizational form that can perform a wider range of tasks. Depending on the country's legislation the range of operation that agencies can perform varies. Agencies perform certain banking activities according to contract for the agreed commission and their most important role is to establish trade finance. The resources they use come from the parent bank. This organizational form is usually established when the volume of trade between the two countries is high and where establishing branch is not cost-effective. A possibility for establishment of agencies mostly depends on a host country banking legislative. In Serbia, agencies are not recognized by Law on banks.

The first two forms of foreign direct investments, representative offices and agencies, are often linked to the theory that explains bank multinationalization by motive known as follow clients. In this case the foreign banks establish a representative office or agency that will be focused on high profit specialized services which they provide to a limited range of clients (Miklaszewska and Mikolajczyk, 2009, p. 4).

Branch or branches do not have legal status and are integrated part of the parent (foreign) bank. Usually they provide a full range of services, from receiving deposits and lending to households and businesses through transactions in foreign exchange markets, trade finance and all the other bank operation that Law on bank in host county allows them to do. Branches that are established in a foreign country legally are integrated with the parent company and because of that fact they are subject to regulations of the country that the parent bank in registered in. By adopting single passport in the EU, banks licensed to operate in any EU country can establish branches across EU, without establishing a separate legal entity. Branch is obliged to operate under the laws of their home country but also to respect the laws of the country in which branch is established (host country). According to Law on banks in Republic of Serbia c of Serbia (Law on banks, Official Gazette 107/ 05, Article 2 , paragraph 3) branch is defined as organisational part of a bank without legal personality, which performs activities that a bank may carry out in accordance with this Law. The same law regulates establishing branches and representative offices of domestic banks in foreign country and the opening of the representative office in Serbia. These provisions do not regulate the establishment of foreign bank branches in Serbia, but the branch is considered as an organizational unit of the bank which was established and licensed to work in Serbia. Banking professionals rated this as the lack of domestic legislation (Marinkovic, 2008).

Subsidiaries can perform all banking operation that they are allowed by law. Their primary goal is conquering domestic market and they compete with domestic banks and their products and services. Subsidiaries are legally separated from the parent bank, have their own capital and independently of the parent bank take responsibility and consequences in the event of bankruptcy. Identically in case of bankruptcy of the parent bank the consequences should not be transferred to a subsidiary. Since it is a stand-alone business entity they need a license to operate issued by the regulatory body of the host country. However, although the subsidiary operates as an independent bank, it is majority -owned (not rarely 100%) by the parent bank. Due to these facts the parent bank retains control over important strategic decisions. Except in the legal form, the difference between branch and subsidiary is in the organization. While subsidiaries are trying to operate as domestic banks and their business is adjusted to the domestic market the activities of branches are largely associated with the parent bank and their business is much more similar to the business of the parent bank. There is a difference in the way of raising financial resources. Branches rely on resources of the parent bank and it is their primary source while subsidiaries acquire a significant amount of resources in the domestic markets. The results obtained in the research by Goddard et al (2007) and Cerruti et al (2007) emphasize the subsidiary as the dominant organization form of international bank activities even in developed countries, indicating that there are still significant barriers to global integration of markets. Also, Marinkovic (2008) points out to the fact that bank subsidiary is not completely autonomous organization, but part of a larger system of the parent bank holding company with an internationally diversified portfolio (Marinkovic, 2008, p. 91).

In addition to these organizational forms, there are some specific forms such as consortium bank, Edge Act Corporation, etc. A consortium bank is a joint venture bank separately incorporated and owned by two or more banks, usually situated in different countries. Edge Act Corporations are organizational forms unique to the United States. According to an amendment of Section 25 of the US Federal Reserve Act, they are authorized to engage in lending and deposit-taking activities connected with international or foreign business outside their state of incorporation in the United States.

As we could see so far, banks can choose between different forms. However, they use certain criteria when opting for one of the form (Curry et al, 2003). The primary factor for determining the organizational form is the type and volume of business in a foreign country. Depending on the scope and type of activities that the bank wants to establish, it opts for one of the possible organization form. If the bank does not have needs for physical presence it will establish a correspondent relationship with a local bank. As bank level of operations increases organizational form will change and evolve. Second factor of choice for organizational form are necessary resources which are inseparable from the type and volume of business and are defined according to them. Needs for human, financial and other resources are the least in correspondent relationships, while the costs of establishing subsidiaries and branches require biggest financial investment.

The limiting factor in the choice of organizational form may be regulatory and legal framework of the host country. In some cases (UK and Switzerland) entry of banks is possible only on the principle of reciprocity. There is also the question of licensing, minimum required capital, tax issues, and many more.

4. Concludig remarks

From the nineties the general tendency in the world is the change in capital flows or its direction from developed countries to emerging markets and transition economies. The main reasons for moving the focus of the world economy includes significantly higher growth rates in less developed countries than in the developed world, increasing economic and political stability of undeveloped countries and the creation of institutional prerequisites and framework for the banking sector. Serbia as compared to other countries in the region has a ten-year delay for the tendency toward globalization and transition. Foreign direct investments in banking sector should provide the ability to integrate into the global flows of capital, in order to obtain resources at lower-cost. The logical consequence was the entry of foreign banks, namely 22 of them, some of which have already disappeared, and some blended into the larger organizational structure at the global level.

A type of organizational form foreign bank chooses to implement is not one side choice. A set of economic and legal circumstances in home and host countries and an individual bank internationalization strategy are most important determinants of deciding on organizational form. In most cases host nation regulation is the major determinant of the organizational form adopted by a multinational bank. On the other side, the regulation can be incentive for banking internationalization and determining factor when deciding about host country. Individual bank internationalization strategy is of great importance, where every bank individually is driven by factors such as type and volume of foreign business, resource requirements and set of other factors. However, even if branches are defined as legal entities dependent on parent bank several researches confirm that subsidiaries as the dominant organization form of international bank activities indicating that it is more likely to enter retail markets and establish large local networks by a subsidiery. Also this implicates that there are still significant barriers to global integration of markets.

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MODALITETI REALIZACIJE STRANIH DIREKTNIH INVESTICIJA U BANKARSKOM SEKTORU SRBIJE

Apstrakt: Globalizacija i liberalizacija finansijskih tržišta je dovela do dramatičnog povećanja prisustva stranih banaka u mnogim zemljama, pogotovu u zemljama u tranziciji. Za male otvorene privrede bez odgovarajučih izvora domaće štednje, direktne strane investicije i zdrav finansijski sistem koji ima mogućnost da podrži ove investicije od vitalnog značaja su za stvaranje preduslova za budući ekonomski rast. U poslednjoj deceniji, direktne strane investicije u bankarskom sektoru Srbije su promenile bankarski pejzaž i izazvale značajne promene u sturkturi bankarskog sistema. U članku su razmatrani organizacioni oblici banaka vezanim za ulazak novog bankarskog kapitala u formi direktnih stranih investicija. Postoje mnogi razlozi i teorije vezani za internacionalizaciju bankarskog sektora. Nakon odluke da se pojavi na novom stranom tržištu svaka banka mora izabrati organizacionu formu. Tokom istorije bilo je različitih rešenja koje su banke primenjivale u pogledu svoje organizacione forme u cilju njiove ekspanzije. Obično postoje tri faktora koja se razmatraju kada se donosi odluka o formi orgnizovanja. Prvi faktor je tip i obim bankaraskog poslovanja, druge je potreba za korišćenjem sredstava i trećii je regulatorni okvir. U ekonomskoj teoriji banke se mogu orgaizovati kao oblik korespondentskog bankarastva, predstavništva, agencije, podružnice i filijale, mada je u Srbiji ovaj izbor sužen.

Ključne reči: direktne strane investicije, bankarstvo, organizaciona forma.