

LOCATION DECISIONS OF ITALIAN BANKS: DRIVERS OF EXPANSION INTO EMERGING AND TRANSITION ECONOMIES¹

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Introduction

The foreign presence in economic activities located in emerging and transition countries has been broadening in recent years. FDI inflows, estimated at the record level of 410US\$bn in 2006, are now the largest single source of external finance in many developing countries. For long time, economists have focused their analyses on real FDI. But as internationally active banks began to play a significant, in some cases dominant, role in emerging markets, FDI in financial sector have started attracting the attention of researchers.

In gradually transforming the nature of their involvement, from cross border lending to local business and capital markets activities, banks have moved the focus from “interest-earning” to “fee-based” business lines². This shift has supported the development of local markets, offering, at the same time, additional business opportunities to foreign banks. Thus, despite the fairly recent and costly experience of banking crises, the interest in foreign banking has never diminished substantially.

On the contrary, financial sector FDI have been prompted, in most cases, by the opening of banking sectors to foreign participation as local Authorities sought to recapitalize and spur efficiency improvements, in the aftermath of the financial distress.

In the 90's, the break up of the Soviet Union fostered the entry of foreign banks into Central and Eastern Europe leading to foreign ownership often in excess of 80 percent of local system's assets (see Baudino et al. 2004 and Table 3 below). Banking sector liberalizations in Latin America have produced similar outcomes. In contrast, total foreign-owned assets have substantially reduced their share in several African countries, especially the poorest one. As pointed out by De Nicolò et al. (2004) the concentration of international banking activities in medium and high-income countries is becoming a stylized fact and it may well be determined by risk-returns considerations or by the presence of some kind of competitive advantage (Van Horen, 2007).

Nowadays, policymakers of still protected countries are under substantial pressure to open their banking markets. Recently India's government promised greater opening of its banking sector by 2009, and the Chinese government has been selling equity stakes in some of the largest domestic banks to foreign investors. Even less integrated economies, such as Vietnam and Libya, are currently preparing strategies for opening their banking sectors to foreign capital and competition.

¹ All findings, interpretation and conclusions expressed here are entirely those of the author and do not necessarily reflect the views of Intesa Sanpaolo. I am grateful to many colleagues at the bank for providing valuable information on issues related to the topic of the paper. I would like to thank Gregorio De Felice and Zeno Rotondi for supporting my involvement in this research. Finally, I wish to thank Nijlte Van Horen for kindly reply to my email requests. This paper is forthcoming on the Fondazione Rosselli “XII Annual Report on the Italian Financial System”.

² Actually, according to the OECD Bank Profitability Report 2005, the majority of OECD banks generate around forty percent of their global revenues from non interest activities.

Financial liberalizations and growing volumes of cross border banking activities have triggered a burgeoning literature on financial FDI, mainly focused on merits and pitfalls of foreign-bank presence – either from the perspective of risk management in the source country or the nature of spillovers in the host market (Goldberg 2004, Martinez Diaz 2007). Yet, little attention has been paid to how that presence is established, i.e. on the location choices of multinational Institutions.

Only recently, a strand of research has established a body of empirical evidence on determinants of location decisions. The role of market integration, large banking margins, banks' efficiency, banks' size, degree of internationalization as well as restrictions on banking activities at home are found to be positively related with the decision to enter a foreign market (Focarelli and Pozzolo, 2001, Buch and Lipponer, 2004, among others). Most investigations, however, analyse location decisions in OECD countries and do not take into consideration features that are peculiar to emerging economies (Buch and DeLong, 2004).

This paper aims to explain banks' location choices into emerging and transition markets from the perspective of the Italian banks.

Within the wave of internationalization of the Italian banking system, still on its way from the mid '90s, several factors have been influential. At the beginning, financial innovation and competition among regulatory and fiscal frameworks have prompted the expansion towards other industrialized countries or international financial centres. Lately, the development of trade linkages with many emerging economies has led Italian banks to actively expand their business lines towards them. So, after the rationalization occurred in 2002–2004, they have gradually augmented their presence in Central East Europe, the Balkan region, Asia and some Mediterranean countries whereas they appear less represented in Latin America.

There are at least two main reasons why studying the internationalization of the Italian banking industry is of some interest.

First, over the last decade organizational forms have changed significantly. Many branches or representative offices have been closed while, contemporaneously, subsidiaries have been acquired. This shift is coherent with the strategic move from wholesale activities, that IT progress allows to process directly at home, to retail banking, locally based and managed by owned foreign banks. Between January 2004 and December 2006, the number of Italian subsidiaries in EME has increased from a negligible figure to over 20 units. This spur is due not only to the merger of Unicredit with HypoVereinsbank but also to the acquisitions of foreign participations by other Italian banks.

Second, the internationalization of the Italian banking sector is undersized with respect to other major competitors. And this leaves room for interesting developments in the next future. Despite the presence in 41 emerging and transition economies³, the exposition of the Italian banking system towards them is still quite modest: only 85US\$bn (3% of the foreign claims of banks reporting to BIS) with respect to that of France (228US\$bn), UK

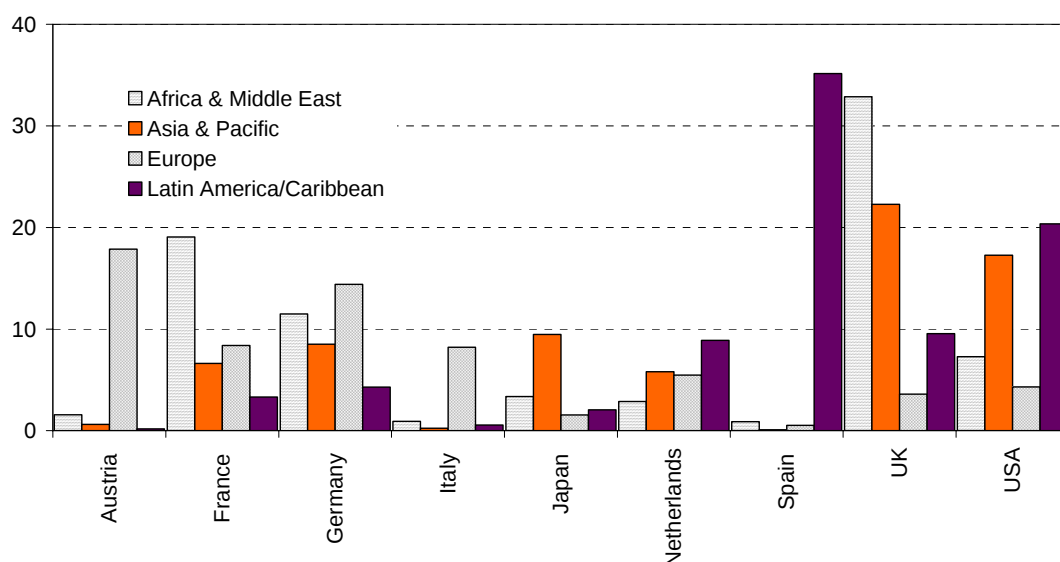
³ Italian Banking Association (ABI), "Internationalisation of the Italian banking system" data base available on ABI internet site. According to information provided by ABI, December 2006

(419US\$bn) and Germany (281US\$bn). But the ratio of Italian claims to EME to total foreign claims is, nonetheless, increasing: 21% at the end of September 2006 well above 10% attained in 1999.

When it comes to flows of banking FDI from Italy towards emerging and transition economies, it is worth noting that they have tripled their value during the last six years; a rise in line with the dynamics of total FDI into emerging banking sectors.

Unfortunately, the use of FDI time series⁴ in empirical works is prevented by a severe underestimation bias, as triangular operations – through foreign subsidiaries – are not accounted for.

FIGURE 1. Foreign claims of banks reporting at BIS by geographical area in percentage of regional totals (September 2006)



For some time, the lack of reliable data has inhibited econometric analyses on the geographical pattern of Italian financial FDI. This paper tries to fill this gap by using, as a proxy of FDI intensity, data on the entry mode into emerging and transition economies. The Italian Banking Association classifies the presence of Italian banks abroad according to the following organizational forms: desks, representative offices, branches and subsidiaries.

Entry decisions are analysed using ordered probit regressions that model organizational forms to be dependent on several “push” and “pull” factors. The former apply to home country/sector characteristics motivating internationally active banks to expand their operations abroad. The latter refer to host country/sector features that amplify the attractiveness of domestic markets.

With reference to the push factors, the parent bank’s size and the ratio of non-interest income to total income are allowed to influence entry choices. As pointed out in the introduction of the Rosselli Foundation’s “XI Annual Report on the Italian Financial System”

⁴ The Ufficio Italiano Cambi (UIC) collects banking FDI flows to 36 emerging markets on a monthly basis starting from 1997. They are available on the UIC internet site.

the relationship between banks and geo-economic factors has encouraged Italian financial institutions to follow their client in the delocalisation process. To assess the importance of defensive strategies we analyse whether the presence of Italian firms and the volume of trade linkages have a role in how and where banks operate.

Among the pull factors, to draw some inference about the impact of institutional features we control for quality of institutions. We even consider determinants that are rarely used in this type of analyses, such as quality of infrastructures and human capital. In addition, along with a selected number of macro variables, we allow risk factors to impinge on location decisions as they could alter the creditworthiness of domestic clients and the risk profile of the bank itself. The introduction of risk variables represents an innovation with respect to the extant literature on Italian foreign expansion strategies. In particular, we consider the EIU index of overall risk and the ratio of M2 to international reserve, as an early warning indicator of future banking distresses. Finally, we control for distance, effectiveness of entry barriers, efficiency and profitability of the host banking market.

The results validate most of the ex-ante expectations but pose some questions. Firstly, the “follow the client” strategy appears fairly important but clearly not sufficient to explain the actual broadening of foreign activities of Italian banks. Second, the lack of significance of the variables representing risk, apart from the M2 ratio, together with the relevance of the index of comparative advantage in institutional quality requires further analyses on the spillovers from international banking activities, especially during crisis periods (see Gallego et al., 2003). It appears, in fact, necessary that home and host supervisors develop robust information-sharing arrangements to enhance the overall degree of financial stability.

The rest of the paper is structured as follows. Section 1 presents a brief overview of the determinants of entry. Section 2 describes the recent empirical evidence. Section 3 presents the empirical strategy and the data and section 4 includes the results. The last section concludes the paper.

1. Determinants of entry

Internationally active banks can decide to enter a market via foreign direct investments (establishing desks, opening representative office or branches, acquiring or establishing ex novo a foreign bank) or to provide cross border services without settling down their own base abroad.

From a general point of view, location decisions on foreign markets have to be consistent with the optimization of the bank's portfolio. According to a simplified approach (Buch, 2000), optimal portfolio weights are function of expected excess returns on loans and deposits both at home and abroad and on the degree of risk aversion of the individual bank. This scheme fails, however, to account for other aspects related to FDI decisions (i.e. the cost of entry and exit a market) nor involves it the value of postponing FDI vs. the choice to continue to lend into foreign markets (Wezel, 2004).

Seminal works on banking FDI have borrowed their inspiration from the theoretical framework used in multinational corporations' studies. Hence, motives and advantages

behind expansion were, at first, focused on microeconomic and organizational aspects. Only recently, macroeconomic factors have been encompassed in the analysis, revealing their influential role on where and how banks operate abroad. Moreover, despite a clear prevalence of papers devoted to exploring the effect of banking FDI on the host country⁵, spillovers from international banking have been proven to be in both directions⁶.

Thus, in defining the analytical background for banking location choices, an eclectic framework, which accounts for features of host and source countries, along with macro and micro determinants, appears the proper way to proceed. In this section, various contributions are summarized according to the push–pull factors approach⁷ that considers both expected gains and costs related to location decisions.

1.1 Push factors

Push factors identify drivers of location, such as parent banks' features or home country's characteristics, that exert an effect on expected gains from foreign expansion strategies. Expected benefits generally relate to bank's comparative advantages, profitability and efficiency improvements – including the ability to provide services to home clients abroad – and risk diversification motives.

Exploiting the similarities with manufacturing FDI, *comparative advantages* are frequently cited as an important driver of entry decisions. This hypothesis expects foreign owned banks to have comparative advantages usually related to innovative products, advanced technologies, superior management quality and better access to an educated labour force. This is the case of many emerging economies, where the dominance of state owned banks is commonly associated to low competitive environments and high entry barriers.

*Informational advantages*⁸ are also very important. In point of fact, corporate clients should prefer to keep long lasting financial relationships only with a selected number of banks (Gray et al., 1981 and Casson, 1990) not to reveal sensitive information to other financial institutions. Asymmetries of information and comparative advantages are strictly intertwined in the “follow the client” motive that simply assumes that banks expand cross borders to serve the domestic customers who have gone abroad, the so called gravitational effect (Grubel 1977). This could be considered a defensive strategy necessary to maintain home market shares and to limit the lack of information about the customer when he/she transfers (partly or fully) the business in a foreign country (Farabullini et al., 2003 and Grubel, 1977). From a different perspective, informational asymmetries and costs enhance the role of banks also as promoters of home firms' internationalization. Banks, indeed, may provide services and knowledge of business environment that are valuable especially if host countries are culturally and institutionally very diverse from the source economy.

⁵ Claessens et al. (2001) for an overview.

⁶ See the collection of papers for the Working Group on Financial FDI of the BIS Committee of the Global Financial Stability System, published in March 2005 and 2004 available on the BIS internet site.

⁷ Albuquerque et al. (2002) analyse the push–pull approach on real FDI. A similar approach for total capital flow is implemented in Calvo et al. (1993).

⁸ Mody et al. (2003) formalize the role of informational costs on FDI.

Yet, despite the fact that FDI in banking are supposed to be horizontal rather than vertical, informational costs may render FDI and cross border services complements rather than substitutes (Buch and Lipponer 2004). As matter of fact, the presence of affiliates favours the collection of information useful also for cross border lending activities. This result stresses the role of informational costs that for banks are what transportation costs are for manufacturing firms, as pointed out by Petersen and Rajan (2002).

Just as the last wave of multinational banking has focused on retail activities, so defensive strategies have appeared no more sufficient to explain why and where banks expand abroad. De Paula (2002) finds that in Latin America the wave of acquisitions of majority, controlling, or minority stakes is difficult to understand only on the basis of the *follow your customer* motive, as foreign banks are deeply integrated in the local markets and serve mainly local clients⁹.

A third set of entry motives is associated with *efficiency and profitability* issues. Internationally active banks may take advantage of their presence on global capital markets to manage assets and liabilities in a more efficient way. In this context, banks' size and degree of internationalization – by favouring the exploitation of economies of scale and low transportation costs – enhance the profitability. In the same way, banks with large share of non-interest income are commonly assumed to be more innovative and therefore able to adopt aggressive strategies both at home and abroad (Focarelli and Pozzolo, 2005).

Geographical risk diversification is another factor that accounts for the banks' internationalization process. Theoretically, banks may diversify their income base if the correlation among business cycles across different countries is low. Similarly to the international portfolio diversification rationale, expanding in diverse markets across different regions might weather adverse cyclical effects in line with risk sharing aspects stressed by Amihud et al. (2002). Acharya et al. (2001) find that geographical diversification improves the risk-return trade-off for banks with low levels of risk. The reverse is true for banks characterized by high risk profiles. De Nicolò et al. (2004) find no conclusive evidence on the impact of bank's internationalization and reduction of risk on the basis of geographical diversification. On the contrary Meon and Weill (2005), providing evidence of the sub optimality of the loan portfolio of European banks in terms of geographical risk diversification, point out the existence of potential gains from inter-country mergers as business cycles are not perfectly correlated across EU member. Finally, Choi et al. (2006) analyse the risk-adjusted performance of internationally active banks in 40 countries and find that geographical diversification is likely to enhance their performance. This evidence is in line with the results of Buch et al. (2004a).

Of course, institutional characteristics of the home country are also appointed to affect foreign entry strategies. Regulatory and antitrust constraints as well as the competitive level

⁹ Seth et. al.(1998) studying the presence of foreign banks in USA suggest that the follow the customer motive is not sufficient to explain the phenomenon as most of the foreign banks do not provide credit to home clients. Similarly, Berger et al. (2003) find that nearly 66 per cent of the non-domestic multinationals firms in Europe choose a bank headquartered in the host nation and less than 20 per cent select a bank from their home nation. Miller and Parkhe (1999) find that especially for developing countries the follow the client motive is not sufficient to explain foreign bank activities.

of the national banking sector may transform expanding abroad policies into defensive strategies to preserve the status quo domestically (Clarke et al., 2003, Focarelli and Pozzolo, 2001, Mathieson and Roldos, 2001). This rationale may be binding if the *size of the source bank* is such that it could be hard to expand loan and deposit bases at home¹⁰. Focarelli and Pozzolo (2001) provide evidence that countries with more developed financial markets are more likely to be at the origin of cross border activities towards countries with high potential growth and less efficient banking sector. Regulations and degree of concentration in source countries are found to encourage European banks to expand abroad also by De Felice and Revoltella (2003).

1.2 Pull factors

The “pull approach” posits that host-country specific conditions might lure or discourage banking FDI. These factors encompass several institutional, socio-economic and political issues within the destination country and tend to highlight available business opportunities and pending political risks. Among others, the determinants commonly cited include: openness of the host country Authorities towards foreign bank entry, exchange rate risk, banking sector size, cultural (dis)similarity, financial regulation, quality of the financial supervisor, quality of law enforcement, protection of property rights, openness of the economy to international trade, fiscal and other non-tax incentives, political stability, monetary policies and external vulnerability indicators.

FDI decisions are generally supposed to show a positive correlation with a favourable *business climate*, that on its turn depends on several variables depicting the socio-economic and cultural environment. In this context, the quality of institutions is predicted to be critically important. However, both theoretically and empirically, the relation between institutions and FDI, in general, is not clear-cut. Mody et al. (2003) formalize a model where FDIs decrease as the transparency of institutions increases. On the contrary, Daude and Stein (2004) find that there exists a positive correlation between FDI and a broad set of indicators of institutional quality comprehensive of corruption, regulatory quality, government efficiency.

Differences among countries in terms of financial development and quality of institutions are still huge, despite financial services industries have been subject to similar trends worldwide. As for banking FDI, the cost of learning how to deal with different *legal and institutional frameworks* could be perceived as a barrier to entry. Mian (2006) argues that different corporate culture, legal environment, or regulatory framework can foster asymmetries in information so that the CEO of a foreign bank may encounter huge difficulties in designing policies specially suited for the emerging economies. Claessens and Van Horen (2007) suggest, moreover, that the absolute assessment of institutional quality does not matter as much as the *competitive advantage* with respect to competitors. For someone with no working experience in a corrupted environment it may be extremely difficult doing business according to transparency standards but the opposite is equally

¹⁰ Guillen and Tschoegel's (2000) study the Spanish banks' entry in Latin America find that market's saturation in Spain led banks to pursue a policy of asset seeking elsewhere.

true. Hence, banks headquartered in countries with relative weak institutions could find it easier to enter developing countries with low institutional quality.

Along this line of reasoning, a common legal origin represents a push factor (Galindo et al., 2003) as existing products may be placed on the market with slight changes (Garcia Herrero and Simon, 2004) whilst differences in legal codes, regulations and rules of law have to be considered a concrete entry barrier for the banking industry.

Of course, *bank supervision and credit policy* can alter the attractiveness of the target country as well. Regulatory barriers are usually stricter for banking rather than for industrial firms, especially in countries that went through harmful financial crises triggered by the presence of common creditors¹¹. Obviously, lowering regulatory barriers is then a strong factor of attraction to foreign entry (Magri et al., 2005; Barth et al., 2002 Focarelli and Pozzolo, 2001 and Papi and Revoltella, 2000).

In the same way, *market reforms* have a strategic role in favouring the entry of foreign banks. Various papers find that economic reforms, specially in the banking sector, are strongly affecting bank's entry decision via enhancement of efficiency conditions and augmenting domestic investments (Lensink & De Haan, 2004). Baudino et al. (2004) point out that the upward trend in financial FDI in transition economies is mainly explained by the privatisation process that characterized the region from 1996–2001. Similarly the on going privatization process in the Balkans States is prompting a major wave of foreign banks entries (Kraft, 2002). As suggested by Claessens (2006) reforms, indeed, help overcome political constraints that reflect on heavy regulations.

In addition, differences in *corporate taxes* are predicted to attract FDI and to impinge on the organizational form chosen by the parent bank. For example, Cerutti et al. (2005) find that high corporate taxes are associated with high probability of foreign bank to operate as branches rather than subsidiaries, as the former may shift profits and losses across borders.

With reference to *technological progress*, one should expect that – by easing the weight of relationship banking in favour of virtual links – it diminishes the need of a physical presence in the host country in proportion to the diffusion of the Internet banking (Garcia Herrero and Martinez Peira, 2005).

In practise, were the *characteristics of the host banking system* relevant, market's size, domestic credit's growth rate, competitive conditions, expected profitability, non performing loans rate etc should influence the desire of individual banks to expand abroad. Multinational bankers, for example, may decide to enter a market if increasing the host market share is perceived as relatively easy. Focarelli and Pozzolo (2001) point out that the probability of entry increases as expected growth rate –a proxy of future profits – is higher

¹¹ If banks from the common creditor country experience a strong deterioration of the quality of their loans to one country, they may attempt to reduce the overall risk of their loan portfolio by reducing exposures in other higher risk investments elsewhere, possibly including in other emerging markets which are most correlated. Caramazza et al.(2004) find that the role of common creditor is of paramount importance in triggering the Asian crisis contagion phenomenon. This may explain why the Asiatic countries are cautiously fostering privatization and liberalisation of domestic banking sectors. On the contrary Tschogel (2003) finds that foreign banks have relatively little effect on crisis mainly because their presence was no very significant before the occurrence of the turmoil.

and banking system is less efficient, given that foreign banks envision to restructure inefficient banks using their expertise.

“Going local” (i.e. acquiring local banks) appears the preferred strategy for internationally active banks that want to do retail activities in emerging countries (Clarke et al., 2003). However this strategy is not without consequences from the point view of risks. The shift from cross border lending to acquisition of subsidiaries shifts the focus from transfer to country risk (McCauley et al., 2002). In fact, when lending abroad banks are exposed to exchange rate risk (Wezel, 2004), transfer risk – to the extent that there may be limitations on capital movements and/or restrictions to currency convertibility– and country risk that includes regulatory, legal and political risks (Gallego et al., 2003).

Therefore, *economic and political risks* in the host country are agreed as important determinants of banks’ organizational choice. Dell’Ariccia and Marquez (2007) argue that differences in the liability structure and the jurisdictional location of bank capital matters. They develop a model, based on expected profits, that explains why branches are preferred when political risk is paramount (capital is kept at home and the risk of losses from expropriation is very low). Subsidiaries, instead, are preferred when the concern is on economic risk, as a fragmented liability structure protects parent bank from losses due to economic slowdowns.

1.3 Mode of entry.

Having once decided where to go, banks are left with the choice of how to enter the target country.

Broadly speaking, banks can decide between two forms of market entry. They can either enter the market in cooperation with local banks or autonomously. Entry forms are also intrinsically related to the degree of influence of the parent company, the size of invested financial resources as well as risks and parents’ accountability for in case of losses. Foreign representations can occur through: the establishment of desks, representative offices, branches and subsidiaries¹².

Desks require a contract with a host bank to let the home bank to do business abroad through a local partnership and free of any capital commitment. This agreement allows home banks to serve their customers providing wholesale services and to collect information on the host economy in exchange of the payment of personnel salaries (one or two people) and utility bills.

Representative offices usually do not provide banking services and are not allowed to do banking transactions at their own risk but collect information and deliver consulting services for firms that intend to expand abroad. They are established to test the possibility of further independent involvement in foreign markets, particularly so since no foreign institutions are involved. Offices are used to find out whether more efforts of market penetration, which would be related to higher risks and costs, would be appropriate. The

¹² In this paper, for empirical reasons, no distinction is drawn between acquisitions of subsidiaries and greenfield investments. However, asymmetries of information (Dell’Ariccia and Marquez, 2004) may induce foreign entrants to prefer acquisitions as they can benefit from extant customer contacts and local bank’s reputation (Buch, 2000).

representative office is usually a valuable strategy in case of heavy market entry barriers and is often a temporary solution.

In many countries the establishment of *branches* is legally permitted¹³, but it may require permission by the host Central Bank. From a legal point of view, branches have no independent personality and they do business under the name of their parent company. Thus, the parent bank is directly responsible for all risks and liabilities accepted by the branch. Branches may operate all banking transactions like in the home country, if the local supply is not limited by regulations. Their business activities are part of the parent bank's activities and capital for regulatory purposes can be supplied at the consolidated level. Activities are predominantly on supplying and processing corporate customers.

A *subsidiary* is an independent legal entity whose corporate policy is determined exclusively by the parent bank. Accounting for risks and chances involved, to install a subsidiary abroad is the most capital intense form of entry. Subsidiaries are fully owned by the parent bank and are under the supervision and political risk of the host country. This organizational form allows exploiting retail banking opportunities and a new base of customers including family and small and medium entrepreneurs. Moreover, when subsidiaries are established via acquisitions the parent bank can take advantage of the fidelity to the local brand.

[INSERT TABLE 1]

Provided that establishing a subsidiary (ex novo or through acquisition) may be costly, Canals (1997) identifies, as an alternative strategic solution, the acquisition of minority stakes connected to trade agreements between the two banks. *Minority stakes* allow establishing long term partnership between home and host bank. This strategy may represent an *escamotage* of foreign banks to enter the market with a limited amount of capital. In most cases, foreign banks acquire minority stakes in order to convert them into majority participations or –on a long-term basis– even into 100%–owned subsidiaries and to take over the foreign address completely if business is going well and appropriate legal prerequisites are given (Domanski, 2005; De Paula, 2002).

2. Recent empirical evidence

The econometric evidence on location decisions of foreign banks differs substantially in scope and design.

A body of studies, only partially related to the topic of this paper, focuses on the implications of multinational active banks on competition and efficiency in the host market (e.g. Martinez Peira and Mody, 2004 and Mian, 2006). Overall, the evidence points out that the presence of foreign banks in EME triggers higher profitability of the destination banking sector, due to higher returns on interest margin (Cardenas et al. 2004). However, the other side of the coin is that multinational presence in the banking sectors may reduce the appeal of host capital markets because of the delisting of acquired banks and the downgrading of local managerial functions.

¹³ See World Bank online Databank on Bank Regulation and Supervision.

Another strand of literature analyzes, instead, the empirical relevance of the factors mentioned in paragraph 1.1 and 1.2. Table 2 summarizes the findings of some of the most recent and influential studies. Results are difficult to compare as the researchers use various definitions of the dependent variable, diverse home and host countries and different estimation techniques. Moreover, only a minority of the papers deals with developing economies as destination countries.

Nonetheless, some important indications can be drawn from Table 2. The co-presence of socio economic and institutional factors, both at home and in host countries, are often found to be the drivers of location decisions of multinational banks. Evidence of a relationship between financial FDI and real FDI is sparse and not unique but it still stands out as quite important. Bready and Kaplanis (1996), Yamori (1998), among others, find that there is a strong relationship between foreign direct investment in the banking sector and the degree of economic integration between host and home country represented by trade linkages and real FDI.

[INSERT TABLE 2]

Some studies document that location decisions are also influenced by parent bank's characteristics. The home bank's size, its degree of internationalisation and the share of non-interest income are candidate factors to explain entry choices as well as the intensity of the investment.

This paper follows with the analysis of the location decisions of the Italian banking system. We investigate the hypothesis that – if the organisational form of foreign bank representation is not exogenously determined by local regulation – “the follow the client” and market seeking reasons, along with some kind of risk assessments, provide guidelines to foreign expansion and to the choice of the organizational form.

3. Empirical strategy and data

By implementing an ordered probit model – a well established methodology developed to analyse ordered choices – we study how characteristics of the host and the source country affect both the decision of Italian banks to enter an emerging banking market and their mode of entry. Banks' organizational form is assumed to be function of parent bank's characteristics, trade and economic linkages between host and home country, host banking sector's efficiency and profitability levels as well as specific socio-economic factors.

3.1 The empirical strategy

We estimate ordered regressions for the observed qualitative response dependent variable describing the entry mode of Italian banks in emerging and transition economies. Ordered response models recognize the indexed nature of the response variable. The core idea is that there is a latent continuous metric (foreign direct investments intensity) underlying the observed ordinal responses expressed as organizational forms.

In contrast to ordered response models, multinomial logit and probit models (used in most of previous empirical analysis) neglect data ordinality and require estimation of more parameters in the case of three or more alternatives, thus reducing the degree of freedom available for estimation. Moreover they are associated with undesirable properties, such as

the independence of irrelevant alternative (IIA in the case of multinomial logit see Ben-Akiva and Lerman, 1985) or lack of a closed-form likelihood (in the case of a multinomial probit, see Greene, 2003 p.728). In this study the latent continuous variable y_n^* is a linear combination of some predictor and a normal disturbance term so that

$$y_n^* = \beta' z_n + \varepsilon_n \quad \varepsilon_n \sim N(0,1), \forall n=1, \dots, N \quad (1)$$

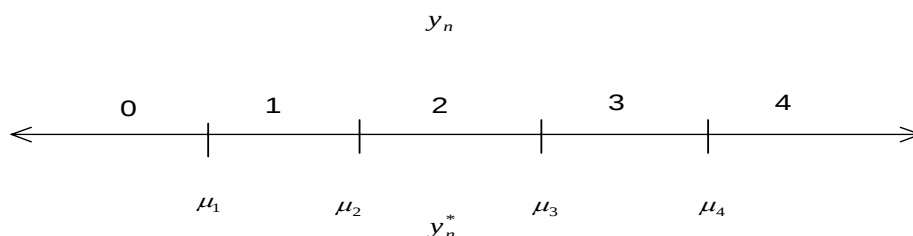
Where y_n^* is a continuous measure of foreign investment; z_n is a vector of explanatory variables describing host and home country characteristics; β is a vector of parameters to be estimated; ε_n is a random error term (assumed to follow a standard normal distribution).

The relation between observed and coded mode of entry is determined as follows

$$y_n = \begin{cases} 0 & \text{if } \mu_0 = -\infty \leq y_n^* \leq \mu_1 \text{ (no entry)} \\ 1 & \text{if } \mu_1 < y_n^* \leq \mu_2 \text{ (desk)} \\ 2 & \text{if } \mu_2 < y_n^* \leq \mu_3 \text{ (representative office)} \\ 3 & \text{if } \mu_3 < y_n^* \leq \mu_4 \text{ (branch)} \\ 4 & \text{if } \mu_4 < y_n^* \leq \mu_5 = \infty \text{ (subsidiary)} \end{cases}$$

Where μ_k , for $k=0$ to K , represent the thresholds to be estimated along with the parameters β . Figures 2 illustrates the correspondence between the latent variables FDI intensity and the mode of entry

FIGURE 2



The probabilities associated with the coded responses of an ordered probit model are given by

$$P_n(0) = \Pr(y_n = 0) = \Pr(y_n^* \leq \mu_1) = \Pr(\beta' z_n + \varepsilon_n \leq \mu_1) = \Pr(\varepsilon_n \leq \mu_1 - \beta' z_n) = \Phi(\mu_1 - \beta' z_n)$$

⋮

$$P_n(k) = \Pr(y_n = k) = \Pr(\mu_k < y_n^* \leq \mu_{k+1}) = \Phi(\mu_{k+1} - \beta' z_n) - \Phi(\mu_k - \beta' z_n)$$

⋮

$$P_n(K) = \Pr(y_n = K) = \Pr(\mu_K < y_n^*) = 1 - \Phi(\mu_K - \beta' z_n)$$

Where $P(y_n = k)$ is the probability that a bank chooses entry mode k and $\Phi()$ is the standard normal cumulative distribution function. The threshold values and the β_j coefficients are estimated by maximizing the log likelihood function:

$$\log \mathcal{L}(\mu, \beta) = \sum_{n=1}^N \sum_{k=0}^K X_{nk} \log[\Phi(\mu_{k+1} - \beta' z_n) - \Phi(\mu_k - \beta' z_n)] \text{ where } X_{nk} \text{ is an indicator variable, which equals 1}$$

if $y_n = k$ and 0 otherwise, $\Phi_{nk} = \Phi(\mu_k - \beta' z_n)$ and $\Phi_{nk-1} = \Phi(\mu_{k-1} - \beta' z_n)$.

It is worth noting that β_j indicates unequivocally the direction of the effect of explanatory variable z_j on estimated $P(y_n = 0|\mathbf{z})$ and $P(y_n = K|\mathbf{z})$. For instance, if β_j is positive an increase in the value of z_j definitely increases the probabilities that banks will choose option 4 and reduces the likelihood of no entry. However, the impact on the estimated probabilities of intermediate classification can be either direction. Furthermore $\hat{\beta}$ in a probit model does not estimate the change in the probability of a given outcome due to a change in the relevant explanatory variable. This probability change is given by the partial derivative of the Probability $\Pr(y_n = k)$ with respect to z_j the so called marginal effects. For the probability of having a Type 3 entry the marginal effect is then

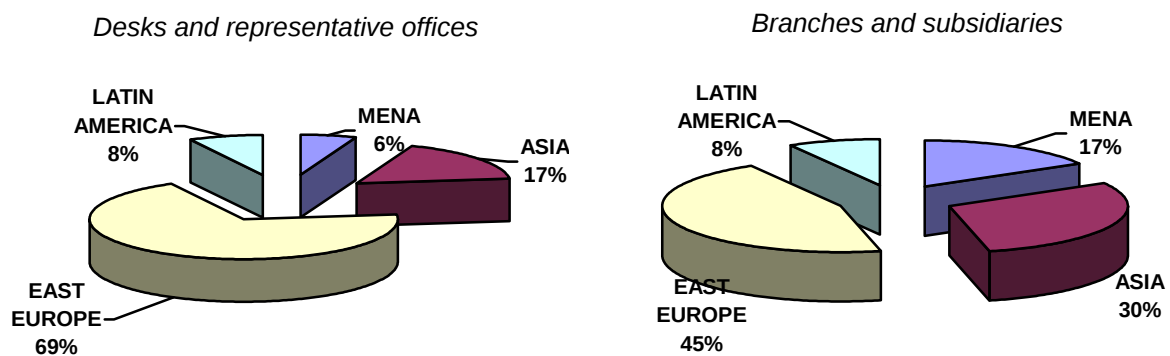
$$\frac{\partial \Pr(y_n = 3)}{\partial z_j} = (\phi(\mu_3 - \beta' \mathbf{z}) - \phi(\mu_2 - \beta' \mathbf{z}))\beta_j$$

where ϕ is the probability density function.¹⁴

3.2 The dependent variable– bank entry data

The organizational forms chosen by Italian banks are drawn from the ABI Report on the internationalisation of the Italian banking system, available on the ABI internet site (see Appendix I). After the phase of rationalisation in 2002–2004, at the end of December 2006, 19 Italian banks were present with physical establishments in 41 emerging and transition countries. The ABI database has been integrated with public information on acquisitions and minority stakes. The primary source of information on minority stakes is Bankscope. Minority stakes are accounted for since it is not at all unusual for banks to enter a foreign market by acquiring a small number of stakes with the purpose to increase their shareholding subsequently. For example, the large number of strategic minority stakes in the Chinese banks has obviously been the most common form to circumvent the limitation on foreign presence (Domanski, 2005).

FIGURE 3: Presence of Italian banks by organizational form and geographical region



Source ABI and author's calculations

¹⁴ Replacing Φ with the logit or the gamma distribution gives the "ordered logit" and the "ordered extreme value". For details on ordered probit methods see Wooldridge (2002), Green (2003) and Long (1997).

For this very reason minority stakes have been treated – according to the intensity of financial resources required – as desks (if below 7% of total capital) or representative offices (if above 7%)¹⁵. In our sample only 12 observations are associated to minority participations. Over the last couple of years, Italian banks have sharply increased their presence by acquiring local banks in CEE and the Balkans region, showing a growing interest also in Mediterranean countries less open to foreign capital. The majority of Italian subsidiaries are owned by the three largest banks (Unicredit, Intesa and SanpaoloIMI¹⁶). However there are some notable exceptions; Veneto Banca has subsidiaries in Romania, Bosnia and Moldova; Cassa di Risparmio di Firenze at the beginning of 2006 has acquired directly Daewoo Bank in Romania and indirectly, through the controlled Findomestic Bank, Nova Bank in Serbia; Banco Popolare di Verona e Novara has acquired 81% of ordinary capital of Banka Sonic in Croatia at the end 2006.

[INSERT TABLE 3]

The dependent variable is thus constructed as if, at the end of 2006, bank officers had to answer to the following question for each of the 41 EME in the sample: "What is the organizational form the bank has chosen when expanding in the host country?". Answers are counted only with respect to the most resource-intensive form of organization, e.g. if a bank in that country has a desk and a subsidiary, only the latter enters the data set. The observed qualitative entry choice variables is determined from the following relationship: 0= no entry; 1= desk; 2= representative office; 3=branch; 4 = subsidiary.

3.3 The explanatory variables

This paragraph describes the explanatory variable at the right hand side of equation 1 while Table 4 provides a statistical summary of them.

[INSERT TABLE 4]

The "follow the client motive" is accounted for by the number of Italian firms (FIRMIT) located in the host country at the first of January 2001 and the log of the value of bilateral trade (LTRADE) between Italy and the host country at the end of the year 2000. Time lags are used to avoid potential endogeneity bias. Both factors are expected to affect positively the likelihood of operating as a subsidiary.

In the gravity models, distance is a proxy of information and monitoring costs and is expected to affect negatively the entry mode. Proximity is expressed as the log of the miles (LDIST) between Italy and the host country.

According to Claessens and Van Horen (2007), who point out that absolute assessment of institutional quality does not matter as much as the relative advantage, we use their measure of comparative advantage with respect to potential competitors. Institutional quality governance indicators are provided by Kaufman et al. (2005) and relate to voice and accountability, political instability and violence, governance effectiveness, regulatory quality, rule of law and control of corruption. Each index ranges between -2.5 and 2.5 with

¹⁵ This also applies to the only case when the percentage is around 20%. In this very case – according to press releases on the specific deal– the stake can be considered part of the payment for selling a previously owned bank not the result of strategic expansion policies.

¹⁶ SanPaoloIMI and Intesa are considered here different legal entities since they merged on 1st of January 2007.

high values indicating lower burden. To compute the competitive advantage, the institutional quality in the host country – the average of the six governance indicators above – is compared with the difference between the institutional quality in the source (Italy) country and those of foreign contenders¹⁷. The competitive institutional advantage $COMPADVC_{ij}$ of the source country j in the host country i is defined as: $COMPADVC_{ij} = InstQ_{host_i}(InstQ_{Source_j} - InstQ_{Comp})$ where $InstQ_{Comp}$ is given by the weighted average of the institutional quality of each possible competitor country and weights are proportional to country's size, approximated by the correspondent GDP in PPP US dollars. This measure of competitive advantage is either positive or negative, depending on whether the institutional quality of the source country is above or below the average of competitor countries. The expected sign of the related coefficient is positive. Data refer to the year 2000 to minimize the endogeneity bias as foreign entry may raise the institutional quality in the host country (Cardenas et al. 2003).

Among the host country features, the presence of explicit or implicit barriers is taken into account. For this reason, we consider the quality of infrastructures (QINF), as the establishment of branches or the acquisition of a subsidiary (associated to scattered presences in the foreign country) may be prevented if infrastructures are underdeveloped. The quality of educational system (QEDSYST) is also a factor that likely guides banks' FDI decisions as financial services are human capital intensive. In addition we control for the effectiveness of antitrust policies (ANTRUST) as well as the perception of the business environment (DOBU). The first three variables are constructed by the Global Economic Forum and derived from surveying residents, respectively, on the quality of infrastructure (1= underdeveloped 7= as extensive and efficient as the world best), the quality of educational system (1=it does not meet the need of a competitive economy 7=it meets the needs of a competitive economy) and the strength of anti-monopoly policies (1=lax and not sufficient at promoting competition, 7=effective and promotes competition). The Business climate is measured by the "Ease of doing business" index, computed by the World Bank. It is the average of six indicators measuring: protecting investors, paying taxes, trade across borders, enforcing contracts and ease of closing business.

Quality of infrastructures, high levels of the educational system as well as "easiness of doing business" are likely to impact positively on FDI intensity as in all cases there is an incentive to exploit the local presence of a subsidiary. On the contrary, a stringent antitrust regulation may discourage foreign investments as it diminishes profit opportunities due to dominant market positions. Similarly, high levels of corporate taxation may prevent the decision to invest in the market, hence the maximum tax rate on corporate income (CORTAX) or on bank's profit, when they differ, enter the right end side of equation (1).

Among the host market characteristics, we consider a few profitability and soundness indicators. In particular, the share of non-performing loans to total loans (NPL) is plausibly expected to prevent foreign entry by signalling bad credit conditions, whilst the return on assets (ROA) at industry level is expected to foster investment decisions by signalling room

¹⁷ Australia, Austria, Belgium, Canada, France, Germany, the Netherlands, Portugal, Iceland, Ireland, Japan, UK, USA, Spain, Switzerland.

for efficiency improvements. The domestic credit to GDP ratio (LCRGDP) is also included to capture the degree of the host banking market development and it is expected to have a negative impact since high ratios are associated to lower opportunities and higher competition. In addition, the degree of bank concentration (BC), measured by the assets of three largest banks as share of assets of all commercial banks, is predicted to affect positively entry decisions since it indicates a weaker competitive environments and signals a reduction in the probability that the host country will run into a banking crisis¹⁸.

Risk variables, expected to influence negatively entry choices, are also encompassed in the empirical analysis. In particular, we test the relevance of the overall risk (OVERALL) assessment (1=less risky –100= most risky) measured by the Economist Intelligence Unit. This index is comprehensive of numerous risk components (see Appendix I). Furthermore, the analysis takes account of the ratio of M2 to international reserves (M2RES) since it provides early warning indications of future financial and economic distress, as proven by the empirical literature on financial crises¹⁹. The two year lag captures the anticipating nature of the variable.

Finally, among the parent bank's characteristics we control for "size" measured as the ratio of bank's asset to system's assets (BANKSIZE) and the share of non interest income (NIISHARE), a proxy of the bank's interest in international expansion.

4. Discussion of model results

Having given the details on factors candidate to influence entry decisions, in this section we will present the empirical results obtained from the ordered probit approach.

The Italian banks' entry mode is modelled according to:

$$EM_n = \alpha + \beta_1 FIRMIT_n + \beta_2 LTRADE_n + \beta_3 BANKSIZE_n + \beta_4 NIISHARE_n + \beta_5 LDIST_n + \beta_6 ANTRUST_n \\ + \beta_7 CORTAX_n + \beta_8 DOBU_n + \beta_9 COMPADV_n + \beta_{10} QINF_n + \beta_{11} QEDSYST_n + \beta_{12} NPL_n + \beta_{13} ROA_n \\ + \beta_{14} LCRGDP_n + \beta_{15} BC_n + \beta_{16} OVERALL_n + \beta_{17} MRES_n + u_n \quad (eq1A)$$

where the observed variable *EM* 'entry mode' is the ordered variable described in section 3.2. The assumption that $u_n \sim N(0,1)$ gives rise to the ordered probit model with unknown threshold.

Table 5 reports the results²⁰ for the ordered probit regression 1A. They suggest that most of the variables supposed to influence the mode of operating in a foreign country are statistically significant with the exception of OVERALL, LCRGDP and BC. These variables are clearly important in the ex-ante strategic decision but do not seem to be of relevance for the ex post implementation of the parent bank's plan. As for the OVERALL risk, despite the positive sign, which may be interpreted according to the findings of Dell'Ariccia and Marquez (2007), the lack of significance in all the specifications is likely to be connected to

¹⁸ Beck et al. (2006) find that concentrated bank system are less vulnerable to banking crisis as bigger banks diversify better.

¹⁹ See Demiriuguc-Kunt and Detragiache (1998 and 2005) and Kaminsky and Reinhart (1999).

²⁰ Nuisance parameters are not presented but they are statistically significant and distinguishable from each other.

two factors. First, the NPL ratio and the DOBU index are already picking up the effect of risk on investment decisions and, second, banks are accustomed to evaluate and cover their risk in normal times (Gallego et al., 2003). The significance of the bank concentration variable is likewise absorbed by the antitrust policy index, whose coefficient increases in model (2) when BC is dropped. Finally, the control variable LCRGDP – a proxy for the development of the foreign bank market – is never significant. It is not a surprising result since this variable is found to be correlated with others exogenous factors. Corporate taxation is marginally significant and shows correlations with the DOBU index, which provides a wider measure of impediments to enter a foreign market, and the COMPADV, which accounts for the quality of institutions. We further experimented with dropping these variables but none of the results changes significantly. Significance, sign and size of the coefficients are similar as correlations are not very high.

Finally, given that the sign of the coefficient of the Doing Business index and the Non Interest Income Share may appear counterintuitive, though they have plausible explanations (see below), we drop them in regression model (3). In this case, too, the core set of variables has significant coefficients with the expected signs. Results are robust also across estimation techniques. Standard binominal probit estimations have been implemented transforming the dependent variable in a binary (0,1) index according to the presence or not of Italian banks in the country. To account for many zeros of the dependent variable a Tobit regression model has also been applied. In all cases, the statistical relevance of the explicative variables is confirmed as well as their signs.²¹ Since results are robust across specifications and estimation methods in what follows the focus is on the baseline regression (2).

Turning to the quantitative interpretation of the results, they can be summarized as follows.

First, the “follow the client” motive matters. The variables describing extant economic linkages between Italy and the host market have the expected positive sign and are significant at 1 percent level. The larger the presence of Italian firms and the volume of trade with the host country the higher the probability that Italian banks will invest in subsidiaries as they may be willing to offer a broader set of products and services (e.g. M&As or structured finance activities). Consistent with the hypothesis that big banks have a stronger incentive to expand the retail activities abroad – since they cannot enlarge their presence at home for competitiveness reasons – the bank’s size is always found to yield a significantly positive impact. Quite the opposite, the non interest income share, which is also significant, exerts a negative impact on the likelihood of establishing subsidiaries abroad. This result – despite being in contrast with previous empirical works that use this variable as a proxy for the international attitude of the parent bank – could be explained in two ways. One is that subsidiaries are more strongly connected to interest-based profit opportunities than the alternative entry choices. The other is that the degree of sophistication of most of the emerging financial markets offers low chances to develop fee-based business lines. Distance between host and home country, which captures the cost of

²¹ Results are available upon request to the author. They are not reported here for parsimony.

monitoring, is significant and has a negative influence on the affiliate being a subsidiary, as this choice requires higher investments and expansive monitoring activities.

Second, entry barriers matter. The effectiveness of antitrust policies and, when present in the specification, high corporate tax rates are always significant and reduce the probability of having a subsidiary. As for the index “Doing Business” it exerts a positive impact on the likelihood of entry mode “4”, implying that difficult business environments require the presence of subsidiaries so to exploit deeper knowledge of a complex local market.

Third, institutional quality matters. In particular, comparative advantages with respect to potential competitors increase the probability of establishing a subsidiary. Similarly, the presence of high quality infrastructures, which reduce the cost of monitoring activities spread out across the host country, and high quality educational systems that assure the availability of human capital are significant and positively related to the likelihood of entry the country and the affiliate being a subsidiary.

Forth, profit opportunities matter. The variables describing the host banking market are significant and have the expected sign. High NPL ratios prevent the acquisition of subsidiaries as they signal difficult credit conditions and systemic fragility. On the contrary, low ROAs point to efficiency improvement opportunities, attracting resource-intensive forms of organization.

Finally, risk matters only partially. As pointed out at the beginning of this section overall risk and other measures of credit worthiness, such as the average expected default frequencies associated to sovereign ratings by major rating agencies, were considered without success. Even distinguishing between political and economic risk (as in Cerrutti et al., 2005) has yielded no meaningful change in the estimates. That it is not to say that risk does not count but that more than trade book and portfolio risk it is the likelihood of a systemic financial crisis that matters. In fact, high values of M2 to international reserve, a reliable indicator of future financial distress, lower the probability of entry mode 4.

Given that we are using an ordered probit model, coefficients have not the usual interpretation. To know how the probability of choosing a category, rather than another, changes in function of the explanatory variables, marginal effects estimates are computed. Table 6 gives this piece of information. Among the explanatory variables, parent bank’s characteristics have the largest impact on the probability of choosing a subsidiary as organizational form. Among the push factors, the comparative advantage on institutional quality plays a major role. Interpretation of marginal effects, the slope of the probability curve, however, can be misleading given the non linear nature of ordered probit models. We thus proceed analysing discrete changes in probability by comparing two scenarios.

Table 7 shows the economic impact of a change in the explanatory variables by considering what happens to the predicted probability of the affiliate being a subsidiary when each of the exogenous variable increases from its sample mean average²² by one standard deviation and the other explicative variables are kept at their sample mean. Focusing on the column

²² To check if the skewness of some of the independent variables could make a difference we also compute the scenario analysis for changes relative to the median as suggested by Long (1997 p.138). From a qualitative point of view the results are the same.

Δ , the number of Italian firms abroad, the parent bank's size, the institutional quality and the quality of infrastructures have the largest impact. One standard deviation increase/decrease from the average in bank's size augments/reduces the probability to operate as subsidiary by 4.4 percentage point. The shift in the number of Italian firms located in the country yields a change of the likelihood of 1.8 percentage points. Among the host country characteristics, the effect of the relative advantages in terms of institutional quality is comparable to that of the quality of infrastructures with impacts around 2.3 and 3.1 percentage points respectively. An increase in the non-interest share and in the ratio of non-performing loans to total loans (in the host country) have the largest negative impact, around 1 percentage points, on the likelihood that the affiliate will be a subsidiary. Furthermore, the overall effect of a variable on the probability is detected by computing the average of the absolute values of the changes across all the outcome categories²³. Clearly the "follow the client", the parent bank's size, the quality of institutions and infrastructures, as well as the quality of the host banking system and the strategic attitude have the strongest effect on entry modes chosen by Italian banks.

Our results are in line with the findings of Piscitello and Pozzolo (2006), who, by analysing a sample of European internationally active banks, infer that the size of the parent bank is important for location choices. They detect that banks are less involved in countries characterized by developed credit markets and low restrictions to banking activities, as these are signals of higher degree of competition and lower profit opportunities. Their estimates for non-OECD countries, as destination locations, also point out the positive effect of bilateral economic linkages on the decision to operate as a subsidiary. This study, however, limits the analysis to variables representing home and host banking market features. Social and institutional variables are not accounted for whilst we find that this type of factors has an influential role in location decisions.

Results from table 5 also offer some interesting insights when compared with the answers, given by a sample of Italian banks, to a survey about determinants of location decisions reported in Poli (2006). Italian bankers point out that potential economic and financial growth, low degree of competition and the possibility to transfer the product know-how to the foreign affiliates are the main drivers of their internationalization strategies. Although not mentioned among the very top motives, banks affirm that the acquisition of new domestic customers, wishing to delocalise or already present in the foreign market, is also a push factor for location decisions, especially when considering the positive spill-overs on real estate, consumer and commercial lending and on corporate finance activities. Coherently with the econometric analysis, the survey reveals that the "follow the client" motive has to be encompassed by other factors to explain the internationalisation strategy of the Italian banking system in recent years. Moreover, the respondents consider tax and fiscal advantages only secondary drivers.

To conclude our empirical investigation, the predicted probability of entering a foreign market either operating as branches and subsidiaries or desks and representative offices is compared to the actual probabilities for each of the 41 host countries (see Table 8). The

²³ Absolute values are computed since the simple sum of all changes is necessarily zero.

estimated under and over representations reveal that the Italian banking system, according to the influence of the exogenous variables encompassed in the study, has room for expansion mainly in Asia and in the Middle East²⁴ and only selectively in Latin America and East Europe. In this exercise, India and China appear still open opportunities for the Italian banks.

It is worth noting that this outcome is quite similar to the results of Bready and Kaplanis (1996) who use 1992 data about the overseas presence of 37 parent and 82 host countries. The pattern of under representation of foreign banks is, by and large, the same despite differences in the context and in the variables used for the empirical analysis. Interestingly, opposite results are obtained for China. In Bready's paper, the country appears to have an abnormal presence of foreign banks while according to our analysis there is room for new branches and subsidiaries. A difference explained by the recent intensification of trading and financial linkages, triggered by the process of WTO membership, that might have enhanced business opportunities in the banking sector.

5. Conclusions

In this paper we have shown that several factors influence the location decisions of Italian banks. The econometric analysis accounts for both home and host country characteristics including institutional and socio economic features. In particular, the parent bank's size affects expansion choices favouring the adoption of more complex and resource-intensive organizational forms.

Trade linkages as well as the presence of Italian firms in the host country are important factors supporting the choice of the organizational form of the affiliates. Clearly these motives are not sufficient to explain the rise of subsidiary's acquisitions in recent years.

Competitive advantages in institutional quality, with respect to other competitors, seem to matter in favour of the establishment of a subsidiary. Subsidiary is also the preferred mode of entry in countries with high quality of infrastructures – a proxy of the easiness of reaching branches spatially distributed on the host territory– and high quality educational systems since banking services are human capital intensive. An increase in the "Doing Business" index, too, enhances the likelihood to operate as a subsidiary, since difficult business environments may require profound knowledge of complex domestic markets, which is better achieved when buying existing local banks.

The average return on assets and the NPL ratio in the host country affect negatively the entry choice. High levels of the former indicate that there are meagre opportunities of increasing the efficiency by acquiring a foreign bank; the latter conveys, instead, information on the quality of the foreign credit market; as high ratios are usually associated to bad market conditions.

Some evidence of the impact of risk factors on location decisions is provided by the ratio M2 to International reserves. Its ability to send early warning signals of an upcoming

²⁴ Given the lack of significance of the political risk variable, the result of Iran has to be interpreted with care.

banking crisis– proven by a large body of empirical literature – makes high value of the ratio impinge negatively on the organizational form and prevents the establishment of subsidiaries.

From a policy perspective these results stress two important conclusions.

First, the paramount importance of the bank's size clarifies why the internationalization of the Italian banking system is lagging behind with respect to other industrialized competitors. Therefore, the recent wave of consolidation in the Italian banking system likely preludes to a more active attitude towards foreign expansion. The internationalisation of Italian banks is, in fact, gradually moving from a defensive strategy to keep internationally active costumers to a proactive attitude in seeking new profit opportunities.

Second, the pattern of geographical expansion is connected to the quality of institutions and supervision. The acquisition of subsidiaries in countries where Italy has a comparative advantage in terms of institutional quality, while responding to an economic rationale might not be reassuring from the risk management point of view. According to the World Bank Database on institutional quality, Italy has a lower ranking with respect to other OECD competitors. This could potentially create costs if subsidiaries, though separate legal entity, are poorly supervised. Besides, for countries where financial liberalisation has taken place over the last fifteen year, there are legitimate concerns with respect to the ability of the host supervisors in safeguarding the stability of financial systems dominated by foreign owned banks. Thus, the recent wave of foreign expansion in emerging economies is somehow reinforcing the need to develop more robust information-sharing arrangements between home and host supervisors under the new capital framework of Basle II. Host supervisors' knowledge of local markets may be essential for the home supervisors' assessment of the international banking groups on consolidate basis. At the same time, the valuation of the consolidate group may contribute to an effective supervision of the subsidiary.

The lack of the time series dimension has limited the scope of this paper. Future research agenda would require to explore the relationship between location decisions and risk variables in a dynamic framework. It would also be interesting – in line with the recent literature on firms' location choices and despite obvious measurement problems– to consider the effect of total factor productivity on banking internationalization modes.

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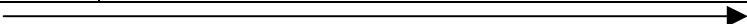
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Table 1. Mode of entry

Entry Choice	Desk c/o Correspondent Bank	Representative Office	Branch Abroad	Subsidiary
Features	- Contract between home and foreign correspondent bank - Continuous communication between the partners	- No foreign institutions involved - Organisational form equivalent to a customer service department - Not allowed to do banking transactions	- Completely dependent on parent bank - Asset and liabilities are accounted in the parent bank's balance sheet - Parent company fully responsible for risks and liabilities	- Legal independent entity - Subject to the supervision and political risks of the host country - No direct access to financial resources from the parent bank
Plus	- Low risk - Enhancement of products portfolio - Deeper knowledge about host market	- Collection of valuable information on new potential markets - Strategies to circumvent market entry barriers - Low set up and maintenance costs	- No separate capital endowment is required - Strengthen the home client relationship	- Subject to bank supervision of the host country that could be less stringent - New customer base, higher business volumes - Borrowing on the basis of their own capitalisation but parent bank may inject fund if deemed appropriate
Minus	- No additional business possibilities - Partner bank earns the largest part of margins	- Business is possible only through the parent company and this may be costly and slow - Temporary solution	- Subject to bank supervision of both host and home country - Capital is procured only by parent bank	Corporate policy determined by parent bank
Increasing degree of investment Intensity	Cooperative approach	Going alone approach		
				

Source: Information are taken from Gallego et al. (2003) Mutter and Neugerbauer (2000) and Poli (2006)

Table 2. Synopsis of recent empirical evidence on location choice and form of entry

Authors, year of publication	Dependent Variable	Main explanatory variables	Other explanatory variables	Methodology	Findings	Home: (o) Country of origin – Host: (d) Country of destination
Claessens et al.(2007)	Ratio of the sum of assets of foreign owned banks to total bank assets in the host country	Comparative advantage in Institutional quality (multilateral) Distance (bilateral) Trade(bilateral) Legal origin (o and d) GDP(o and d); Entry barriers(d)	Colonial links (bilateral); Common border (bilateral); Per capita GDP (o); Financial depth(d); Regional dummies.	Tobit regression model	High institutional quality is not a prerequisite for attracting FDI. Comparative advantages with respect to competitor source countries is what matters.	(o) not defined (worldwide) (d) 98 developing Countries
Focarelli et al. (2006)	Number of M&As in the banking sector	Trade (bilateral) Common colonization (bilateral) Common language (bilateral) Corporate taxation (o and d) Stock mkt Cap./GDP (o and d) Old dependency ratio(o and d) Saving ratio (o and d)	Total number of M&A (d); Credit /GDP (o and d); Population (o and d); Per capita GDP (o and d).	Negative binomial regression and probit	The “ <i>Follow the client</i> ” motive and implicit entry barrier are more important than risk factors in explaining M&As in the banking sector.	(o)37 Countries (d) 42 Countries
Voinea et al.(2006)	Foreign claims of parent bank reporting to the BIS vs host country	Trade (bilateral) Real interest rate differential (bilateral) Banking Reform Index (d)	Real FDI (d); Distance (bilateral); Corruption (d); GDP (o and d)	Feasible Generalised Least Square	The significance of trade and interest rate point out the validity of “ <i>follow the client</i> ” and “ <i>exploit profit opportunity</i> ” rationale. Reforms in the banking sector and lack of corruption are also positively affecting foreign bank activities.	(o) Austria, Finland, France, Germany, Greece, Italy, the Netherlands, Portugal, Sweden, Switzerland, UK, USA (d) Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Serbia and Montenegro, Slovakia, Slovenia, Turkey, Ukraine.
Van Horen (2007)	(1) Ratio of the sum of assets of foreign owned banks to total bank assets in host country. (2) Ratio of number of foreign banks owned by each source country to total number of banks in the host country.	Distance (bilateral) Trade(bilateral) Legal origin (o and d) GDP (o and d) Institutional quality(d) Entry barriers(d)	Colonial links (bilateral); Common Border (bilateral); GDP per capita (o); Financial depth(d); South dummy	Tobit regression model	Similar quality of institutions and dimension of the host country are important for financial FDI entry choices. Economic integration, common language and proximity are confirmed to be drivers of FDI decisions.	(o) not defined (worldwide) (d) 102 developing Countries

Table 2: continue

Authors, year of publication	Dependent Variable	Main explanatory variables	Other explanatory variables	Methodology	Findings	Home: (o) Country of origin– Host: (d) Country of destination
Cerutti et al. (2005)	Branches & subsidiaries of top 100 banks	Corporate tax; Regulatory burden (d) Economic and political risks (d)	Country size (d); GDP per capita (d); Bank's size (o)	Heckman Probit	Higher corporate tax and political risk, low regulation barriers and economic risk favour the establishment of branches vs subsidiaries	(o) OECD, China and Hong Kong. (d) Countries in Eastern Europe and Latin America
Focarelli et al. (2005)	Branches & Subsidiaries of 260 banks	GDP per capita(d) Size credit market(d) Schooling(d) Rule of law(d)	Distance (bilateral); Trade (bilateral); Return on assets (o and d); Bank's size(o); Bank's share of non interest income(o)	Multinomial logit	Profit opportunities and institutional aspects affect subsidiaries more than branches. Integration is significant but less than other explicative variables	(o) OECD Countries (d) OECD Countries
Herrero et al. (2005)	Share of local to total foreign claims held by Italian, Spanish and US banks abroad	Minimum capital requirement to enter the market(d) Start-up costs (d) Distance (bilateral) Number of internet host (d) Index Economic Freedom(d)	Trade (bilateral); Banking freedom (d); GDP (d); GDP growth (d); Taxation (d)	Individual cross country regression for each source country	Banking freedom is a prerequisite to operate in the host country. Market size, informational costs, cultural and institutional affinity influence positively the share of foreign claims in the host country.	(o) US, Spain and Italy (d) 100 Countries worldwide
Wezel (2004)	FDI annual change divided host country GDP	Non-financial FDI(d) GDP per capita (d) Stock mkt Cap. to GDP (d) M2 to International reserve (d)	Trade(bilateral); Real interest rate margin (d); Political risk (d); Country risk (d); Degree of trade openness (d); Regulatory burden (d); Real exchange rate volatility (d)	Pooled OLS	The importance of integration variables for Germany is confirmed. Early warning signals are also found to play an important role on the FDI directions.	(o) Germany (d) 24 Countries in CEE, Latin America, Asia and Africa
Buch et al. (2004a)	Log of the number of M&As between home and host country	GDP per capita (o and d) Economic Freedom (d) Offshore status (d) Distance (bilateral) Same language (bilateral) Same law (bilateral)	GNP (o and d); Credit to GDP (o and d); Population (d); Standard deviation of bank's returns (d)	OLS and Probit	High information costs – approximated by common law and language and distance – together with regulations do not favour M&As. Emerging countries need to be treated differently.	(o) 29 OECD Countries (d) 29 OECD Countries

Table 2: continue

Authors, year of publication	Dependent Variable	Main explanatory variables	Other explanatory variables	Methodology	Findings	Home: (o) Country of origin – Host: (d) Country of destination
Berger et al.(2004)	Ratio of the number of M&As in financial sector to the sum of GDP in source and host country	Similar GDP (bilateral) Similar GDP per capita (bilateral). Same language (bilateral) Same law (bilateral) Distance (bilateral)	GDP (o and d); GDP growth (o and d); Degree of trade openness (o and d); Index of regulation (o and d); Index market economy (o and d); Dummy for EU countries	Tobit model	M&As increase when the characteristic of the host and home countries are similar. The US has a comparative advantage in exporting and importing financial institutions management via M&As.	(o) 30 OECD Countries (d) Same as in (o)
Buch et al. (2004b)	(1) Ratio of the flow of primary and secondary investment in equity capital minus profits to losses for the current financial year (2) Cross border financial services approximated by a) bank premium b) interest rate returns paid and received	Claims and liabilities to total claims and liabilities (d); Log bank assets (o); Operational income to total asset (o) Euromoney index of risk (d) Economic Freedom (d) Capital Controls (d) Transparency (d) Supervision (d)	Distance (bilateral); Trade (bilateral); GDP (d); Inflation (d); Dummy for members of the European Union	Tobit regression model	Geographical proximity, low risk and absence of capital controls, along with trade, host market size and parent bank degree of internationalisation are the main factors luring banking FDI. For country with tight supervision cross border services are substituted for FDI.	o) Germany (d) Not defined (worldwide)
Buch et al . (2004 c)	Log of the number of M&A's between home and host country	Index of supervision (o and d) Index of regulation (o and d) Index of openness (o and d) Degree of supervision (o) Deposit insurance (o and d)	GDP (o and d); GDP per capita (o and d); Distance (bilateral); Same law (bilateral); Same language (bilateral)	Tobit regression model	Banks are attracted by growth opportunities not by lax regulatory contexts. No support of comparative advantage on regulatory standards	(o) OECD Countries (d) OECD Countries
Galindo et al. (2003)	Log (1+foreign control) Foreign control is defined as: sum of assets of banks of the host country in which the source country owns 50 % or more of their equity	Diff. in legal origin (o and d) Diff. in corruption (o and d) Diff. bank regulation (o and d) Diff. rule of law (o and d) Diff. efficiency judicial system (o and d)	Trade (bilateral); Distance (bilateral); Common border(bilateral); Colonial links (d) ; Common language (bilateral)	Panel OLS	Legal and institutional differences across countries limits the presence of foreign banks in the host country.	(o) Up to 152 Countries (d) Up to 130 Countries

Table 2: continue

Authors, year of publication	Dependent Variable	Main explanatory variables	Other explanatory variables	Methodology	Findings	Home: (o) Country of origin– Host: (d) Country of destination
Focarelli et al. (2001)	Ratio of cross border M&As to total acquisitions in banking sector; (transformed in a (0,1) variable	Index of restriction on banking activity (d) Bank's ROA (o) Non interest income (o) Number of Public banks (d)	Export/GDP(d); Credit/GDP (o); Stock mkt Capit./GDP(o); ROA(d); GDP pc (d); Total asset(d); Population (d); Judicial system (d)	Binomial Probit	Importance of factors associated with efficiency of single bank and banking sector in the home country	(o) OECD Countries (d) OECD Countries
Mathieson et al. (2001)	Three increasing measures of foreign control and participation	Dummy for banking crisis in previous 3 years (d) ROA(d) ; Operating costs(d)	GDP growth (d) ; Inflation(d)	Panel OLS	Index of banking crises help to explain the increased foreign bank presence in EME	(o) Unknown ; (d) Argentina; Brasil; Chile; Colombia; Czech Republic; Hungary; Korea; Malaysia; Mexico; Peru, the Philippines; Poland; Thailand; Turkey; Venezuela
Moshirian (2001)	Stock of source FDI in the banking sector of the host country	Foreign banks assets (o) Real FDI (o) Market size (d) Exchange rate (bilateral)	Differential between cost of capital (o and d); GDP growth (o and d); Trade (bilateral)	Generalized Method of Moments	Correlation between financial FDI and number of offices owned by bank abroad. Strong link between financial and real FDI. Exchange rate depreciation is found to exert a positive impact on banking FDI.	(o) USA, UK and Germany (d) Not defined
Papi et al. (2000)	Number of investment initiatives in the banking sector from a foreign to a host country Distinction between majority and minority stakes	Inflation (d) Index Risk Inst. Investor(d) Degree of openness (d) Currency toM2 (d) Banking sector cap.(d) Real FDI (d)	Population (d); GDP per capita(d); GDP share of services (d) Tax rate (d) Interest rate spread (d)	Panel GLS	Minority stakes, the first step leading up to further investments, are influenced by mkt opportunities, economic stability, trade and distance. Majority stake are influenced by few variables: political/ economic stability and bank customer relationship.	(o) Not defined (worldwide) (d) Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.
Breadly et al. (1996)	Bank offices abroad	GDP (d) Export to host country (o) Real FDI (d)	--	OLS	Trade and FDI are important driver of foreign banking location decisions	(o) Australia; Belgium; Canada; France; Germany; India; Italy; Japan; Netherlands; Spain; Switzerland; UK; USA. (d) 33 Countries including developed & developing economies

Table 3: Foreign bank penetration in emerging economies where Italian banks are present

<i>CEE, SEE And CIS</i>	Foreign bank assets in total banks assets	<i>Middle East and Africa</i>	Foreign bank assets in total banks assets
Albania	0.91	Algeria	0.21
Bosnia-Herzegovina	0.74	Egypt	0.08
Bulgaria	0.81	Iran	0.00
Croatia	0.89	Morocco	0.17
Czech Republic	0.89	Tunisia	0.27
Estonia	0.99	Lebanon	0.12
Hungary	0.94	South Africa	0.10
Latvia	0.45	Kuwait	0.00
Lithuania	0.92	United Arab Emirates	0.31
Macedonia FYR	0.49		
Moldova	0.08	<i>Asia</i>	
Poland	0.70	China	0.03
Romania	0.51	Hong Kong	0.90
Russia	0.15	India	0.03
Serbia Montenegro	0.53	Singapore	0.76
Slovakia	0.97	South Korea	0.08
Slovenia	0.23	Thailand	0.05
Turkey	0.14	Vietnam	0.02
Ukraine	0.45		
<i>Latin America</i>			
Argentina	0.40		
Brazil	0.22		
Chile	0.37		
Mexico	0.68		
Peru	0.75		
Venezuela	0.44		

Source: Information are taken from Van Horen (2007 Table 1), Fitch-IBCA Banking System Reports and IMF Country Reports for the remaining countries. A foreign bank is here defined to have at least 50% foreign ownership. Average over 2000–2005 apart from China data refers to 2006.

Table 4: Univariate statistics for the determinants of location decisions

Push factors	Mean	St.dev	Pull factors	Mean	St.dev
Follow the client			Entry barriers		
–Number of Italian firms* (FIRMIT01)	137.44	139.56	– Regulatory burden (ANTRUST)	3.936	0.76
–Log volume of bilateral trade (LTRADE00)	3.21	0.49	– Corporate taxation (CORPTAX05)	24.38	8.37
Efficiency and profitability			–Easiness of doing business (DOBU05)	75.62	42.44
– Bank's size (BANKSIZE)	0.042	0.07	Institutional quality		
–Non interest income share (NIISHARE)	0.41	0.09	– Index of comparative Advantage in Institutional Quality (COMPADV00)	–0.707	0.39
Cost of monitoring			– Quality of infrastructure (QINF05)	3.80	1.19
– Log Geographical distance (LDIST)	7.34	1.07	– Quality of education (QEDSYST05)	3.61	0.87
			Host market features		
			– Non Performing Loans/Tot Loans (NPL05)	7.80	8.15
			– Return on Assets (ROA05)	1.57	0.83
			– Potential growth (LCRGDP)	3.99	0.63
			– Bank concentration (BC04)	0.59	0.17
			Risk Factors		
			– Overall risk (OVERALL05)	40.69	11.43
			–M2/International reserves (MRES04)	2.85	1.29

Note:* local firms with shares owned by Italian residents

TABLE 5 Entry choice drivers– Italian Banks

DEPENDENT VARIABLE: MODE OF ENTRY (0=no entry; 1=desk; 2= representative office; 3=branch; 4= subsidiary) Ordered Probit (Quadratic Hill Climbing)			
Variables	Coefficients (st.dev) ^o		
Model	(1)	(2)	(3)
FIRMIT01	0.0026*** (0.0005)	0.0027*** (0.0005)	0.0024*** (0.0005)
LTRADE00	0.5217*** (0.1887)	0.4990*** (0.1651)	0.5641*** (0.1593)
BANKSIZE05	9.7228*** (0.7769)	9.6289*** (0.7722)	8.8026*** (0.7043)
NIISHARE05	-1.619*** (0.6240)	-1.5991*** (0.6234)	
LDIST	-0.1240* (0.0736)	-0.1326** (0.0626)	-0.1432** (0.0627)
ANTRUST05	-0.2211* (0.1329)	-0.2847** (0.1268)	-0.2698** (0.1256)
CORTAX05	-0.0189* (0.0105)		
DOBU05	0.0057** (0.0025)	0.0049** (0.0021)	
COMPADVC00	1.1135*** (0.3917)	1.1156*** (0.3408)	1.0903*** (0.3393)
QINF05	0.3967*** (0.1312)	0.4502*** (0.1133)	0.3488*** (0.1045)
QEDSYST05	0.3675*** (0.1067)	0.3156*** (0.0903)	0.2804*** (0.0894)
NPL05	-0.0667*** (0.0137)	-0.0652*** (0.0129)	-0.0550*** (0.0119)
ROA05	-0.3070*** (0.1086)	-0.3128*** (0.0959)	-0.2853*** (0.0953)
LCRGDP04	0.1543 (0.2044)		
BC04	0.2444 (0.4452)		
OVERALL05	0.0091 (0.0117)		
MRES04	-0.1434** (0.0704)	-0.1490** (0.0633)	-0.1038* (0.0589)
N. obs	779	779	779
%correctly predicted+	72.27	72.02	72.01
p-value on statistical significance of the regression	0.0000	0.0000	0.0000
Pseudo R2	0.25	0.24	0.23

Note:^oGLM Robust Covariance matrix;*significant at 10% ** at 5%; *** at 1%;+obtained from the number of observations with highest predicted probabilities and the actual number of obs. at each category.

Table 6. Marginal effects of explicative variables model (2)

Variable	Coeff.	EntryType	Marg. Effect	Variable	Coeff	EntryType	Marg. Effect
FIRMIT01	0.0027	0	−0.0005	COMPADVC00	1.1156	0	−0.2088
		1	−2.7E−05			1	−0.0112
		2	−0.0003			2	−0.1109
		3	−3.0E−05			3	−0.0125
		4	0.0002			4	0.0742
LTRADE00	0.4990	0	−0.0933	QINF05	0.4502	0	−0.0846
		1	−0.0050			1	−0.0045
		2	−0.0496			2	−0.0447
		3	−0.0056			3	−0.0051
		4	0.0332			4	0.0299
BANKSIZE05	9.6289	0	−1.8021	QEDSYST05	0.3156	0	−0.0591
		1	−0.0966			1	−0.0032
		2	−0.9570			2	−0.0314
		3	−0.1082			3	−0.0035
		4	0.6404			4	0.0210
NIISHARE	−1.5991	0	0.2992	NPL05	−0.0652	0	0.0122
		1	0.0160			1	0.0006
		2	0.1589			2	0.0065
		3	0.0180			3	0.0007
		4	−0.1063			4	−0.0043
LDIST	−0.1326	0	0.0248	ROA05	−0.3128	0	0.0585
		1	0.0013			1	0.0031
		2	0.0132			2	0.0311
		3	0.0015			3	0.0035
		4	−0.0088			4	−0.0208
ANTRUST05	−0.2847	0	0.0533	M2RES04	−0.1490	0	0.0279
		1	0.0029			1	0.0015
		2	0.0283			2	0.0148
		3	0.0032			3	0.0017
		4	−0.0189			4	−0.0099
DOBU05	0.0049	0	−0.0009				
		1	−4.9E−05				
		2	−0.0005				
		3	−5.5E−05				
		4	0.0003				

Note: Marginal effects are computed as average of all observations (Long J.S, 1997, p.134)

Table 7. Scenario analysis (baseline= variable at their sample average; scenario 1 = the related exogenous variable is increased from its sample average by 1 standard deviation while the other explicative variables are kept at their sample mean)

Variable	Predicted probabilities–	
	subsidiaries*	Absolute average discrete change**
	$\Delta \%$	$\bar{\Delta} \%$
FIRMIT01	1.84	3.68
LTRADE00	1.04	2.27
BANKSIZE05	4.42	7.36
NIISHARE	–1.12	3.86
LDIST	–0.39	1.04
ANTRUST05	–0.55	1.52
COMPADV00	2.32	4.46
DOBU05	0.85	1.88
QINF05	3.12	5.65
QEDSYST05	1.21	2.58
NPL05	–0.97	3.06
ROA05	–0.63	1.78
M2RES04	–0.50	1.38

Note * difference between scenario 1 and baseline predicted probability ** $\bar{\Delta} = \frac{1}{K} \sum_{k=0}^K \left| \frac{\Delta \Pr(y = k | \bar{z})}{\Delta z_n} \right|$

Table 8. Presence of Italian banking system in EME by geographical area. Difference between predicted and actual probability of referred entry categories

World Bank Income Level	CEE, SEE And CIS			Middle East and Africa			Latin America			Asia		
		B+S	D+RO		B+S	D+RO		B+S	D+RO		B+S	D+RO
Low										India Vietnam	0.08* 0.04*	-0.21 0.03
Lower Middle	Albania	0.01	0.13*	Algeria	0.02	0.00	Brazil	0.02	-0.02	China	0.09*	-0.34
	Bosnia-Herzegovina	-0.07	0.06	Egypt	-0.03	-0.05	Peru	0.00	-0.04	Thailand	0.03+	0.01
	Bulgaria	0.00	0.11*	Iran	0.06*	-0.13						
	Macedonia FYR	0.02	0.00	Morocco	0.03	-0.10						
	Moldova	-0.02	0.07	Tunisia	0.04*	0.02						
	Serbia Montenegro	-0.16	0.06									
	Ukraine	0.00	0.12									
Upper Middle	Croatia	-0.02	0.08	Lebanon	-0.01	0.04	Argentina	-0.03	0.04			
	Czech Republic	-0.03	-0.01	South Africa	0.02	-0.01	Chile	0.01	-0.02			
	Estonia	-0.04	0.03				Mexico	0.03+	-0.04			
	Hungary	-0.08	0.01				Venezuela	0.02	-0.01			
	Latvia	-0.02	0.07									
	Lithuania	-0.03	0.05									
	Poland	0.03	-0.05									
	Romania	-0.04	0.11									
	Russia	0.04*	-0.07									
	Slovakia	-0.03	-0.03									
	Turkey	0.04*	0.02									
High	Slovenia	-0.03	0.08	Kuwait	0.00	-0.04				Hong Kong	-0.16	-0.06
				UAE	0.04*	-0.02				South Korea	0.06*	0.03
										Singapore	0.02	0.07

Sources: Author's calculations, World Bank Classification by income July 2006 B=Branch; S=subsidiary; D=desk; RO=Representative Office *significantly different from zero at 5 percent on a 1 tailed test (upper tail alternative); + significant at 10 percent

Appendix I –Data Source

Forms of entry: ABI Report on the Internationalisation of the Italian Banking System December 2006, available on the ABI internet site. Minority stakes are derived from bank's ownership structure reports provided by Bankscope.

List of the financial institutions involved in the empirical analysis (alphabetical order): Banca Carige; Banca di Roma; Banca Ifis; Banca Intesa; Banca Lombarda Piemontese; Banca Nazionale del Lavoro; Banca Popolare dell'Emilia Romagna; Banca Popolare di Sondrio; Banca Popolare di Verona e Novara; Banca Popolare di Vicenza; Banca Sella; Banche Popolari Unite; Cassa di Risparmio di Firenze; Mediobanca; Monte dei Paschi di Siena; SanPaolo IMI; Unicredit; Unipol; Veneto Banca.

FIRMIT01: number of firms in the host country with capital owned by Italian residents– source Politecnico di Milano–Reprint/ICE Data Bank.

LTRADE00: log of the value of bilateral trade between Italy and the host country – source International Monetary Fund– Direction of Trade Statistics.

NIISHARE 05 and BANKSIZE05: respectively the ratio of the non interest bank's income to the sum of interest and non interest income and the ratio of bank's assets to total assets in the banking industry for Italian banks – source Bankscope

LDIST: log of the distance between Italy and the host country –source the CIA Factbook 2007 for geographical coordinates.

ANTRUST05, QINF05 and QEDSYST05: effectiveness of antitrust policy, quality of Infrastructures and quality of educational systems – source Global Economic Forum– Global Competitiveness Report and Arab Competitiveness Report 2006–2007. Data on Iran from World Trade and Tourism Council and Potential Competitiveness Report 2006 from Japan Center for Economic Research

DOBU05: "Ease of Doing Business", index – source IFC World Bank – Doing Business database.

CORTAX05: tax rate on corporate or bank's profit, if different, in the year 2005– source Heritage Foundation– Country Reports.

COMPADV00: arithmetic average of six governance indicators– source World Bank– Kaufmann, Kraay and Mastruzzi (2005) database.

ROA05 and NPL05, Return on Asset (average) and non performing loans to total loans for the host banking system – source EBRD Transition economies report and IMF Global Financial Stability Report 2005. For Albania, Algeria, Macedonia, Iran and Vietnam data are taken from press releases and Central Banks statistics.

LCRGDP05: Log of Domestic credit to GDP– source International Monetary Fund – IFS.

BC04: Bank concentration in the host market measured by the assets of three largest banks as share of assets of all commercial banks. – source World Bank –Financial Structure database 2007 Beck, Demirgüç–Kunt and Levine, (2000), "A New Database on Financial Development and Structure," World Bank Economic Review, v.14: 597–605.

OVERALL05: Overall risk assessment Index is the average of the following sub components: security risk, political stability risk, government effectiveness risk, legal and regulatory risk, macroeconomic risk, foreign trade and payments risk, tax policy risk, labour market risk, financial risk infrastructure – source EIU – Risk Service

M2RES04: Ratio of Money stock M2 to International Reserve stock– Economist Intelligence Unit CountryData database.