DETERMINANTS AND EFFECTS OF FOREIGN MERCHANT BANK ENTRY INTO SOUTH AFRICA

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THE ABSTRACT

The expansion of foreign-owned banks into South Africa portrays similar characteristics to those of foreign bank entry into other emerging economies of the world. The literature on the determinants of entry and implications of foreign bank presence has focused on developed markets in Europe and the United States, while literature devoted to emerging economies has predominantly examined Asia, Eastern Europe and South America. Drawing on the international studies of foreign bank entry, this report attempts to critically analyse the reasons behind the expansion of foreign banks into the South African market. The report also examines the impact that foreign banks have on the South African banking industry, and identifies apparent comparative advantages that international foreign banks have over their South African counterparts. Lastly, the paper includes a survey of what the Investment Banking landscape in South Africa may look like for Global Investment Banks in five years time.

The research elicited some interesting findings. Foreign banks are entering the South African economy to capitalise on various new market opportunities offered by a sophisticated and interesting financial market and well-developed infrastructure. They also, however, are nurturing their customer relationships by following global companies abroad in order to serve their investment and commercial banking needs in these markets. Global banks are in a strong position to offer services to multinationals due to their global brand, international location and global network. Many foreign banks have identified Africa as an untapped market with attractive business opportunities. Since South Africa is the 'listening post' into Africa, foreign banks have an added advantage in holding a presence in South Africa. Foreign banks operating in South Africa hold comparative advantages in that they exist as global financial networks. They can, for instance, draw on their parent bank's capital base and the group's global knowledge base. Lastly, foreign banks have introduced healthy competition and efficiencies into the local banking market, and have contributed to South Africa's competitiveness in the global financial market arena.

THE DECLARATION

I, Mary-Jane McNaughton, declare that this research report is my own, unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

Signature

Mary-Jane McNaughton

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1 INTRODUCTION

1.1 Background to the Research

Globalisation is a growing phenomenon, impacting economies and industries worldwide in innumerable ways. The global trade in goods and services also includes the trade in financial services, which is known as internationalisation. The banking industry world-wide is being transformed by globalisation as well as consolidation, deregulation and liberalization in the industry. Internationalisation is a common theme among both emerging and developed economies, but has particularly been facilitated in recent years in developing economies by the relaxation of barriers to entry in many of these economies.

Following the lifting of sanctions and the deregulation of the stock exchange in 1996, South Africa experienced an influx of foreign banks into the financial sector, the effects of which impacted dramatically on the structure and competition in the sector. As economic theory suggests, new business opportunities encourage new entrants into that industry, the consequences of which, in South Africa, have had far reaching implications for industries ranging from automobile manufacturing to investment banking. In a recent survey conducted on domestic banks, heightened foreign interest was identified as one of the most important threats to local banks' future growth and their achievement of long-run objectives in the South African market (Metcalfe, 2005). The main driving forces of this phenomenon in South Africa have been deregulation of the banking industry in the 1990s, the introduction of financial sector reforms such as those on the Johannesburg Stock Exchange in 1996 to provide for corporate ownership and foreign ownership (Metcalfe, 1999), as well as globalisation (Steenkamp & Burgess, 2005). Since South Africa is classified as an emerging economy, but it is one with a mature banking system, this study is one of the first of its kind. The study is an investigation of the phenomenon of bank internationalisation into South Africa, and the drivers of this phenomenon and the impact on domestic financial players.

1.2 Significance of the Research

Following the deregulation of the banking sector in 1996, foreign bank presence constituted a major threat to the domestic banks in South Africa up until 2002. During 2002, the South African banking sector experienced a major shake-out, driven initially by the curatorship of Saambou (Absa, 2002) and the volunteering of banking licenses by small banks in South Africa during the same year. Most foreign banks withdrew their operations from South Africa.

Over the past few years, a large number of foreign banks have shown an increasing commitment to the African continent and more specifically South Africa. Several foreign banks have re-entered the country, or expanded their operations in South Africa, devoting a growing level of resources to a growing market (KPMG, 2004). Bank internationalisation is therefore a strong force influencing the South African banking market. A survey undertaken by PriceWaterhouseCoopers (PWC) in South Africa revealed that domestic banks anticipate that the market share of foreign banks will continue to grow in the investment banking sector (Metcalfe, 2005). Thus it is of great value to investigate the determinants of this increasing interest, as well as the implications for the domestic financial system and the lessons learnt for future investors.

Furthermore, there does not exist a large body of literature on the impact of foreign bank entry in an emerging economy with a mature banking system. South Africa contrasts with other emerging markets because of its sound banking system. Therefore this research was undertaken in the hope of adding richness to the body of literature on internationalisation of banks. The study allows a greater understanding of the impact of globalisation on the structure and future direction of the South African financial industry.

1.3 The Research problem and sub-problems

The aim of the research is to investigate the internationalisation of foreign investment banks into the South African banking market by identifying the key determining factors for entry into the local market, to understand the comparative advantages for foreign banks operating in South Africa, as well as to recognize the fundamental implications of foreign bank presence for the domestic economy.

In order to achieve the above-mentioned aim, the following sub-problems are identified:

1. What are the drivers of foreign bank internationalisation into South Africa?
2. What comparative advantages are apparent for foreign banks operating in South Africa?
3. What are the implications for the domestic economy of foreign bank entrants into South Africa?

1.4 Delimitations and Limitations

The structure of foreign bank presence in South Africa consists of: registered banks foreign controlled; registered branches; foreign banks' representative offices. The study focuses on registered branches, subsidiaries of parent companies, and representative offices. The presence of a representative office allows only limited operation (Frauendorfer & Gantenbein, 2002), while a branch, which is an integral part of the parent bank, offers a far wider range of services. The third organizational form, subsidiaries, ensure even a greater impact, as they are permitted to engage in an even broader sphere of financial service than branches as well as having identical powers as the domestic bank, and thus are regulated in the same manner (Clarke, Cull & Martinez Peria, 2001). Banks that are foreign controlled are excluded from the study.

1.5 Assumptions

This study assumes that the pattern and phenomenon of the internationalisation of foreign banks is identifiable and that sufficient information exists to examine these. It also assumes that the impact of the entrance of foreign-owned banks into South African markets is identifiable and that sufficient information exists to examine this.

2 LITERATURE REVIEW

2.1 Introduction

The context of the study is for all intents within the emerging markets realm, since South Africa is classified as an emerging economy (Harvard Business Review, 2001; Metcalfe, 2005). Arguments surrounding foreign bank entry are retrieved from the literature on emerging and developed economies in the topics of consolidation, internationalisation, liberalization and globalisation (Hawkins & Mihaljek, 2001).

The focus of the study is within the investment and commercial banking arena since it is here that foreign banks have penetrated the local market. A study in 2005 in South Africa revealed foreign banks' greatest successes in the distinct areas of corporate finance, structured products, foreign exchange, capital markets and commercial lending. These areas of activity all fall within corporate and investment banking and the commercial banking arena (Metcalfe, 2005).

2.2 Bank internationalisation

2.2.1 Background to bank internationalisation

Foreign participation in banking is a consequence of the process of banking internationalisation that results from technological innovation and the deregulation of financial services (de Paula & Alves 2003, Hawkins & Mihaljec, 2001). It is also driven from the opening up of borders to international competition, changes in corporate behaviour such as growing disintermediation and increased emphasis on shareholder value (Hawkins & Mihaljek, 2001), as well as cross-border consolidation (de Paula, 2003). Nikitin (2002) adds the diminishing distinction between banking and capital markets and the increasingly free convertibility of currencies. The increased integration of banking sectors around the world has been facilitated by the liberalization of those countries' financial markets. The opening up of financial markets has proceeded on the premise that gains from foreign entry to domestic markets offset the possible losses by domestic banks (Frauendorfer & Gantenbein, 2002). In Africa, most countries' financial development is inextricably tied to the policy of market liberalisation. The most profound and encouraging change in many countries in Africa over the past decade has been the rapid move towards integration with the global economy (Lwiza & Nwankwo, 2002).

Although there may be strong incentives for foreign banks to expand abroad, they have until recently faced substantial barriers to entry in most emerging market economies (Mathieson & Roldos, 2001). Foreign banks have faced strict limits on the availability of banking licenses, restrictions on the number of branches, controls on permissible activities, and restrictions on the extent of foreign ownership of individual banks and/or bank assets. However, in recent years, a greater openess to foreign trade and investment combined with the need to build up more efficient and stable financial systems in some emerging economies, and the desire to hold globally diverse portfolios have typically been major catalysts for the removal of barriers to entry of foreign institutions in emerging markets (Mathieson & Roldos, 2001). “Today’s banking industry is characterised by intensified global competition and rapid advancements in the liberalisation of the banking market”, (Chen, 1999: 83).

Emerging market economies may exhibit serious shortcomings, which create the need for foreign bank participation. These shortcomings include: a lack of capital; a lack of commercial banking skills; and an inefficient banking infrastructure, (Hawkins & Mihaljek, 2001).

Hawkins & Mihaljek (2001) argue that emerging economies are undergoing deep changes in their banking structures, and identifies four forces underlying these changes: Development of information technology, which lies at the heart of financial intermediation; domestic deregulation and the external opening-up of financial sectors; changes in corporate behaviour; and banking crises.

Banking in the emerging economies was traditionally a highly protected industry, with pervasive restrictions and domestic and foreign entry, and with those in the industry benefiting from good spreads on regulated deposit and lending rates. Global market and technology developments, macroeconomic pressures and banking crises in the 1990s have been the main forces for change in the traditional cosy environment of emerging markets. As a result, borders between financial products and banks and the geographic locations of financial institutions started to break down in the 1990s, which placed significant competitive pressure on banks in emerging economies, and leading ultimately to changes in the structure of the banking industry. These large changes included the establishment of many new institutions, privatisation of state-owned banks, mergers and consolidation, and a large increase in the presence of foreign banks (Hawkins & Mihaljek, 2001).

The issue surrounding IT is its impact on the processing of information, which is the essence of the banking business. New technology is affecting the structure and performance of the banking industry in developed as well as emerging markets, in the form of cost advantages and optimal scale of operation. Furthermore, banking systems and strategy are being influenced by the introduction of sophisticated financial instruments such as derivative products which have significant implications for advanced risk management functionality (Hawkins & Mihaljek, 2001).

The spread of IT has also affected corporate behaviour in the way of financing new capital projects, particularly new technology projects which require substantial capital. Corporations have been forced to turn to the capital markets as alternative forms of funding for projects that may be seen as too uncertain and risky for traditional banks. As a result, banks are under increasing pressure to keep their customers and hence are forced to develop techniques for better pricing and provisioning of credit risks (Hawkins & Mihaljek, 2001).

Hawkins & Mihaljek (2001) maintain that the existence of banking crises, deregulation and globalisation of financial services have been the major forces leading to a dramatic increase in the presence of foreign banks in the emerging economies in the second half of the 1990s. In central Europe, the share of foreign banks in terms of both total assets and capital is now around two thirds, making these countries' banking systems amongst the most open in the world. In Latin America, the market share of foreign banks rose to 40% in 2000 from a mere 7% in the early 1990's. In Asia, foreign banks have increased their presence significantly in Thailand and the Philippines.

The decision to expand abroad requires the identification of potential markets and establishing of an order of priority for entry into these markets; the decision on the extent of the marketing effort to which the firm will commit itself; the decision of the timing of the entry and the extent of the marketing effort it will invest in these potential markets (Mas-Ruiz, Nicolau-Gonzalbez & Ruiz-Moreno, 2002).

On deciding on the market, the internationalisation process of banks may be further affected by such aspects as:

- Regulatory changes;
- The influence of home-market conditions upon the timing of the decisions to internationalise; and
- The international behaviour and requirements of private and public sector clients (Alvararez-Gil, Cardone-Riportella, Lado-Couste & Samartin-Saenz, 2003).

2.2.2 Consolidation in the banking industry

Banking crises, financial deregulation and the globalisation of financial services have accelerated the process of consolidation in emerging economies, changing a traditionally protected industry. de Paula (2003) holds that the new phase of bank internationalisation is a consequence of this consolidation process, with financial institutions looking to diversify their activities and increase their minimum scale of operation in order to remain competitive and to enhance their ability to generate profits. As a result, borders between financial products, banks and non-bank financial institutions and the geographical locations of financial institutions have begun to disintegrate. These changes have significantly enhanced competitive pressures on banks in emerging economies, driving bank consolidation in some economies (Hawkins & Mihaljek, 2001).

The banking systems of most emerging economies are largely fragmented in terms of the number and size of institutions, ownership patterns, profitability and competitiveness of the banks and the use of modern technology. Typically, there are three or four large commercial banks, which co-exist with a large number of smaller urban and rural banks. In some cases, profitability and operating efficiencies vary widely with vast differences existing in managerial capacity, technology, and liquidity management. In general, profitability varies widely, with some banks earning high returns but operating inefficiently, and other banks competing fiercely for a narrow segment of the market. In some countries, recent bank crises have weakened banking systems, such as in Argentina and Mexico. Under these conditions, it is natural to consider bank mergers as a possible vehicle for improving the structure and efficiency of the banking industry (Hawkins & Mihaljek, 2001).

In general, advances in technology, deregulation and globalisation have reduced margins in traditional banking activities, driving the merger process between banks, other banks and non-bank financial institutions at home and abroad.

2.2.3 Forces driving bank consolidation

The forces driving consolidation in emerging and developed economies are similar, but the former shows some distinguishing features (Hawkins & Mihaljek, 2001; Gelos & Roldos, 2002).

The underlying force for consolidation in a developed economy is to increase efficiency through eliminating excess capacity and cutting costs, while in emerging economies the underlying reason is that it is often a way of dealing with a crisis (Gelos & Roldos, 2002).

In emerging economies, the authorities tend to play a larger role in the consolidation process, that is the government conducts directly or indirectly the process of banking consolidation through programs of banking restructuring, privatisation of public banks, increasing flexibility in the rules of foreign bank entry (Gelos & Roldos, 2002; Hawkins & Mihaljek, 2001). In mature markets, the consolidation process is purely market-driven, (de Paula & Alves, 2003).

In many emerging economies, local banks started as family-owned institutions. These ownership structures, regulatory shortcomings, and concerns about job losses remain the main obstacles to market-driven consolidation in emerging economies. Furthermore, only a handful of banks are publicly listed in emerging market banking systems, making both friendly and hostile take-overs very difficult to execute (Gelos & Roldos, 2002).

One of the most common elements separating emerging and developed economies is the degree of cross-border mergers and acquisitions. While it is rare in mature markets, it accounts for a significant share of the consolidation activity in emerging markets (Gelos & Roldos, 2002), and hence large-scale foreign bank ownership has continued to grow in these economies. Foreign institutions now control over half the banking system assets in Argentina, Chile, the Czech Republic, Hungary, Poland, and Mexico. In many of the Latin American and Central European countries, foreign banks are currently integrating their previous acquisitions with some of the larger banks bought in the late 1990s (Gelos & Roldos, 2002). African banking markets are also beginning to experience larger degrees of foreign ownership (Games, 2003).

Notwithstanding these differences, the main forces at work in the consolidation of emerging and mature markets are similar. The main activities encouraging consolidation are globalisation, advances in technology and deregulation, while those discouraging it are lack of information and transparency, cross-country differences in regulatory frameworks, ownership structures, and cultural differences (Gelos & Roldos, 2002).

Hameeteman & Scholtens (2000) summarise the main reasons for bank consolidation as:

- profitability – big banks are more profitable than small ones;

- economies of scale – only gained in larger entities;
- bank concentration – management of banks is rewarded on basis of profitability, which drives banking concentration;
- client internationalisation; and
- bank competition.

2.3 Theories on international expansion

Cardone-Riportella, Alvarez-Gil, Lado-Couste & Sasi (2000) identify two groups of conditions determining the entry form of service-sector firms in the internationalisation process. These conditions are described briefly below:

Market seeking – a service firm enters foreign markets primarily to access new markets and opportunities. These firms strive to maximise profits and, as such, choose the markets with the highest economic growth potential first. When these are saturated, the firms will next turn to less attractive markets.

Client following – To minimise perceived uncertainty, firms enter markets (regardless of their economic potential) to maintain and improve the relationships with their original clients. One of the dominant features of the internationalisation of service companies is the phenomenon of 'customer-following'.

In addition to these two perspectives, and certainly in accordance with what they prophesise, a number of theories were developed around the 1970s – 1980s which attempted to explain the international expansion of banks. Of these, the most popularised are discussed here. Nikitin (2002) describes the *comparative advantage theory* as applied by Aliber (1976) to the banking industry, where it is assumed that banks that will become multinational are those located in countries with comparative advantages in producing bank products or services. According to the theory, banks with a comparative advantage in producing bank products will likely dominate the world banking market, as they can access world capital markets on increasingly favourable terms due to higher relative profits.

The second approach, the *industrial organisation theory*, was addressed by Grubel (1977) and is described by Nikitin (2002) wherein multinational banks move abroad in 'customer-following' activities. This expansion may not be aimed at generating profits in the new location, but is instead aimed at minimizing losses in a pre-existing activity. The bank is investing offshore in order to internalise its existing contractual and information relationships.

The third approach, the *international investment theory* argues that the major motivation for foreign bank entry lies in the existence of exogenous imperfections in the international financial markets, such as interest rate differentials. The argument lies in the benefits that may be achieved from geographical diversification: "the total risk of a multinational bank's global assets is lower than that of a purely domestic bank" (Bouteiller & Marois, 1999: 5).

The literature of the 1970s and 1980s built a theory of international banking as heavily based on the theory of foreign investment in manufacturing (Peinado-Sanchez, 2003), and is related to the *industrial organisation theory* above. The theory was built on the premise that multinational banking grows in parallel with direct foreign investment (FDI) as banks attempt to meet the demand for banking services of multinational firms abroad. Bank behaviour of moving abroad is seen as a defensive strategy necessary to assure the continued business with the domestic parents of foreign subsidiaries. The strategy ensures the preservation of the existing flow of information which has resulted from the bank/firm relationship. Therefore, the ability to draw on the information and personal contacts between a bank and existing client's parents in a foreign country at a very low marginal cost represents the main source of comparative advantage for the foreign bank (de Paula, 2002).

Early writers on the theory of multinational enterprise (MNEs) were concerned with how it can be explained that some firms engage in transnational operations, despite having the inherent disadvantage stemming from the greater knowledge that domestic firms possess regarding their local markets and from the extra costs MNEs must incur in coordinating entities across different geographic locations. For MNE's, including banks, to be able to compensate for this disadvantage, they must possess intrinsic capabilities which give them a competitive advantage over the domestic rivals (Mata & Portugal, 2002). These advantages would usually be related to the possession of particular assets, which, once developed in a particular location, can be employed in other locations at lower cost than developing it locally. Thus, these firm-specific assets have allowed the firm to enjoy some degree of economies of scale, which allow them financial advantages, product differentiation, and marketing advantages (Mata & Portugal, 2002).

2.4 Drivers of foreign bank entry

In their study on determinants of Spanish banks entry into Latin America, de Paula (2003) found the following determinants:

a) *The increasing competitiveness of the banking sector in developed nations*

Expansion strategies may be interpreted as a response to this more competitive environment, where several factors can be seen to be eroding returns from traditional banking business.

b) *The deregulation in the broader context of political and economic reforms since the early 1990s*

The deregulation of financial services makes more room for entry of foreign companies into key economic sectors, such as banking telecommunications and utilities.

c) *The valuations of host country companies are much lower than those of investing countries*

This makes it easier to attain a large market share with a lower cost.

d) *The prospect of much higher returns in host countries for foreign financial institutions*

This is as a result of the intermediation margins which banks operating in emerging economies are much higher than in the developed world *e) The potential gains in efficiency are high since the degree of banking efficiency in emerging economies is generally lower than in developed economies.*

These economies are characterised by high operating costs and high interest rate spreads, which are largely a result of the legacy of high inflation periods, where inflation revenues generated easy profits for the banks and, consequently, there was little pressure to cut costs.

The determinants in the above discussion can be summarised as: local market opportunities; higher expected rates of economic growth; more stable economic conditions, and bank inefficiencies in the host country.

Frauendorfer & Gantenbein (2002) categorise the motivational factors influencing foreign banks' decision to go abroad as 'location-specific' factors and 'bank-specific' factors.

2.4.1 Location specific factors

a) Economic Integration

Broad consensus exists about the fact that foreign direct investment by banks is significantly correlated with the degree of economic integration between the home country of the foreign bank and the host country. Frauendorfer & Gantenbein (2002) maintain that an obvious explanation is that banks follow their home clients abroad in order to satisfy their banking needs in foreign countries. The 'follow-the-customer' strategy is considered by the above-mentioned "*industrial organisation theory".*

de Paula (2003) and Cordone *et al (*2000) maintain that a major determinant for internationalisation is the desire to provide services to existing, global customers, while Clarke *et al* (2003) cite the degree of economic integration between a foreign bank's home country and the host country into which it enters as a compelling reason to expand into a foreign market.

Hawkins & Mihaljec (2001) maintain that foreign banks have historically followed their home-country customers to emerging markets, and as a result, are often seen as specializing in servicing large corporate clients, either multinational companies or “cherry picked” host country corporations.

Konopielko (1999) maintains that the most important reason for expansion is the perceived need for support by the client base, which means the “follow-the-client” behaviour remains the most important factor shaping attitudes towards new investment projects.

b) Local market opportunities

A second reason why banks may expand abroad is the attractiveness of the host market. The market of the host country may offer new opportunities to make profits, depending on the characteristics of the economy, i.e. size, stability of the country, features of the local banking sector (Lensink & De Haan, 2002).

Focarelli & Pozzolo (2000) argue that profit opportunities are the major driver of expansion abroad. Cordone *et al* (2000) maintain that the current trend is for banks to seek profitable opportunities through accessing new market opportunities.

de Paula (2002: 12) notes that financial institutions are not only internationalising their operation in order to nurture existing client relationships, … “but also (and increasingly) in order to widen their financial activities in the host market mainly through the acquisition of majority, controlling stakes, or the acquisition of minority, non-controlling stakes”. Although there are few recent works that establish a pattern of foreign bank entry, one of the most common effects finds itself in increased bank competition as a result of deregulation. As margins and fees are tightened in the domestic financial services area, financial firms seek to expand overseas into markets which promise growth and greater net interest margins (de Paula, 2003).

A number of recent studies provide support for this notion that foreign banks are increasingly being attracted by profitable opportunities in host countries (Clarke *et al*, 2001). In particular, a comprehensive study by Focarelli & Pozzolo (2000) indicated greater foreign bank entry where the expected and potential rate of economic growth is higher and the banking system is, on average, less efficient, i.e. where banks have higher costs, lower net interest margins and higher cash-flows resulting from inefficient use of capital. The total number of banks in the study was 143, which had shareholding across 28 countries. Since these banks were representative of many different countries, the study represents the most extensive "from-many-to-many" study to date (Clarke *et al*, 2001).

de Paula (2002) argues that local market opportunities in the host country which include a higher expected rate of economic growth, a more stable economic environment and the banks' inefficiency in the destination country are the main determinants of the banks' decision to expand abroad. Banks prefer to invest in countries where expected profits are high, owing to higher expected economic growth. Banks operating in countries where the banking sector is larger and more profitable may be able to export superior skills and therefore are morel likely to expand their activities abroad (de Paula, 2002).

Clarke *et al* (2001) find that foreign banks enter developing countries for different reasons than they would for those which are developed and, in particular, the 'follow the customer' motivation is less important for entering developing countries.

Nikitin (2002) argues that it is mainly experienced and strong international banks that follow this strategy because 'market-seeking' strategies are tied to greater risks. The author continues that such banks, in aiming to achieve a geographically wide service network, should be multicultural, synergistic and whole.

c) Regulatory restrictions

A third motivation for foreign banks to expand abroad is the *regulation,* which generally limits competition and protects inefficient banks (Lensink & De Haan, 2002). Regulatory restrictions by their very nature seem to considerably reduce the degree of internationalisation of a country's banking market (Focarelli & Pozzolo, 2000). The level of economic reforms and political reforms may be a significant consideration for foreign banks to enter certain countries. Generally, countries that have successfully established safe, transparent and enforceable rules for financial markets are probably attractive for foreign banks. Additionally, the removal of entry barriers, membership of the World Trade Organisation (WTO) and enterprises operating according to Western 'standards' with respect to financial structure, corporate control, etc., make the market more attractive for foreign banks (Lensink & De Haan, 2002).

2.4.2 Bank specific factors

a) Size

Greater foreign presence is found where the average bank size is smaller, implying it is easier to acquire such banks and there is greater opportunity to increase market share after restructuring. Furthermore, it is the large banks from the foreign country which tend to expand abroad. Generally, larger banks have larger and more international customers, and thus follow these customers to serve them abroad. Additionally, large banks have a greater incentive to expand abroad to diversify their risk. Economies of scale and scope, portfolio management and investment banking are also strongly influential in a decision to go abroad.

b) Efficiency

Studies on developing countries indicate that foreign banks outperform domestic ones, since they have higher interest margins, profitability and less overhead expenses than domestic banks (Focarelli & Pozzolo, 2000). In some developing countries, such as Costa Rica, Jamaica and Venezuela, foreign banks are able to realize net interest income of over 10 percent of assets. Claessens, Demirgüç-Kunt & Huizinga (2001) maintain that foreign banks are able to realize higher net interest margins in developing countries because they are frequently exempt from credit allocation regulations and other such restrictions. Within emerging economies where market inefficiencies and outmoded banking practices are common, higher net interest margins are pervasive, which may outweigh the information disadvantages foreign banks face. Claessens, Demirguc-Kunt & Huzinga (2000) find that high inflation and high real interest rates lead to higher bank margins and profits, although the cost of operating in those environments is also higher.

When capital markets are segmented, or partially segmented, banks from large, well-diversified capital markets will have a cost advantage over those banks which have to raise their equity capital in narrower markets. Equity capital cannot be imported without bringing ownership in terms of FDI (Tschoegl, 1987).

Lensink & De Haan (2002) point out some macroeconomic variables used as a proxy for identifying the attractiveness of the host country, such as GDP, population, FDI, investment rate, export of host country. Furthermore, variables that relate to the performance of a domestic financial sector, such as return on equity, net interest margin, overhead costs and after tax income serve as useful proxies. Other examples of variables used are the size of the financial system of the host country (total assets, private credit, central bank assets, concentration ratio), information costs (distance from home country, common language, legal system, country risk, culture), as well as the presence of an international financial centre.

2.5 Entry Strategies into a domestic banking system

Hawkins & Mihaljek (2001) established that historically the pattern of foreign bank entry followed that of economic integration between countries: banks extended their services abroad in order to assist their home country customers in international transactions. As they grew to understand the foreign market, in particular the regulatory and institutional aspects, and as they developed relationships with local financial institutions, foreign banks would extend their range of operations and services. Following this pattern, foreign banks would first establish a representative office to handle trade credit operations and possibly arrange international private debt and equity placements between borrowers in the host (emerging) country and lenders in the source country. At a later stage, foreign banks would open branches, which are typically involved in wholesale deposit and money markets. Following this, the next step would be to establish a subsidiary and to use them to enter retail banking markets.

At present, this pattern of internationalisation is different and depends on more than merely the degree of economic integration between countries. In particular, the profit opportunities in the destination market have become a key factor in determining and driving foreign bank participation. This shift in drive underpins the current varied nature of bank participation, which includes full acquisition, targeted purchases of specific activities, joint ventures or alliances with local banks, and outsourcing of administrative and financial services (Hawkins & Mihaljec, 2001; Cordone & Cazorla, 2001). Foreign banks are trending toward running wholly owned acquisitions as subsidiaries rather than as branches. Major international banks that originally created networks of branches around the world, such as Citibank, HSBC, ING, ABN-AMRO and Deutsche Bank, have gradually moved towards a strategy of making selective acquisitions in key emerging markets and have kept them as subsidiaries (Hawkins & Mihaljec, 2001).

2.5.1 Modes of entry

The form of foreign bank entry is mainly determined by the motivations of the respective banks for entering the foreign country (Focarelli & Pozzolo, 2000).

In entering foreign countries, banks seek to exploit certain advantages for themselves in the targeted country (Cardone-Riportella & Cazorla-Papis, 2001). Kim & Lee (2004) identify financial sector FDI as broken down into two categories: Foreign entry to the banking sector, the securities and the insurance through green-field investments or mergers & acquisitions (M&A), and foreign bank entry through opening branches and representative offices. Similarly, other authors describe foreign bank entry as taking the form of a branch, a subsidiary, or the purchase of an existing franchise (Pomerleano & Voita, 2001;

Frauendorfer & Gantenbein, 2002). Frauendorfer & Gantenbein (2002) maintain that the presence of a representative office allows only limited operation and therefore only the other two forms offer an effective entry possibility. Both these strategies have their pros and cons. While entry via a branch or subsidiary requires more time and inherits a certain additional risk related to the missing local market experience, the purchase of an existing entity involves internal restructuring and transfer of know-how, operations processes, and staff. A branch is an integral part of the parent bank, meaning it can draw from the parent's capital base as well as offering a wider range of services than the agency or representative office. The next organizational form, the subsidiary, is permitted to engage in even a broader sphere of financial service than a branch as well as have identical powers as the domestic bank, and thus are regulated in the same manner (Clarke *et al* 2001). In general, subsidiaries over and above branches seem to offer comparative advantages for foreign banks.

Goldberg (1992) holds that the most limited, but easiest to establish of the organizational forms is the representative office. These offices neither take deposits nor make loans, but rather act as agents for the foreign bank by forwarding payments to the home office. Goldberg (1992) argues that the representative office is established in order to test the possibility of further involvement in the host country.

In a recent study, Gelb (2002) found that developed country firms wishing to enter other developed country markets did so through M&A in order to leverage their existing advantage by integrating successful foreign firms into their operations.

In considering some of the worlds largest banks, Citibank, JPMorgan-Chase and Deutsche Bank have traditionally followed an entry strategy of opening up a branch or a subsidiary. In contrast, ABN-AMRO, Commerzebank, HSBC and Banco Santander have tended to purchase existing franchises.

2.5.2 Products and Services offered

The main focus of foreign banks entering developing countries have been wholesale products and services that had either not been successful or not offered by domestic banks. This list of products illustrates the fact that foreign banks have advanced access to necessary components such as, international capital, human resources endowment and technology, in order to provide sophisticated services for demanding multinational and domestic clients. The results from Pomerleano & Vojta (2001) identify that foreign and domestic banks may have a comparative advantage in different product areas, and that foreign banks explore those niche areas in the local market in which they will have a comparative advantage. The authors hold that foreign banks have a competitive advantage in products that require a global platform, such as those already identified by Frauendorfer & Gantenbein (2000), but that local banks will have a competitive advantage in products that require local capabilities, particularly funding and know-how, and additionally will have a competitive advantage in serving small and medium-size enterprises (SME's)**.** While foreign banks reap significant yet not universal competitive advantages in corporate lending, their capacity to penetrate the SME is limited. One of the main reasons for this is the high transaction costs and credit risks associated with small loans. Additionally, significant barriers to entry exist in this market: regulatory barriers; cultural familiarity; the high costs of establishing a branch network; and poor profitability (Pomerleano & Vojta, 2001).

By contrast, local banks are familiar with local conditions, benefit significantly with the time horizon of their credit information and the longevity of relationships with SMEs, and they hold a wealth of knowledge from which they can make precise calculations about credit worthiness. As a result, domestic banks command this arena and thus enjoy competitive advantages in SME lending (Pomerleano & Vojta, 2001).

2.6 Impact of foreign banks on domestic banking system

It was not until the late 1990's after barriers to entry were significantly reduced that foreign financial institutions began to acquire a substantial presence across emerging markets. The increase in foreign participation led to a series of studies focused on the effects of foreign bank entry in domestic financial systems.

Hawkins & Mihaljec (2001); Clarke, Cull, D'Amato & Molinari (2000); de Paula (2002); Mathieson & Roldos (2001) identified a number of benefits of foreign bank participation for the emerging economies. They identify benefits in the state of the art technology introduced by foreign banks, the training for domestic bankers, the sophisticated financial instruments and techniques, as well as the faster and cheaper access to international capital markets and liquid funds. Mata & Portugal (2002) state that managerial abilities give multinationals an advantage over domestic ones.

Frauendorfer & Gantenbein (2002) conclude that the opening up of a closed financial system, such as in the case of China, tends to promote efficiency and stability in the banking system and as a result helps to stimulate sustainable economic growth. Similarly, Pomerleano & Vojta (2001) find that the presence of foreign banks is not a zero-sum game, but rather complements the services of domestic banks and deepens the domestic financial market.

Local regulatory authorities, however, may rely too heavily on these effects occurring. Following the Mexican crisis, the quick pace of growth of foreign banks into the Argentine and Brazilian banking system was seen by monetary authorities as a solution to handle the impact that the Mexican crisis had on the domestic financial system. The belief was that, with the entrance of foreign banks, emerging countries have enhanced access to foreign savings, an essential ingredient to finance development; an enhanced financial system which would increase its soundness and resistance to shocks; the incorporation of new technologies, introduction of new management methods and new financial products; and improved operational efficiency in the banking sector. However, the foreign bank entry into Argentina and Brazil did not have the scale of desired effects expected initially. The subsequent findings are that the increased presence of big foreign global banks since 1995 has not resulted in a sustainable credit growth and macroeconomic instability is still the hallmark in the two countries (Mathieson & Roldos, 2001).

2.6.1 Arguments for foreign bank entry

a) Efficiency and stability of the financial system

It is a widely held belief that foreign bank presence may have a positive effect on the efficiency of developing countries, improving the quality, pricing and availability of banking services directly and indirectly (Frauendorfer & Gantenbein, 2002; de Paula & Alves, 2003), and will particularly have positive implications if occurring as part of a liberalisation process (Lensink & De Haan, 2002).

Allowing foreign banks to enter is typically viewed as having the most beneficial effects when occurring within the context of a more general liberalization of trade and production of financial services. A general liberalization of trade in financial services induces countries to produce and exchange financial services on the basis of comparative advantage. Allowing foreign bank entry as part of this liberalization process is seen as improving both the efficiency and stability of the banking system in the way of improved quality, pricing and availability of financial services directly through enhanced services or indirectly through competition with domestic banks, which will encourage the latter to introduce similar improvements. A transfer of technology occurs if authorities allow high-quality international banks with solid reputation to enter and permit the immigration of skilled banking personnel. Since these banks will also hire local bankers with a superior knowledge of the local economy, these local bankers will assimilate the practices and technology of the international banks, which they will retain when they move back to domestic banks (Mathieson & Roldos, 2001).

Mathieson & Roldos (2001) note that foreign banks entry into emerging markets force domestic banks to become more efficient if they wish to survive. In addition to efficiency, foreign banks bring new products, improve the allocation of credit and provide a more stable source of credit. This greater stability comes from access to the parent bank in the home country, which would hold a more internationally diversified portfolio implying its' income stream would be less correlated with domestic shocks. Although it is often argued that local operations of foreign banks are likely to have recourse to additional capital from their head-offices, which implies more stability in lending capacity, there is additionally the issue of whether foreign banks can contribute to the stability of the domestic deposit base. Foreign banks can introduce stability if local depositors shift their deposits to foreign institutions which are perceived as sounder than domestic banks rather than engaging in capital flight. The market share of deposits in foreign banks tripled in Korea and Indonesia between 1997 and 1998.

Of noteworthy significance is the finding from Hawkins & Mihaljec (2001) that in countries with mature markets, foreign banks appear less efficient, as these are markets with a generally efficient domestic banking system.

Financial stability of the domestic banking system has been found to improve as a result of foreign bank entry, as numerous studies have shown. However, Mathieson & Roldos (2001) argue that the stability effects of foreign bank presence is mixed but that an increasing body of evidence points to the fact that banks with a longer-term commitment to emerging markets tend to provide a stable influence. Foreign bank presence enables a country to import strong prudential supervision into the banking system. Local subsidiaries are technically stand-alone entities, but parent companies will typically oversee their activities in order to protect their reputation. Moreover, the presence of foreign banks engaging in sophisticated activities and providing new products may lead to the upgrading and increased efficiency of staff supervising activities of both domestic and foreign banks (Mathieson & Roldos, 2001).

More often than not, benefits emerge in terms of microeconomic stability rather than macroeconomic stability. The findings from the Argentinean and Brazilian case indicated that foreign banks brought microeconomic stability to Latin America in terms of lower costs of supply of credit enabled by new best practice and technologies (de Paula & Alves, 2003).

Clarke, Cull, Martinez Peria & Sanchez, (2003) shows how cross-country evidence indicates that, on average, foreign entry has provided net benefits in terms of stability. In individual country cases, the outcome most likely depends on the roster of entrants. Too much exposure to banks from any single country may increase instability, particularly if that country is subject to fluctuations and the entrants do not hold diversified portfolios of assets. For example, there is concern that Latin American banking sectors may be to exposed to economic fluctuations in Spain.

Claessens *et al* (2001) conducted a comprehensive investigation into the relationship between foreign banks entry and the performance of the domestic banking sector in 80 countries. 7900 bank observations were conducted between the period 1988-1995. The main result of the study was that, foreign banks tend to have higher profits than domestic banks in the developing countries, while in developed countries foreign banks are less profitable than domestic banks. The results also indicated that higher foreign bank presence is associated with lower profitability, costs and margins of domestic banks.

b) Competition in the domestic banking market

Clarke *et al* (2000) find that although foreign banks compete beyond the wholesale market, they do not compete with domestic banks in all sectors equally. These results are consistent with the hypothesis that foreign banks enter specific areas where they have a comparative advantage putting pressure on those domestic banks which already focus on those specific lines of business. The results of Barajas, Steiner & Salazar (2000), studying the case of Columbia, also suggested that foreign banks concentrate their focus on a subset of areas rather than competing against domestic banks in all banking areas.

Goldberg (1992), in his study on foreign banks in America, notes that newly entered foreign banks are able to price their products below their domestic competitors in order to obtain business. They were able to accept smaller profit margins than their domestic competitors because of lower capital requirements and a greater ability to use leverage.

Foreign banks have competitive advantages in terms of management process and quality of support. Foreign banks hire competitively, introduce pools of specialised and seasoned skills, invest heavily in training and development of human capital and offer salaries and bonuses that are more globally competitive, thus drawing the local market into the global, competitive arena (Pomerleano & Vojta, 2001). These factors can, importantly, represent sustainable competitive advantages for foreign banks operating in the local market (Pehrsson, 2004).

Clarke *et al* (2003), however, argue that the high cost of doing business in a foreign country means that foreign banks will often find themselves at a competitive disadvantage, which they need to overcome either through special expertise or services. In mature banking systems with strong domestic banks, it is particularly hard for banks to find a competitive advantage through expertise or service, and hence in these markets, banks compete largely on price and in the wholesale market. In this type of environment, the only niche expertise that many foreign banks can offer is their knowledge of and links to their home country.

Clarke *et al* (2000) provides empirical evidence that a larger foreign ownership share of banks indeed reduces the profitability and the overall expenses of domestically owned banks. They suggest that foreign bank entry improves the functioning of national banking markets, with positive welfare implications for banking customers. Interestingly, the authors find that it is the number of entrants that matters rather than their market share, indicating that foreign banks affect local bank competition upon entry rather than after they have gained market share.

In concluding their study on developed nations, Clarke *et al* (2003) motion that the majority of studies have found that domestic banks are more efficient in terms of costs and profits than foreign competitors in the local economy, while in emerging economies, Mathieson & Roldos (2001) claim that it is foreign banks that, largely, have been more efficient in terms of both costs and profits, i.e. they exhibited higher net interest margins, higher profitability and higher tax payments than domestic banks.

c) Management skills and new technologies

Cardenas, Graf, & O'Dogherty (2002) hold that foreign bank presence may foster efficiency and development of domestic financial markets by increasing the number of financial products available to local customers through imported technologies and know-how. One of the strategies employed by major international banks when they enter an emerging market is to offer a variety of new and sophisticated products, such as over-the-counter (OTC) derivative products and other derivative products such as structured notes, equity swaps, and credit derivatives. Mathieson & Roldos (2001) maintain that these products can be a considerable source of benefit since they increase the ability to separate and market risks and thereby allow for improved hedging of a variety of risks that were previously undiversifiable. The results of empirical work support the notion that liberalizing market entry for foreign banks has positive spill-over effects and encourages the development of the domestic financial system (Frauendorfer & Gantenbein, 2002), and as a result most emerging economies now increasingly look to foreign banks to provide the capital, technology and know-how required in banking (Hawkins & Mihaljek, 2001). Peek & Rosengren (2001) hold that, among the benefits of opening up the domestic markets to foreign bank entry, are the importation of new management and information technologies to improve banking services, the provision of new source of funds to recapitalize a troubled banking sector, the provision of an alternative "safe-haven" within the domestic country that may reduce the volume of domestic funds that are likely to flow offshore during a crisis, and the presence of deep-pocket, well capitalized (foreign) banks that can continue lending following any adverse shocks that have the potential to substantially weaken the economy (Peek & Rosengren, 2001). This phenomenon also provides stability.

Analysing foreign bank entry into the Turkish banking market, Denizer (2000) finds that foreign penetration has a positive impact on bank management, such as in planning, credit evaluation, marketing and recruitment. Furthermore, foreign bank presence reduces overhead expenses, return on assets, and net-interest margins of domestic banks, and, as concluded by Frauendorfer & Gantenbein (2002), foreign banks indeed foster competition. The increased competition forces local banks to introduce new practices and products, as well as upgrading of systems of internal control in order to respond effectively to the needs of their clients. In agreement, Pomerleano & Vojta (2001) categorise the strategies adopted by domestic banks as:

- Domestic banks are adopting the technologies and services associated with foreign banks;
- Domestic banks are refocusing their role in the corporate sector to provide distribution and investment capabilities in international financing and local corporate services;
- Domestic banks are allocating resources to the retail and SME sector, enhancing products and upgrading the technology and infrastructure necessary to attract customers.

The results from Pomerleano & Vojta (2001) indicate that foreign banks contribute to the development of better and more efficient processes in domestic banks. The authors note that there has been notable transfer of technology from foreign banks leading to the enhancement of management processes and information systems in domestic banks. Additionally the transfer of auxiliary services, such as accountants, marketers, lawyers, research analysts and consultants, if transferred to the domestic system, all enhance the quality of domestic banks' services.

d) Sophisticated products and techniques

Pomerleano & Vojta (2001) outline domestic banks' strategies in response to the competitive pressures posed by foreign banks. The penetration of foreign banks has created a ripple effect of technology and process transfers into the domestic market. The presence of foreign banks pressurises domestic banks to upgrade their services and encourages bank customers to demand more sophisticated products and services. Domestic banks increasingly adopt products, services, credit measurement, compensation, and management methods used by foreign banks. Beyond these immediate transfers within the banking sector lies a much a broader transferral of related services: marketing, public relations, accounting, law, etc to which the domestic market is exposed and increasingly adopts. This transferral promotes a service transformation within the host country, which, in turn, enables further sophistication of financial and other services to occur (Pomerleano & Vojta, 2001).

A second pattern identified on the domestic banking system is the relative contraction of exposure to wholesale lending to prime corporate clients, an area in which foreign banks have traditionally demonstrated superiority and has been difficult and costly to challenge for domestic entities. Pomerleano & Vojta (2001) hold that domestic banks are not equally affected by foreign banks, such as in Latin America, the entry of foreign banks is posing a threat to domestic franchises, whilst in Asia it is not as yet.

On entering host countries, foreign banks may import financial system supervision and supervisory skills from their home country regulators. Foreign institutions may be seen to help to further the goal of an active and efficient private banking network, and may bring important attributes that are lacking in domestic financial institutions (Dages, Goldberg & Kinney, 2000). Foreign bank presence may lead to improvements of bank regulation and supervision, since these banks will likely demand improved systems of regulation and supervision from regulatory authorities in the recipient countries (Lensink & De Haan, 2002). Hence, the presence of foreign banks in many cases leads to domestic supervisory authorities upgrading the quality and size of their workforce in order to administer the sophisticated products and techniques introduced by foreign banks' entry. Where foreign bank expansion has been rapid, such as the Czech Republic, authorities may often become overwhelmed by the complex task at hand, with poorer supervision resulting in increased systemic instability (Hawkins & Mihaljek, 2001).

Frauendorfer & Gantenbein (2002) find that foreign banks complement the range of wholesale and retail products and services offered by domestic banks, and continue to have positive roles in all market segments.

Uiboupin (2004) summarizes the possible benefits to the domestic financial system:

- Introduction of new banking technology and financial innovations, as for foreign banks it is generally relatively easy to introduce new products and services to the local market;

- Possible economies of scale and scope. Foreign banks can help encourage consolidation of the banking system, they have knowledge and experience of other financial activities such as insurance, brokerage, and portfolio management services;
- Improvement of the competitive environment since foreign banks bring competition to the local industry;
- The development of the financial market, since foreign bank entry may help deepen the inter-bank market and attract business from customers that may otherwise have gone to foreign banks offshore;
- Improvement of the financial systems infrastructure in the form of transfer of good banking practices and know-how, accounting, transparency, financial regulation, supervision and supervisory skills.
- The attraction of foreign direct investments as the presence of foreign banks may increase the amount of funding available to domestic projects by facilitating capital inflows, as well as diversifying the capital and funding basis (Uiboupin, 2004).

2.6.2 Arguments against foreign bank entry

Uiboupin (2004) summarizes the main arguments against foreign bank entry as:

- Fear of foreign control. Control over the allocation of credit implies substantial economic power in any economy.
- Foreign banks may have different objectives. Foreign banks may only be interested in promoting exports from the home country or in supporting projects undertaken by home country firms.
- Regulatory differences, wherein supervisors of the host country lose regulatory control and if the home country has weak bank supervision, this may lead to unsound banking in the host country.

A major concern apparent in the literature is that foreign banks “cherry pick” the most profitable domestic markets and customers, leaving domestic banks to serve the more risky customers and thereby increasing the overall riskiness of domestic banks’ portfolios. Foreign banks typically “cherry pick” wealthy individuals and credit-worthy corporations (Mathieson & Roldos, 2001).

Some authors have argued that foreign bank entry can worsen the stability of the banking system. If domestic banks are relatively inefficient and have weak capital positions, for instance, they may respond to increased foreign competition by undertaking higher-risk activities in an attempt to earn the returns needed to rebuild capital positions and to maintain their position in the market, or they may be forced into bankruptcy. This problem would be intensified where foreign banks tend to "cherry pick" the most creditworthy domestic markets and customers, leaving domestic banks to serve the riskier customers, thereby increasing the overall risk profile of domestic banks' portfolios (Mathieson & Roldos, 2001).

A further argument involves foreign banks' behaviour during times of crises. Evidence from Asia suggests foreign banks "cut and run" during a crisis Mathieson & Roldos, 2001: 23).

Furthermore, on supervision, Mathieson & Roldos (2001) note that the complex cross-border financial transactions undertaken by international banks may be difficult to supervise by either the host or the home country supervisors, resulting in certain transactions to 'fall between the cracks" (Mathieson & Roldos, 2001: 29).

2.7 The South African banking market

2.7.1 History of South Africa's financial landscape

Unlike most other countries on the African continent, South Africa has a well-established financial structure which includes a relatively independent central bank, sophisticated modern banking institutions and a competitive financial market (Harvard Business Review, 2001).

South Africa's financial services sector dates back to the late 18th century and the formation of the first commercial bank in the Cape of Good Hope – the Cape of Good Hope Bank, which was established in 1836. The banks, which existed at that time, were "unit banks" or "one-office" banks which were small with little financial expertise. During the second half of the 19th century the "imperial banks" found a foothold in South Africa, i.e. the Standard Bank of British SA Ltd and The Netherlands Bank of SA Ltd. A few decades later, Barclays National Bank and Volkskas appeared on the local banking scene.

Until after the Second World War short-term wholesale funds in South Africa were traded in the London money market. In an effort to create a money market in South Africa, both the authorities and the private sector undertook a number of initiatives. The government established the National Finance Corporation of SA in order to provide call-money facilities, while the first merchant bank, Union Acceptances Ltd, and the first discount house, The Discount House of SA Ltd, were established respectively in 1955 and 1957. From mid 1960 till about 1980, private banking activities and the developments of the securities markets were restricted by the extensive use of direct monetary control instruments, such as credit ceilings in an attempt to curtail overspending in the economy and to dampen inflation. During the 1980s, but particularly after the implementation of the De Kock Commission recommendations in 1985, South African banks were faced with increasing adherence to free market principles, and as a result, deregulation, consolidation and rationalisation took place on a large scale. By the early 1990s, nearly all building societies were transformed from mutual societies into banking institutions, which merged into larger banking groups. By the mid-1990s, more than 95% of the total assets of banks were held by the four large banking groups – Absa, Nedbank, Standard Bank and First National Bank.

For many years, the policy of the South African authorities was to ban the entry of foreign banks into the Republic. This policy was reversed under the Deposit-Taking Institutions Act of 1990 (renamed the Banks Act in 1993) when the shareholding restrictions on foreign banks operating in South Africa were removed, which was followed in 1995 by the scrapping of the regulation which had banned foreign banks from opening branches in South Africa. These developments were in line with international trends, but were also designed to attract foreign investment into South Africa (Absa, 1997).

South Africa's central bank – the South African Reserve Bank (SARB) is one of the oldest central banks outside Europe. It was established in 1921, and has played a major part in the development of the country since this time (Metcalfe, 1999).

South Africa was, by the mid-1980s, the pariah of international banking as a result of anti-apartheid political campaigning, widespread protests, and the September 1985 default of $13 billion in foreign debt, along with the imposition of exchange controls. During the 1970s and 1980s South Africa suffered from punitive economic sanctions which included trade boycotts, withdrawal of foreign loan funds and active disinvestment campaigns (Metcalfe, 1999). The local representative offices of international banks, such as Barclays and Standard Chartered, divested and soon the four domestic banks were in near-total command of the local market. At the peak of consolidation in the early 1990s, South Africa's four largest banks dramatically increased their share of total bank assets, from 69% in 1991 to 84% in 1995.

When the Government of National Unity came into power in April 1994, it was accepted as a policy objective to remove exchange controls. As a result economic opportunities opened up for South Africa to re-integrate its economy once again into the global environment (Stals, 1997a). Nevertheless, the need for exchange controls remained apparent, as reiterated in an address by ex-Governor of the Reserve Bank, Dr Chris Stals. Dr Stals noted that financial sector reforms were necessary due to South Africa's major social and political transformation and the liberalisation of the financial market. Along with the reintegration into the world economy, South Africa's financial sector had to adapt to new standards in bank supervision and regulation, as set out by the Basel Committee; foreign banks were allowed to enter and establish branch offices, subsidiaries and representative offices; major changes were introduced in the operations of financial markets; and with the gradual relaxation of exchange controls, the South African foreign exchange market became more competitive and volumes increased significantly. Financial sector reforms were to be continued for a certain period in order to protect the South African financial sector from being exploited by international opportunists whilst the economy was adapting to significant political and socio-economic changes (Stals, 1997b).

Currently, the SARB's approach to exchange control stipulates that "except with permission granted by the Treasury, and in accordance with such conditions as the Treasury may impose, no person other than an authorised dealer shall buy or borrow any foreign currency or any gold from, or sell or lend any foreign currency or any gold to any person not being an authorised dealer" and "an authorised dealer shall not buy, borrow or receive or sell, lend or deliver any foreign currency or gold except for such purposes or on such conditions as the Treasury may determine" (SARB, 2006:1). The legal framework of exchange control is therefore one of a total prohibition to deal in foreign exchange except with the permission of and on the specified conditions as laid out by the Treasury. However, the economic policy underlying exchange control is not totally prohibitive, since such an approach would not be conducive to the conduct of normal international trade and payments. In setting out the rules and procedures pertaining to exchange control, there is a clear distinction between current transactions, capital transactions and transfer payments (SARB, 2006).

2.7.2 Regulation and Supervision

The importance of designing and maintaining an efficient and effective system to regulate financial markets, financial institutions and financial service providers lies at the core of a nation's economic well-being. The banking sector worldwide has experienced substantial structural changes since the 1980s. One of the major challenges has been to keep abreast with, and adapt to, these changes, which are often of an international nature. In South Africa, the financial regulatory system has undergone enormous change during this period, including the transfer of responsibility for banking supervision from the Department of Finance (now know as National Treasury) to the South African Reserve Bank in 1987, the establishment of the Financial Services Board in 1989, as well as the creation of the Policy Board for Financial Services and Regulation by Act of Parliament in 1993 (Bamber, Falkena, Llewellyn & Store, 2001). The Policy Board for Financial Services and Regulation was established to advise the Minister of Finance with regard the changes in the financial services sector and its regulation, as well as to propose amendments to financial legislation in order to co-ordinate financial regulation and supervision of the Registrar of Banks. At present, the financial system is tightly controlled by legislation and by state agencies working through the South African Reserve Bank (SARB) and the Financial Services Board. Banks are subject to the regulation and supervision of the Registrar of Banks whose office forms part of the SARB.

Foreign bank branches are subject to most of the regulations governing South African banks. Foreign branches must maintain a minimum “endowment capital” of the greater of R50 million and 8% of risk weighted assets, as is applicable to locally registered banks. Foreign banks with net assets greater than US$1 billion and an investment grade rating from an international rating agency may be considered for the formation of a local banking branch. Full banking subsidiaries follow a similar process. To establish a representative office in South Africa is a less rigorous process, but requires the written consent from the Registrar of Banks. Representative offices are prohibited from engaging in banking activities such as accepting deposits.

2.7.3 Liberalisation of the South African banking market

The reintegration of South Africa into the world economy brought with it the need for liberalization of the banking sector and the development of the domestic financial market, such as the foreign exchange market, the upgrading of the national payment, clearing and settlement systems, as well as the re-admitting of foreign competitors.

Central to the programme for financial reform was the gradual phasing-out of exchange controls. Comprehensive exchange controls were imposed during the period 1961 – 1993, to protect the domestic economy from the adverse effects of unacceptable political and social policies that had afflicted South Africa over a long period of time (Stals, 1997a).

The internationalisation of South Africa’s banking system has, however, also exposed it to increased contagion from foreign counterparts, thus necessitating a gradual liberalization process.

2.7.4 History of foreign bank participation in SA

Following amendments to the South African Bank Act in 1994, foreign bank branches, representative offices and subsidiaries entered the South African financial market. Many of these banks had previous connections with South Africa, some remained active during sanctions, some divested at the time but returned, but the majority of foreign banks entered the South African market for the first time.

Generally, foreign banks have chosen to enter niche markets that are not dominated by the large South African banking groups, such as in the areas of foreign currency loans, foreign trade finance, and securities market related activities. Foreign lending is not a particularly profitable area for domestic banks since margins are small and foreign banks are better situated to serve this market with their strong foreign connections and limited overhead costs. Increased foreign competition is enhancing the sophistication of the domestic banking sector, creating additional liquidity in the markets, thereby forcing banks to identify and focus on areas of core competence.

The South African financial system is highly concentrated and is similar in nature to the U.K., Canada and Australia. At the end of 1994, the four big banks, ABSA, Standard Bank, First National Bank and Nedcor accounted for 90 percent of the banking systems' asset base. However, as a result of foreign bank entry after 1994 and the growth of smaller domestic banks such as Investec and Rand Merchant Bank, the four largest banks have experienced erosion in market share. By the end of 1997, their assets and deposits represented 75 percent and 76 percent respectively of the overall banking system (Metcalfe, 1999). By 2000 there were 80 foreign banks participating in the South African banking sector.

During 2002- 2003, dramatic changes in the South African banking sector altered the financial services landscape. A large number of the foreign banks were reportedly downscaling or leaving the country, and many had already divested. A survey undertaken by PWC in 2002 indicated that 88% of domestic banks found the market to be overcrowded, whilst in a similar survey in 2005 only 40%

of domestic banks believed the banking sector to be overcrowded (Metcalfe, 2003).

2.8 Recent internationalisation trends in South Africa

The process of internationalization in South Africa is underpinned by globalization, domestic deregulation and opening up of the financial sector, as well as the impact of technology.

During 2003, Barclays Plc moved its African head office from London to South Africa. Within South Africa, the focus was on corporate and merchant banking only, until its recent acquisition of South Africa's largest retail bank, Absa bank. The current strategic context of the acquisition for Barclays is that it accelerates Barclays' strategic priority of expanding its corporate, investment and merchant banking advantages abroad. Barclays Plc is renowned for its global brand in corporate and investment banking, and hence poses a looming threat to domestic banks within this arena. Barclays CEO of International Retail and Commercial Banking, David Roberts, confirms Barclays' choice to expand into South Africa is driven by the "strong macroeconomic growth prospects; attractive banking market with excellent growth prospects and returns; and sophisticated economic and financial services infrastructure" (Cronje, Booysen & Roberts, 2005: 24).

HSBC is another large foreign bank which has committed itself to South Africa by obtaining a banking license in August 2003. The Johannesburg hub serves as the regional headquarters for all sub-Saharan operations, and trades in corporate and merchant banking activities, corporate finance, treasury and capital markets, investment banking activities and research (KPMG, 2004).

Standard Chartered Bank received consent from the SARB to establish a branch in South Africa during 2003. Standard Chartered entered the market with a comparative advantage in its purchase of the online banking services offered by 20Twenty, which complemented the bank's wholesale operation. This acquisition has provided an ingenious platform on which the bank has engineered its expansion into the region and the penetration of the consumer banking market (KPMG, 2004).

Citibank, the largest foreign banking operation in South Africa in 2004, has built up its staff complement to 450 people and a client base of 2000 since 1994. The bank is actively engaged in treasury activities, corporate banking, international personal banking, investment banking and equity brokerage.

Stals (1997b) holds that foreign banks in the latter half of the 1990s were largely prevalent in wholesale banking, international trade financing, and the market for foreign exchange. Governor Stals also noted that the presence of foreign banks significantly squeezed margins of the banking business (Stals, 1997a).

Foreign bank presence is particularly focussed on certain niche areas of the market, such as stock-broking and investment (merchant) banking, with limited activity in commercial banking. Largely, foreign financial institutions have entered particular product markets in Corporate, Investment and merchant banking (Competition Commission, 2000).

2.9 Characteristics of the South African banking sector

Much of the literature on emerging markets focus on financial systems which are either in their infancy, are inefficient, or have undergone a recent crises (e.g. Brazil, Mexico, EEC). However, South Africa exhibits a unique environment. It is an emerging economy with a sophisticated financial system, hence embracing both first world and third world characteristics. Since the beginning of the 1990s, the South African banking industry has undergone substantial changes. New bank legislation and regulatory requirements have been introduced, foreign banks have entered the domestic market, competition from non-bank entities has intensified, international scrutiny has increased and customers now demand more sophisticated products and quality of service, (KPMG, 2004).

Although the Asian financial crisis of 1997 and 1998 revealed banking in emerging markets to generally be a weakness in the international financial system, South Africa's banking sector was considered by Moody's as strong, well-organised and technically advanced with its offering of sophisticated banking services and products akin to those found in developed markets (Harvard Business Review, 3 April 2001). An IMF report in 2001 concluded that South African banks had transparency and supervision which was in line with international standards.

Like the rest of the world, South African banks offer both commercial and investment banking products. Commercial (or retail) banks serve as intermediaries between those individuals wanting to save and those wanting to borrow money. Investment banks serve as intermediaries between companies wanting to raise capital and institutional investors who want a high return (Harvard Business Review, 2001). The banking sector is dominated by the Big Five, who operate in both commercial and investment banking product sectors – First National Bank, Nedbank, Standard Bank, Investec, and ABSA, (KPMG, 2004).

Prudent regulatory and legal infrastructure coupled with strong accounting standards and disclosure practices are some of the attributes of the well-developed banking system in South Africa. The five major banking groups continue to dominate the South African banking sector. They collectively control around 89% of total banking assets in the country. The partial disappearance of the second-tier banks in 2002 has strengthened the big five's position, but it has also made it more attractive for foreign banks to hone in on certain niches. Standard Chartered, for instance, entered the Internet banking market through its acquisition of 20Twenty (KPMG, 2004), while Barclays, who initially entered the credit card market, now exists as a major corporate and merchant bank in South Africa as a result of its recent acquisition of Absa bank.

The South African banking industry is highly concentrated, as characterised by most emerging market economies. Consolidation may be a driving force in the industry going forward, given an anticipated fall in banks' cost-to-income ratios, lower interest margins, and the impact of AIDS on banks' operating expenses and bad debt exposures. Foreign competition from money and capital markets operating out of London, as well as the foreign banks operating in South Africa, may be a catalyst for further consolidation through mergers and acquisitions between existing groups (Falkena & Llwellyn, 1999).

2.9.1 The consolidation of the South African banking industry

Mirroring international trends, South African banks consolidated during the 1990s, some with insurance companies. In 1998, Firstrand had been formed out of a merger between the insurance and banking businesses controlled by Anglo American and Rand Merchant Bank. Earlier in the 1990s, ABSA was formed out of an amalgamation of smaller banks. Analysts were of the opinion that these moves were on the grounds of the country's banking sector being too crowded (Harvard Business Review, 2001).

The take-over of BOE by Nedcor represents the most significant consolidation in the South African banking industry since the early 1990s. The consolidation process was further enhanced by the decisions of small banks to cancel their banking licenses in 2002, as well as by Firstrand's take over of Saambou, which went into curatorship in 2002 (Absa, 2002).

Market conditions within South Africa during the 1990s made it difficult for small banks, such as Saambou, to compete in the banking market. The low growth conditions, poor domestic savings ratios and low disposable income saved by households, all characteristic of that decade, drove small banks to take on unjustified risks. Faced with the Big Five, at the time, and big institutional investors, small banks battled to sustain a competitive advantage. Furthermore, a phenomenal amount of capital was required to sustain banking licenses – between R25 million and R35 million per year – and many small banks realised that the levels of capital required to support its banking license were no longer sustainable (Absa, 2002).

The turmoil in the South African banking industry continued during 2002 as most small banks cancelled their banking licenses. Even larger institutions, such as Brait and CorpCapital followed suit. According to the Registrar of Banks, banks that held licenses reached a peak in 1997/1998. Between 2000 and 2002, 23 banks deregistered from the Registrar of Banks.

2.10 Propositions on the research undertaken

2.10.1 Proposition 1

Foreign banks are expanding into South Africa in order seek new market opportunities.

Throughout the literature, three main themes occur on expansion determinants of foreign banks: Foreign banks follow their customers abroad; the host market of interest has specific attractive new business opportunities; and lastly the geographical diversification of risk.

- The economic literature provides a number of theoretical attempts towards understanding the existence of international banks, and from this, three main theories have been isolated which have been carried through in recent works by many authors. The three traditional theories leading to these three main themes were: the *comparative advantage theory* where foreign banks have a comparative advantage in producing certain goods and services and hence find local market opportunities, such as possibilities of high interest-income, extremely profitable (Aliber, 1976); secondly, the *industrial organisation theory* where banks follow customer's expansionary activities abroad (Grubel, 1977); and lastly the *international investment theory*, where benefits can be gained from geographical diversification of risk.
- The market of the host country may offer new business opportunities, depending on the characteristics of the market, such as size, stability of the host country's economy, features of the local banking sector, and expected economic growth (Lensink & De Haan, 2002; de Paula, 2002).
- As margins and fees are tightened in the domestic financial services area, financial firms seek to expand overseas into markets which promise growth and greater net interest margins (de Paula, 2003; Focarelli & Pozzolo, 2000).
- The current trend is for banks to seek profitable opportunities through accessing new market opportunities (Cardone *et al*, 2000).
- Banks operating in countries where the banking sector is larger and more profitable may be able to export superior skills and therefore are more likely to expand their activities abroad (de Paula, 2002).

- Foreign banks enter developing countries for different reasons than they enter developed ones and, in particular, the 'follow the customer' motivation is less important for banks entering developing countries. This suggests that foreign banks are genuinely interested in exploiting potential profit opportunities in the host, developing country (Clarke *et al*, 2001).

2.10.2 Proposition 2

Foreign banks are using their position in South Africa as a springboard into the rest of Africa.

- Many firms enter the South African market with the explicit intention of expanding into regional markets, such as Southern or sub-Saharan Africa (Gelb, 2002).
- Foreign banks are making a base in South Africa in order to expand into the rest of Africa, since only in Africa and Latin America, do foreign banks achieve higher net profitability than domestic banks (Claessens, *et al*, 2000).
- Many foreign financial services firms are using South Africa as a springboard into Southern Africa. This has led to the growth of South Africa as a regional hub (Hodge, 1999)

2.10.3 Proposition 3

Foreign banks have a comparative advantage over local banking operations because they can draw on their parent for additional funding and capital when needed.

- The literature identifies a number of comparative advantages that foreign banks may have over local banks in their motive to enter the local country, these being: the production of products and services; management; know-how; sophisticated products and services, and the access to parents' funding and capital base when required.

The *comparative advantage theory* assumes that banks that will become multinational are those located in countries with comparative advantages in producing bank products or services. According to the theory, banks with a comparative advantage in producing bank products will likely dominate the world banking market, as they can access world capital markets on increasingly favourable terms due to higher relative profits. (Nikitin, 2002)

Foreign banks enjoy the greater stability that comes from access to the parent bank in the home country, which would hold a more internationally diversified portfolio implying its' income stream would be less correlated with domestic shocks (Mathieson & Roldos, 2001)

Foreign branches and subsidiaries of large international banks can draw on their parent for additional funding and capital when needed (Mathieson & Roldos, 2001).

2.10.4 Proposition 4

Foreign bank presence has led to an improved financial system infrastructure through the introduction of sophisticated financial instruments and techniques.

- A transfer of technology occurs if authorities allow high-quality international banks with solid reputations to enter and permit the immigration of skilled banking personnel (Mathieson & Roldos, 2001) which allows the training for domestic bankers (Hawkins & Mihaljec, 2001)
- Foreign banks bring with them sophisticated financial instruments and techniques and introduce these to the domestic market (Hawkins & Mihaljec, 2001; Mathieson & Roldos, 2001).
- Foreign bank entry leads to the introduction of new banking technology and financial innovations, as for foreign banks it is generally relatively easy to introduce new products and services to the local market, (Uiboupin, 2004; Hawkins & Mihaljec 2001)
- There is improvement in the financial systems infrastructure in the form of transfer of good banking practices and know-how, accounting, transparency, financial regulation, supervision and supervisory skills. (Uiboupin, 2004; Mathieson & Roldos, 2001)
- Foreign bank entry improves the functioning of national banking markets, with positive welfare implications for customers (Claessens, *et al*, 2001).

3 RESEARCH METHODOLOGY

3.1 Method

The research method employed in this study is qualitative in nature and utilises in-depth interviews. The literature review was used to identify existing research on the issues surrounding internationalisation of foreign banks into South Africa. The literature was used to generate researchable proposition statements (Meadow, 2003), which were tested using the qualitative approach.

3.2 The qualitative research method approach

Qualitative research as a form of inquiry has grown significantly over the past decade. The number and quality of qualitative studies in almost every discipline has increased phenomenally (Daley, 2004).

The focus of qualitative research tends to be on understanding the meaning imbedded in participant experiences through open-ended questions with an unstructured and subjective approach (Lincoln & Guba, 1985). The research is mostly conducted in a naturalist setting with a purposive sample (Patton, 2002) and tends to be holistic, descriptive and focuses on the depth and details of experiences (Dezin & Lincoln, 1998).

Data collection methods include interviews, observations, field notes and documents, amongst others (Wolcott, 1994). Data is most often analysed through an inductive, ongoing and evolving process of identifying themes within a particular context (Miles & Huberman, 1994).

The above approach is contrasted with the view that quantitative research is always ‘objective’, while qualitative methods are subjective and will always lead to more meaningful analysis (Laurie & Sullivan, 1991).

3.3 The in-depth interview

The in-depth interview is a technique that is used in exploratory research where respondents are probed on topics in a relaxed environment to maximise the richness of the discussion and data collection (Creswell, 1998).

The in-depth interview technique does not offer closed-ended questions found in structured interviews. On the other hand, it also does not contain loosely defined agenda. Instead it is guided by a list of open-ended questions that focus on core themes being probed by the researcher. An interview guide is constructed to ensure that all propositions will be explored.

Advantages of in-depth interview
The researcher can shift focus as new data comes to light (Leedy & Ormrod, 2001).

Disadvantages of the in-depth interview
The researcher, by nature of his or her presence, may alter what people say and how events unfold (Leedy & Ormrod, 2001).

3.4 Population and sample

The population was drawn from foreign banks within the Gauteng area, which exist as branches or subsidiaries, as defined by the South African Reserve Bank (SARB, 2005).

The sample was small, in line with typical qualitative studies (Schmitt & Klimoski, 1991), because greater insights can be gained from investigating a small sample in depth, rather than superficially investigating a larger sample. Respondents were selected from an 'expert sample', based on their availability and the researcher's view of their potential contributions to the research. A copy of the instrument used appears as Appendix 1.

A representative from the selected companies was contacted for interviewing. The population of this research can be considered to be senior banking managers, directors, and regulatory and support authorities who are stakeholders in the internationalisation process of foreign banks into South African markets, and thus are considered to be in a position to offer an expert opinion on this phenomenon.

The sample was drawn from the population of foreign branches, subsidiaries and representative offices of parent companies. A total of 12 in-depth interviews were conducted over a period of 10 weeks. The interviewees represented a variety of disciplines within the Global banking industry. The bulk of the respondents were drawn from senior management at international banks with a presence in South Africa. A senior regulator in bank supervision at the South African Reserve Bank was interviewed in order to obtain his valuable perspectives and insights. Additionally, a senior Partner at a financial services consulting firm who is well acquainted with the South African banking industry and foreign banks in South Africa was interviewed in order to extract his knowledge on the matter.

Table 1 outlines interviewees.

Table 1: List of Respondents

BANK	**CONTACT PERSONS**	**POSITION**
Barclays Bank	• Bertie Lombard • Lloyd Caughy	• Corporate Director • Head of Global Markets, Barclays Africa
Deutsche Bank	• Murray Winckler • Mike Biggs	• CEO • Economist, Global Markets
CitiBank	• Donna Nemer Oosthuyse	• Head of Strategic Planning
JP Morgan/Chase	• Garth Klintworth	• Head of Global Equity Markets

HSBC	• Andrew Moiyo • Simon Parferman	• COO • Director Global Trade
SARB	• Johan Delport	• Bank Supervision
Bank of China	• Ashley Cameron	• COO
Accenture	• Raj Makanjee	• Partner, Capital Markets.

3.5 Method of analysis

Transcripts from the in-depth interviews with respondents were recorded and analysed in order for them to be studied in more detail. The data obtained from the interviews was used to extract the constructs, themes, perceptions and opinions from the respondents. Common themes were identified and then collated and grouped to draw out the validity of the propositions. The data was also applied to the theories discussed in the literature review.

The technique of concept mapping was applied in order to draw out the conceptual categories and themes evident within the data. Researchers engaged in qualitative analysis are confronted with varying challenges, which mostly have to do with the data analysis process (Daley, 2004). Concept maps provide one strategy to deal effectively with the methodological challenges of qualitative research. A concept map is effective in framing a research project, reducing qualitative data in a meaningful way, analysing themes and interconnections in a study, and presenting findings (Novak, 1998). Concept mapping entails displaying the opinions and views of the respondents in a diagrammatic form (Daley, 2004).

Concept maps are created with the broader, more inclusive concepts at the top of the hierarchy. Concepts are interconnected through linking words with other concepts that can be considered. The important benefit for the researcher in using concept maps is the ability to focus on meaning. The maps allow the researcher to see participants' meaning and to observe the connections in participants' discussions across concepts or bodies of knowledge. Furthermore, maps support researchers in their attempts to ensure that the qualitative data is embedded in a particular context.

Daley (2004) holds that concept maps are useful in presenting the data from a qualitative research study. In their graphical format, concept maps simplify the findings for readers by providing a vehicle which enhances the linkage between actual quotes and larger parts of the study. Moreover, Miles & Huberman (1994) maintain that the data analysis process in qualitative research contains the three sub-processes of data reduction, data display and conclusion drawing. Concept mapping allows for each of these processes to take place.

3.6 Validity and reliability

Research that is to be credible requires both validity and reliability. Validity deals with the accuracy of the instrument to the extent that it measures what we wish to measure. Reliability refers to the research measurement procedure's accuracy and precision (Bendixen, 2004).

Two types of validity occur: The first type, external validity, deals with the 'generalisability' of the research across persons, settings and times. Thus, if research is externally valid, then the same results will be obtained regardless of the researcher, the context, or the period. The second type, internal validity, is also known as content or face validity, and deals with the extent to which the measuring instrument provides adequate coverage of the topic under study (Bendixen, 2004).

Bendixen (2004) outlines the following description of reliability of the research:

- The stability of the research – An instrument is said to be stable if it secures reliable and coherent results with repeated measurements on the same subject.
- The equivalence of the research – Equivalence is a measure of the degrees of error brought in by different researchers, or by different samples of items in the questions.

- The internal consistency of the research – This concept deals with the uniformity and homogeneity among the scaled and measurable items researched.

4 PRESENTATION OF RESULTS

4.1 Introduction

This chapter summarizes the key findings of the research results. Responses to the in-depth interviews are discussed, as derived from the 'concept mapping' technique (refer to Appendix 2). Furthermore, a detailed discussion of the results of the proposition testing will be discussed in Chapter 5.

In this section the responses to the interview questions are set in tabular form, and related back to the propositions. Appendix 2 to this report shows the same responses and the themes they relate to in the 'concept map' format.

4.2 Responses to Proposition 1

Foreign banks are expanding into South Africa in order seek new market opportunities.

Question 1 was designed to be deliberately broad in an attempt to facilitate discussion with the respondents and to provide a starting point for the interview. The question was intended to address Proposition 1, and also to extract any other key information on the subject.

The question elicited 10 key themes around the process of the movement of International investment banks into the South African financial market. Major themes emerging from the concept mapping and which address Proposition 1 are listed in Table 2.

Table 2: Entry processes of international banks into South Africa

• New market and new business opportunities in the local market are attracting / have attracted a plethora of foreign banks. o Historically, banks expanded abroad to serve needs of existing clients, facilitate their banking needs and provide banking facilities. Following this, they banked other clients in that market and hence became multinationals; globalisation key in terms of a global network to cover client base. More recently, banks look at opportunities, e.g. Russia and the lifting of the iron curtain – to accrete value to the global network o HSBC has three core, global product groupings: Retail; private banking and

consumer finance. The decision to go global hinges off opportunities in the host country which can be utilised for one or all of these three areas of expertise. What niche, what mix of business determines if you want to have a presence in South Africa. o M&A growth strategy is the most likely and omnipresent growth strategy for international banks. Banks seek operations in countries with possibilities which they need for their operational and/or growth strategy; for instance, in Greece, HSBC bought Barclays retail; in UK HSBC bought Midlands bank the biggest retail bank in the UK; in Brazil, HSBC bought the 4th biggest bank, and in South Africa Barclays bought Absa for their retail strategy.
• The need for a footprint in Africa drives many global banks to set up shop in SA. o Foreign banks treat SA as a base for Africa. Given South Africa's sophisticated infrastructure, it's a great place to extend into sub-Sahara. SA has a good skills base to support the expansion there, as well as any dealings in Africa. o Africa looks great and there's a definite interest; there's great money coming in from petro dollars signifying huge opportunities for facilitating transactions such as foreign exchange, trade finance o A footprint in Africa is desirable; Barclays invested in sub-Saharan Africa even before we did so in South Africa. o The road into Africa, an untapped market, has to be through South Africa
• Foreign banks follow their customers abroad in order to service their needs globally and in the plight to becoming MNC's o A major driver for expansion abroad is to serve their customers abroad, but this is driven by the underlying motive to make profits in the relevant country; there must be opportunities available. o Bank of China and State bank follow their customers around the world. Furthermore, they internationalise where they see expanding and profitable markets. o A differentiation strategy for banks is to follow their customers.
• Foreign banks are looking to expand their global footprint in the wake of globalisation and in order to maximise shareholder value.
• Globalisation and consolidation are primary drivers of internationalisation of foreign banks, since this drives their quest to be multinationals, to grow through M&A and to entrench a global footprint. o Globally, it is consolidation that drives banks to internationalise o Banks have been 'recreating' themselves' in the last 3 – 5 years. Consolidation has led to a big gap between the top, say 3, and the rest. Most banks want to be Top 5 or higher. There are 2 ways they can achieve this: <u>Organic</u>: this is how all foreign banks have started in this market, except Standard Chartered; <u>Inorganic</u> – acquiring other banks. o Globalisation the main driver, and Global reach in significant financial markets;
• Internationalisation increases global ranking which means greater credibility and easier and cheaper access to credit
• When looking at Africa, South Africa is stable, that's why we invest here
• Trade relations and global trade o Foreign banks go where trade relations are good. Trade relations between South Africa, and China are good. Additionally, global trade is rife between the two countries, i.e. South Africa imports many products from China, such as microwaves, TVs etc.

Question 2 was intended to significantly narrow the scope of the discussion and to focus on the key reasons that foreign banks are moving into the South African banking market. There was a significant amount of overlap between the answers given for Question 1 and Question 2. The key themes emerging from the concept mapping are indicated in Table 3:

Table 3: Drivers of foreign bank entry into the South African economy

• Opportunities in South Africa have attracted a plethora of foreign banks o South Africa looks good for investment for the next five years to the world cup – there is huge growth inevitable in this market, as can be deducted from the massive fixed investment in this country: Eskom and other infrastructure investments; Listing of JSE – this is a huge thing with potential huge impact. When this happens there will be expansion in the market which will increase liquidity o BEE is also providing opportunity in terms of corporate finance deals o Foreign Bank home markets are over-banked and are looking for opportunities to expand for growth strategy o There is a significant amount of FDI coming into the country and Foreign banks want to tap into this resource.
• SA houses global standard companies and critical industries. o There are many sophisticated and global standard corporate businesses in SA, i.e. SAB that foreign banks wish to service o Customers demand sophisticated products o Companies such as Deutsche Bank entered this country for the first time through acquiring an extremely successful local brokerage firm
• SA is a powerful engine of growth for the African continent o For a bank's emerging market strategy it fits well to be in SA o SA produces 1/3rd of Africa's GDP so by investing in SA, you are buying into a country which generates 1/3rd of a continent's growth.
• SA has vast resources and a well developed infrastructure o SA has a highly sophisticated and leading financial infrastructure o The SA economy is good and the market for banking is good o SA is a growing country, a growing economy o SA is an interesting market, very well served, very mature. o There is a growing trend where foreign operations in SA are providing their home country with functions such as back-office operations. Given SA's sophisticated infrastructure, skills base, language, culture and time zone, SA stands as an emerging offshore base.
• The deregulation of the stock market provided liquidity o Most banks entered the SA economy after 1996 purely because of deregulation of the stock market which provided liquidity to the banking system. Liquidity in the banking system in SA rose from 4% to 40% within four years over that period. By definition, deregulation of stock markets causes liquidity to rise.
• SA's reintegration into the world economy attracted foreign banks since it was dormant for so many years during which time it built up its infrastructure. For this reason it seen as a unique destination o In 1994 we (Citibank) looked at coming back to SA as part of global strategy. SA was reintegrating into the world economy, this presented many opportunities for us to explore
• Size of the FS sector in SA is an attraction for foreign banks
o Foreign banks find a space where they can utilise their core competences, i.e. Barclays' purchase of Absa ensured they are utilising their core competence in business banking through Absa retail.
• Foreign banks are entering SA as they are following their customers here o Expansion into SA is largely to do with being customer-focussed, particularly so in SA as it houses a large number of HSBC's clients. o It is important to note that no bank would expand if it wasn't for a positive impact

on bottom line o It's a clear client focus which drives expansion - Services & structures are tied into client need-meeting purposes o A driver for expansion is to serve MNC's who are operating into SA; then the strategy is to "fill up" with local clients who of a similar nature to MNCs operating here, e.g. Sasol. o Its crucial to nurture client relationships o Clients are categorized as high end and other. In SA, 200 of HSBC's global clients are in SA o Strategy is to provide for local clients becoming MNCs. A lot of SA companies have outgrown the SA market and if they want to expand offshore, say to China, they would want to talk to a global bank that has the international presence, infrastructure, experience and offerings etc. o Global banks and global clients go hand in hand o Banks follow their clients – i.e. many European banks - their clients have set up shop here.
• Cultural proximity and historic relationships o Some banks, such as Barclays have a cultural proximity to SA as well as latent brand strength from being affiliated with SA for over 100 years. There is a history between the two countries, SA and England, and ways of doing business are similar. SA also has many affiliations with the US, and similar ways of doing business; hence banks such as Citibank are comfortable doing business here
• Foreign banks are looking to diversify their income stream and choose a particular country based on current and historical relationships o Barclays had become so UK dependent they had to alter their strategy for risk management purposes. Barclays needed to generate 50% of their revenues from outside the UK. Barclays has chosen SA to carry out this strategy as they had been in SA for 100 years prior to withdrawing in the 1990's; they are comfortable in SA, have a history, and a latent brand strength. With the purchase of Absa, they have created a large footprint and are the largest international bank in SA
• Foreign banks are driven by regulatory, political and prudential drivers o Its exactly like the WTO and GATT (General agreement on tariffs and trade) where trade has increased due to reducing tariffs, such is the SA banking landscape where there are now not many impediments to entry. The only thing is its high cost – R250m. We are actually inviting them to set up shop. o The country is stable and is a great destination to carry out emerging market strategy o The South African Government and parastatals are active in the market o Regulatory controls are a huge determinant of entry, for instance exchange controls in SA were a deterrent until recently. Need a presence to be regulated by authorities; if want to operate in a niche market and want to operate in this niche in SA, have to be regulated here, it cannot be done remotely
• SA stands as an emerging offshore base o There is a growing trend where foreign operations in SA are providing their home country with functions such as back-office operations. Given SA's sophisticated infrastructure, skills base, language, culture and time zone, SA stands as an emerging offshore base.

Question 4 was designed to further test Proposition1 (International investment banks are being driven into South African banking markets in order seek new-market opportunities) and also addressed issues surrounding Proposition 2 (Foreign banks are using their position in South Africa as a springboard into the rest of Africa). The question was more directly aimed at eliciting whether foreign banks are here for short-term gains or long-term investment in the local banking environment, as well as to determine whether their intentions are to remain in South Africa and/or Africa for the medium to long term.

Table 4: South Africa's competitive landscape in the next five years

• South Africa's banking landscape will be more competitive, i.e. greater industry rivalry. o The dedicated banks bill is here to ensure SA will have more tier 2 and 3 banks in the market (lower capital requirements than tier 1). Will be increase in competition and decrease costs. o The major thing with foreign banks is they are here to make a profit and to give a high return on equity for investors in their home country. So they are unscrupulous in their attempts at attracting business and making huge profit. o Due to the stronger influence of foreign players, it will be more a mature market than a growth market. Banks will grow less through M&A but more through their client base and organic growth. The market will be more competitive and less attractive.
• Competitive landscape looks promising for future investors o South Africa looks good for investment for the next five years to the world cup – there is huge growth inevitable in this market, as can be deducted from the massive fixed investment in this country, Eskom investments; infrastructure investments o There is a vast amount of FDI coming into the country and Foreign banks want to tap into this resource
• There will be a new mix of foreign banks o Some Foreign Banks will pull out as they may find it too difficult to compete in this environment. The competition amongst foreign banks in SA is fierce, intensely fierce. o Foreign banks will still be a mix, there may be new large players too; however the presence of and market for 2nd and 3rd tier banks will encourage such banks to enter the country, e.g. Rabo bank of India o I definitely believe another foreign bank will buy another retail bank. Most foreign banks are here in some form or another, but will expand, hence more competition
• The competitive landscape will look the same (in terms of foreign bank presence) o Foreign banks will remain in SA for the next five to ten years with certainty, but the competitive landscape will look no different. International banks are not into moving into retail in SA o In SA in next 5 – 10 years: • Retail will continue as is; • Continued pressure as regulation will increase; • International banks that are here will be the ones to be here then. They will keep refining their business models. o Foreign banks are here to make money, to cherry pick; they are not into retail banking as its too expensive o Banks take a long term view in deciding to enter a country, a 25-30 year view
• Due to the stronger influence by the global players SA players will be more efficient, and there will be less of them
• Consolidation o The key thing is consolidation: Some banks will be swallowed up by bigger players. o There has been a proliferation of silos of running after the same customers which will encourage further consolidation o The stronger influence by the global players will make SA players more efficient, and all of this means fewer local players

o Product differentiation is a big thing encouraging consolidation. The challenge exists at the corporate level where differentiation is not where it should be in order to make people move their accounts.

4.3 Responses to Proposition 2

Foreign banks are using their position in South Africa as a springboard into the rest of Africa

Question 3 was designed to test Proposition 2. Concept mapping this question led to the identification of a number of focal points outlined in Table 5.

Table 5: South Africa is a springboard into the rest of Africa

• Yes, SA is a springboard into Africa o Barclays held a sub-Saharan presence first before the rest of Africa, and have now in effect “bought the springboard” which enhances the sub-Saharan presence and global presence. “Usually it’s the other way around, SA is the springboard, but we did it backwards” o Depends on which MNCs are in Africa as these would have to be large global companies with large market cap for a customer-following strategy to be worthwhile o “Yes, foreign banks are using SA as springboard into Africa; our regulation is robust but free; South Africa has a good relationship with Africa through such bodies as the SADC etc” o “These guys (foreign banks) actually ask the world bank, BIS, IMF and IFC where they should go and how they should get into Africa”. o Foreign banks treat SA as a base for Africa. Given SAs sophisticated infrastructure, it’s a great place to extend into sub-Sahara. SA has a good skills base to support the expansion. o Some invest remotely, some set up shop – No one size fits all. There are many running operations from here, through satellite offices
• Yes, SA is a springboard into Africa, but only to operate remotely out of South Africa o In Africa, it does not make sense to have a physical presence with large infrastructure, but rather to have ongoing projects such as large financing deals, maintain relationships and networks to provide service from SA o Everybody is looking to act in Africa. “It is a springboard, it’s a listening post “. However, the danger is that Africa is not a homogenous market. It is multicultural and all banks have to have different strategies to get into this market. There are three banking needs in Africa to be addressed: -Retail provision; -Infrastructure; -Trade. Banks have to be careful to focus on one of these and not on all three. o African securities are of increasing interest, but we will not make a presence there; its too costly and risky. o In Africa, its too costly to set up shop, but there’s value in operating there remotely from SA. o Some invest remotely, some set up shop – No one size fits all. There are many bank running operations from here, through satellite offices o In Southern Africa, there is not enough for a physical presence, i.e. no stock exchange, high fixed costs, poor regulation and legislation etc o
• No, foreign banks are not interested in accessing the rest of Africa through SA

- Africa is on the radar but we have no imminent plans; growth into countries is driven a lot on the magnitude of the market. - "No, not really. In Africa, no sophistication of products, products generally quite vanilla and pedestrian" - "No, the rest of Africa is not the ultimate destination – how many of these countries are bankable? Have to look at credibility, reputational and market risk - Have to be careful with whom you deal as any poor / bad dealings in Africa could well impact the share price of the bank back home. - Banks take a long term view in deciding to enter a country, a 25-30 year view

4.4 Responses to Proposition 3

Foreign investment banks have a comparative advantage over domestic investment banks because they can draw on their parent company for additional funding and capital when needed.

Question 5 was intended to test proposition 3 by seeking respondents' views around how global banks can compete effectively in a highly competitive, sophisticated financial market, and within the arena of the powerful domestic 'big five banking cartel'. The question was also intended to investigate why South African companies would choose to deal with international banks in South Africa rather than the well-established home-grown local banks.

Concept mapping question 5 revealed the following key themes:

Table 6: Foreign banks' comparative advantages over domestic banks

• Balance sheet and liquidity - Foreign banks have a large balance sheet - Their capital base is huge, e.g. we handled the Firstrand BEE deal - The biggest comparative adv of foreign banks is liquidity as they have access to and can leverage off the group - Domestic banks have a problem where local corporates are expanding abroad. MNCs need liquidity and foreign banks have this liquidity advantage - Foreign banks have a comparative advantage in global resources that they can draw on and the global business network - Foreign banks definitely have comparative advantages in the holding company's vast reservoir of capital, huge resource of capital. - Foreign banks bring liquidity into the system due to regulations applicable. Every foreign bank doing business here has to have local capital. They are not allowed to trade off their global balance sheet. Have to import capital from offshore in Rand (known as endowment capital, and has to be minimum R250 million)
• Skill-set - Foreign banks have a skilled set of bankers - We (Barclays) have world class bankers

- Can leverage of the group's knowledge capital
- Foreign banks have brought in useful management and business skills.

- Products and Technology
    - They have comparative advantages due to the design and expertise of their products
    - Global transaction services which constitutes product differentiation
    - Hedging products - are using ability to hedge offshore – this is a huge comparative advantage
    - Foreign banks have a global product range and can execute quickly
- Risk taking ability
    - Foreign banks have comparative advantages due to their ability and appetite for risk in terms of size and sophistication of deal
    - Foreign banks trade onshore and offshore. Those trades done offshore have their risk controlled out of the London office (or parent company). In this way, foreign banks hold a comparative advantage in risk management
- Regulation
    - Foreign banks don't have to comply with BEE requirements as locals do; this gives them an added advantage
- Brand
    - Foreigners coming into the market from offshore will rather trade with a global brand in this market
    - Brand image – we (Barclays) have latent brand strength, since we have been affiliated with SA for over 100 years. A global brand which is recognised by the global community is certainly a great comparative advantage.
    - Global access to global clients, networks, global reach, e.g., Coke would likely deal with brands with which they are familiar
- International experience
    - As an international bank, are used to looking across different countries, currencies; cultural differences, regulations etc
    - International banks are different to local banks in that they are more reactive to market trends, react viciously to external perceptions. For instance, if a product is not doing well in this market, global banks are reactive and make a ruthless decision to pull out of that particular product and move on, whereas locals will keep trying and put more money into it.
    - International experience is key. We and other International banks operate in more than 1 country so we know about regulatory arbitrage and so go where legislation is the least hassle
- Efficiencies of scale – from a systems perspective; Foreign banks are willing and able to spend on infrastructure (IT); buyer power – get things cheaper through the group.
- Size of the foreign bank acts as a comparative advantage
    - It is similar to that which Porter proposes: companies must dominate local and then expand, i.e. HSBC biggest bank in Hong Kong and then expand strategy abroad. So size in the home market is a comparative advantage in this market. It takes 100+ years to get it right in global markets
    - Foreign banks are global; have a global network
- Location
    - Foreign banks have a comparative advantage due to their location, i.e. for trade finance. International banks can service a client by providing a banking platform all over the world, all the way through in whichever market – 1 bank, 1 service
    - If SA clients want to expand abroad, Foreign banks have competitive advantages in helping them there in terms of international presence, know how, capabilities in international markets etc
- Rating
    - Foreign banks generally have a higher rating than local banks in international markets (rating based on profitability, size (balance sheet & other), risk, capital-raising ability, etc). The higher the rating, the cheaper and easier it is to raise money globally.
- Access to global clients and the global reach
    - Foreign banks have a comparative advantage due to their access to global clients,

networks, and their global reach, e.g., Coke would likely deal with brands with which they are familiar o Foreign banks are global; have a global network o Global banks have an advantage when they follow their client, e.g. BOC following its clients has an advantage in providing them investment and banking services.
• Access to global Research and access to global clients o “- Access to Global Research and o - Access to Global Clients; o “Comparative advantage in global resources that can draw on and the global business network”
• Foreign banks actually have a disadvantage when it comes to lending and deposits o “Actually have a disadvantage on the balance sheet here as we (JP Morgan) are not poised to aggressively lend here, rather lend in the US” o “Foreign banks find it hard to compete against local banks in the debt market” o Foreign banks are stealing the cream off the top, not the bread and butter. Investment banks require a retail bank to borrow funds, and foreign banks don’t have a retail deposit base and hence cannot compete on rand deposits, only on dollar deposits

4.5 Responses to Proposition 4

Foreign bank presence has led to an improved financial system infrastructure through the introduction of sophisticated financial instruments and techniques.

Question 6 sought to test Proposition 4 by seeking respondents’ views on whether there had been an increase in welfare in the South African market through introducing sophisticated financial instruments and techniques into the financial system.

Concept mapping responses to Question 6 are indicated in Table 7:

Table 7: The impact of foreign banks on the South African financial market

• Foreign banks have introduced healthy competition o Absolutely. Foreign Banks have had an impact; they have broken the cartel; added competition; brought technology to the market which has benefited the whole of SA. o Foreign banks have introduced a lot of competition, fair competition is good, and has led to benefits such as lower client costs; sophistication in product design. o There has been an impact through the change through investment banking in local economy, i.e. margins driven down in the equity brokerage industry o The impact is positive and is well overdue. Competition is good as a result, as, for too long there has been the" laager" mentality. Complacency has been part of the game.
• Approach to business, industry best-practice and management skills o Foreign banks have raised the bar in terms of relationship management; urgency to sell; and to be proactive rather than have a reactive approach o Foreign banks such as ours (Deutsche Bank) have brought in international expertise. o Foreign banks have introduced management skills and business skills
• Foreign banks have taken market share from local competitors o Foreign banks have taken market share from locals, they've done well in this market. Foreign banks have a deeper penetration in certain products, e.g. equity products, International banking and treasury. Foreign banks have also deepened their service to international South African companies, by serving them abroad as well as at home. o A large impact has been market share –"on the JSE 4 out of top 5 are foreign banks"
• Foreign banks have introduced liquidity, new technologies, and have provided access to capital through FDI and infrastructural investments, all contributing to more well-served and happier customers. o Foreign banks bring in liquidity into the system and access to capital for market participants o Customers have more choice, they reap the benefits from greater efficiencies and a wider product offering o Need global banks for large infrastructural projects, i.e. Gautrain could not be an idea, a real project if it wasn't for the foreign banks big balance sheets. o Infrastructure and technology is fuelled by foreign banks o Foreign banks are better structured for large complex deals as they can take on greater market risk, credit risk and have larger balance sheets, have better access to capital, have an established branch network, and have got the right people o Foreign banks invest huge resources of capital – e.g.. in Johannesburg and Pretoria, there is major building industry going on, and ALL or most of these projects are being financed by Foreign banks in conjunction with other parties to the contract o Presence of foreign banks has diversified the sources of capital for local industries o Interest rates are much lower than in SA so their loans are much more attractive than in South Africa o These companies (foreign banks) have a large capital base and can take on much more risky clients and projects, i.e. Citibank vs. Absa, Citibank can take on collateral of 80% versus Absa 100%.
• .Efficiency o Foreign banks have kept local banks on their toes, "have kept them more honest". o Foreign banks have brought in rigorous compliance governance - have introduced and enforced global best practice . Benchmarks are higher in terms of best practice
• Local banks are internationalising o Domestic banks have to compete and are internationalising, and are learning this game, e.g. Standard Bank has expanded into many countries i.e. London, New York, Russia and Shanghai.
• Customer Welfare o Customers have more choice, reap the benefits from greater efficiencies and a wider product offering. The increased competition and innovation ensures sophisticated product designs, a wider offering and greater access to credit.

An important outcome of this question was that sophisticated products and techniques have increased in the South African economy, but this is mainly attributable to globalisation rather than foreign bank presence, *per se*.

- Sophisticated products and techniques
  - SA has seen increases in level of sophistication of products & expertise, but is a natural transition and natural development, i.e. it is happening in London as much as South Africa
  - "I think international banks have had little effect on the sophistication of the system."
  - "…sophisticated products – this is a global thing, local banks have as much access
  - Skills and knowledge is a global thing – there are smart people here as there are in London and the world over; Locals are able to source the products themselves
  - International bank contribution must not be overestimated: we learn from local market, those people who have been on the ground and know the market, as is the case everywhere in the world.
  - Foreign banks have had no impact on sophistication of products, techniques etc. We (HSBC) are purposefully not trying to compete against local banks

5 INTERPRETATION OF RESULTS

5.1 Introduction

The interpretation of the results of this research is based on the findings from the interviews and is compared to and contrasted with the findings revealed in the literature review. The results of the propositions tested will be discussed by commenting upon the responses to each question as they relate to the proposition.

5.2 Proposition 1

Foreign banks are expanding into South Africa in order to seek new market opportunities.

From the responses to question 1, which was very broadly defined, a strong percentage of respondents confirmed that foreign banks are entering South Africa in order to follow new business opportunities in this market. These included: opportunities provided by liquidity in the banking system following deregulation and opportunities presented by liberalization of the banking industry; the drive to entrench a footprint in Africa which would open doors to opportunities in other parts of Africa; in order to carry out emerging market strategy; to utilise core competences applicable to a particular niche market; and in order to serve an existing large global-standard client base resident in South Africa. However, an equally strong percentage of respondents put emphasis on foreign banks following their clients abroad as a primary driver of entry. Except for one respondent, all confirmed that this would only be the case if there also existed profitable business opportunities. The literature on foreign bank expansion has confirmed that new-market seeking behaviour is internationally regarded as one of the primary drivers for a bank’s expansion beyond the borders of its parent country (de Paula, 2002; de Paula, 2003; Focarelli & Pozzolo, 2000; Cordone et al, 2000; Clarke & Martinez Peria, 2001).

Each foreign bank has a different strategy associated with any particular host country, depending largely on the host country circumstances. Banks in a crisis in the host market may call for an acquisition by a foreign bank, while a country with high economic growth potential and an untapped growing middle class may require a representative office being set up with plans for organic growth.

Globalisation can be viewed as the underlying driver behind most penetration strategies. Multi-nationals entering the global arena for the various reasons in the wake of globalisation encouraged banks to enter these countries in order to serve these multi-nationals which they serve at home. Globalisation facilitates trade in skills, ideas, innovations, etc, which brings business opportunities abroad closer to home and easier to access for foreign companies and banks.

Opportunities particularly expose themselves in countries undergoing drastic changes, such as Russia and the lifting of the iron curtain, as well as South Africa and the lifting of economic sanctions.

Opportunities can only be exploited if trade relations are good between the host and home market. Government regulations can also be major catalysts to investment, such as those exercised by government authorities in Brazil and Argentina and some parts of Africa who were hoping to save a sinking financial sector and achieve macroeconomic relief from foreign banks' acquisition of sinking local banks.

South Africa has a certain focal point of interest to foreign investors: its strategic location as a footprint in Africa. The country produces one-third of the continent's GDP and as such is certainly the driver of economic growth for the continent. Many foreign banks see the rest of Africa as a huge untapped market, but are to be warned of the tremendous risks and costs attached in investing there. Cultural and language difficulties also pose a cavernous barrier to entry.

A few additionally important themes were extracted from the discussions from question one on the processes and decisions underlying expansion. Some respondents were straightforward as to the motive being purely to make profits and that other motives, such as following customers, carrying out emerging market strategy etc, were merely segments of the main motive to exploit opportunities, regardless of whether it is a first world or third world country.

Foreign banks are known to cherry pick in their business dealings by being able to offer attractive investment alternatives at pleasing rates as a result of the value they can create from their brand, global positioning and global network.

Other themes emerging from the responses to question 1 included the size and infrastructure of the financial sector of South Africa, as the country boasts a sophisticated financial infrastructure with many global players participating. According to Frauendorfer & Gantenbein (2002), greater foreign presence is found where the average bank size is smaller in the host country (i.e. tier 2 and 3 banks in SA), implying it is easier to acquire such banks and there is greater opportunity to increase market share after restructuring. Furthermore, it is the large banks from the foreign country which tend to expand abroad. Generally, larger banks have larger and more international customers, and thus follow these customers to serve them abroad. Additionally, large banks have a greater incentive to expand abroad to diversify their risk. Economies of scale and scope, portfolio management and investment banking are also strongly influential in a decision to go abroad.

Many respondents dwelt on global ranking. Foreign banks look to entering SA as it bumps up their global ranking which is an important factor when it comes to raising capital in global markets, as well as peace of mind for depositors. Lastly, consolidation in the sector is attracting foreigners as it allows them to grow through M&A rather than organically.

As supported by the literature, consolidation of banking sectors worldwide is a major force for internationalising. In general, advances in technology, deregulation and globalisation have reduced margins in traditional banking activities, driving the merger process between banks, other banks and non-bank financial institutions at home and abroad (Hawkins & Mihaljek, 2001). In emerging economies, the authorities tend to play a larger role in the consolidation process, that is the government conducts directly or indirectly the process of banking consolidation through programs of banking restructuring, privatization of public banks, increasing flexibility in the rules of foreign bank entry (Gelos & Roldos, 2002; Hawkins & Mihaljek, 2001). In mature markets, however, the consolidation process is purely market-driven (de Paula & Alves, 2003). South Africa poses as an emerging economy with a mature banking market with consolidation being primarily market-driven rather than through government enforcements.

The responses to question 2 were similar to those given for question 1 and, importantly, again confirmed the validity of Proposition 1 (Foreign banks are expanding into SA for new business opportunities).

Respondents' answers were again mixed in terms of the two main objectives for foreign bank entry as provided by the literature, which are market-seeking and customer-following activities (Cardone-Riportella *et al*, 2003; de Paula, 2003; Cordone-Riportella *et al*, 2000; Hawkins & Mihaljec, 2001, Konopielko 1999; Clarke *et al*, 2001). However, the overall picture presented confirms that foreign banks are entering SA in order to follow new business opportunities in this market, and as an equally important reason, to follow their customers abroad but this is only if there is a positive impact on bottom line.

A second major theme underlying expansion was foreign banks' growth strategy, whether by M&A or organically. Obtaining a footprint in Africa, as well as by following their customers and becoming large MNCs, feeds this growth strategy, and underpins their comparative advantages of having a broad global reach and wide global network of clients.

Many of the results can be clustered around the theme on foreign bank emerging market strategy, where South Africa serves as a prime destination to carry out this strategy.

A further distinct theme arising out of the discussions on question 2 revolved around South Africa's unique offerings of vast resources: sophisticated financial infrastructure, engine of growth for the African continent; global standard companies as potential clients; stable financial sector; accommodating regulations for entry (as compared to the rest of Africa); and political affiliations with certain countries. This is consistent with the literature which holds that a major decision factor for banks to expand abroad is the attractiveness of the host market. The market of the host country may offer new opportunities to make profits, depending on the characteristics of the economy, i.e. size, stability of the country, and features of the local banking sector (Lensink & De Haan, 2002).

Additional to South Africa's resources and infrastructures, deregulation of the financial market and re-integration into the world economy have emerged as hallmarks of South Africa's growth and macroeconomic stability of recent years. South Africa is, in foreign investors' eyes, an interesting market which is very mature and very well-served. Part of South Africa's transformation takes the form of Black Economic Empowerment, the implications of which for Banks and Capital Markets are far-reaching. BEE involves opportunities in corporate finance, M&A as well as the huge possibilities arising out of an emerging black middle class.

Question 4 was also designed to test Proposition 1 (Foreign banks are expanding into South Africa in order seek new market opportunities) by attempting to extract respondents' views on the attractiveness of South Africa's financial landscape in the next five years. The responses confirmed the view that South Africa will remain a competitive arena and that current players will still be here in the next five years. However, consolidation will play a key role in the makeup of the industry, with smaller banks being swallowed up by the stronger foreign counterparts - current players and/or new entrants. Consolidation as a global trend is set to continue. In South Africa, the proliferation of silos chasing the same pool of customers will drive further consolidation in the industry. Foreign banks have the potential to become even more of a formidable force and are viewed as a growing threat to domestic banks.

Local banks will be kept more efficient, and, due to the effects of consolidation, there will be less of the smaller operations in existence. Industry rivalry will be the same or more intense since foreign players will continue to compete in niche markets and will be looking for opportunities for M&A as the most effective growth strategy. Purchasing a working operation set with resources, a clientele, a working business plan, etc, is a far easier method to grow market share than through organic growth. There will continue to be many opportunities for investment in South Africa which are of interest to foreign players, i.e. project finance, BEE deals, M&A.

In conclusion, foreign banks are entering South Africa for various reasons, depending on their circumstances. Respondents answers confirmed proposition 1 (International investment banks are being driven into South African banking markets in order to follow new-market opportunities). However, it is clear that "customer-following" objectives are important components of banks' strategy in the quest to maintain existing clients, to build a global footprint, and to make good use of - and build upon - their existing international network, brand and global reach. With globalisation, banks are more easily entering other countries; cross-border expansion contains far less barriers. The increased integration of banking sectors around the world has been facilitated by the liberalization of those countries' financial markets (Frauendorfer & Gantenbein, 2002). Hence it has become a greater part of their strategy to identify opportunities which fit into their global expansion strategy, which align with core competence to allow growth, and which enable them to enter and operate profitably in a niche area.

5.3 Proposition 2

Foreign banks are using their position in South Africa as a springboard into the rest of Africa.

Responses to question 1 also confirmed Proposition 2 (Foreign banks are using their position in South Africa as a springboard into Africa). It was also confirmed that foreign banks invest in foreign countries such as South Africa with the intention of being there for at least 20 – 30 years, given the massive costs and risks attached. This suggests that, although there may be an interest in Africa, South Africa serves as a primary destination with the additional attraction of the gateway to Africa.

The majority of the responses to question 3 indicated that foreign banks are driven to access other parts of Africa, but remotely from South Africa and dependent on the particular country's individual circumstances. That is, they have identified key opportunities in Africa but do not see value in actually creating a physical presence. There are various reasons for this:

- It would require a large capex on infrastructure etc.
- It is too risky; the risk-return ratio is not attractive.
- It is also too costly to operate in Africa.
- Africa is not homogenous, it is multi-cultural which adds a dimension of difficulty in operating there.
- Africa does not contain enough to warrant a physical presence when it comes to crucial factors such as a stock exchange, financial and legal infrastructure, high fixed costs, poor regulation and poorly defined legislation.

The majority of respondents indicated that there would be value in creating and maintaining relationships in African countries in order to position themselves for ongoing financing projects such as financing large infrastructural deals from satellite offices operating out of South Africa.

South Africa is a listening post to the rest of Africa. Foreign banks interested in putting their feelers out in other African markets are well-positioned if they are already operating in the South African market.

The other responses were grouped under the category "not interested in the rest of Africa", supported by arguments surrounding

- Credibility of African countries
- Reputational risk for investing bank
- Market risk
- Lack of sophisticated products
- Poor skills base
- Unbankable communities

5.4 Proposition 3

Foreign banks have a comparative advantage over local banking operations because they can draw on their parent for additional funding and capital when needed.

Question 5 was intended to test Proposition 3. The overwhelming majority mentioned liquidity as a result of access to their parents' capital base. Tied into this were discussions on international rating, which enables cheaper and easier access to capital, and risk-taking ability and risk appetite, which ties into a strong balance sheet.

Foreign banks' capital base can be extremely large. Many foreign banks operating in South Africa have been able to handle massive infrastructural deals due to this factor and because they can take on more risky deals by requiring less collateral from their client than domestic banks. They can leverage against the group's business network.

Respondents also put great emphasis on a global brand; international experience and exposure and along with it access to global clients and global reach. The comparative advantages in producing these products or services are carried elsewhere into other niche markets. The access to their global network of clients, their global reach and their brand value can give immeasurable amounts of opportunity to foreign banks. For instance, Coca Cola, a massive mutli-national company, would prefer to do business with a brand with which they are familiar, can trust and that has a global credibility assurance.

Some of the respondents held that foreign banks enjoy comparative advantages in product differentiation, sophisticated skill-set, technology and economies of scale. The size of foreign banks allows them to capitalise on efficiencies of scale, for instance, they are able and willing to spend on IT and they have buyer power since they can leverage off the group's size.

According to the literature, banks that will become multinational are those located in countries with comparative advantages in producing bank products or services, and these comparative advantages are then carried elsewhere (Nikitin (2002). Companies, including banks, must possess intrinsic capabilities which give them a comparative advantage over their domestic rivals in order for them to compete effectively in the host market. Mata & Portugal (2002) theorise that these advantages would usually be related to the possession of particular assets, which, once developed in a particular location, can be employed in other locations at lower cost than developing it locally. Thus, these firm-specific assets have allowed the firm to enjoy some degree of economies of scale, which allow them financial advantages, product differentiation, and marketing advantages.

Foreign banks' location gives them comparative advantages over domestic banks. International banks can service clients by providing a global banking platform. Additionally, due to their location in global markets, they are able to serve South African companies expanding abroad into other markets.

5.5 Proposition 4

Foreign bank presence has led to an improved financial system infrastructure through the introduction of sophisticated financial instruments and techniques.

The majority of respondents to question 6 held the view that sophisticated products and techniques was due to the process of globalisation and not merely due to foreign bank presence. This is inconsistent with what was found in the literature.

However, there was consensus that foreign banks have had a positive impact on the domestic banking system, but in ways other than those outlined by Proposition 4.

Firstly, many respondents felt that foreign banks have introduced industry best given to practice in the local banking scene, as well as management skills and new technologies to the investment banking business. This is consistent with the literature on the topic (Hawkins & Mihaljec, 2001; Crystal, Dages & Goldberg, 2001; Mathieson & Roldos, 2001; Peek & Rosengren, 2001; Gardenas, Graf & O'Dogherty, 2002; Denizer, 2000; Frauendorfer & Gantenbein, 2002).

Equally important to respondents was the introduction of healthy competition into the banking market, as well as the improvement in efficiency in local banking operations. The proliferation of foreign banks has forced local banks to operate more efficiently and to shift them out of their 'laager' mentality, as a result of the increased competition brought in and the generally more efficient, global bank. The literature supports this (Frauendorfer & Gantenbein, 2002; de Paula & Alves, 2003; Lensink & De Haan, 2002; Hawkins & Mihaljec, 2001; Mathieson & Roldos, 2001; Cardenas *et al,* 2002; Pomerleano & Vojta, 2001). The entry of foreign banks into emerging markets contributes to the development of better and more efficient processes in domestic banks, and may even force domestic banks to become more efficient if these entities wish to survive.

In addition to efficiency, the literature confirms our findings that foreign banks bring new innovations, improve the allocation of credit, improving the quality, pricing and availability of banking services directly and indirectly, and provide a more stable source of credit (Mathieson & Roldos, 2001; Frauendorfer & Gantenbein, 2002; de Paula & Alves, 2003).

Thirdly, other important implications were: Increased liquidity into the banking system, new technologies, provision of capital, FDI into local infrastructural projects. The literature on the impact of foreign banks on the domestic financial system confirms that it is a positive one and there are many benefits to be enjoyed by the host country (Hawkins & Mihaljec, 2001; Clarke *et al,* (2000); de Paula, 2002; Mathieson & Roldos, 2001; Pomerleano & Vojta, 2001; Uiboupin, 2004). However, the introduction of sophisticated products and techniques, which is identified as a major benefit of foreign bank entry in the literature, was not found to be a driving benefit to the local financial market, as suggested by Proposition 4.

A fourth outcome was respondent's views on customer welfare. Investment banking customers' welfare has been dramatically enhanced through the provision of an enhanced access to credit and more appropriate financial products due to the greater competitive levels and know-how introduced from abroad.

A further outcome also supported by the literature was the introduction of management and business skills to the local economy (Peek & Rosengren, 2001; Denizer, 2000; Pomerleano & Vojta, 2001).

The literature indicated that in mature markets, foreign banks appear to be less efficient than local banks. This does not seem to be the case with SA. Although it boasts a mature banking system, South Africa is still a developing country. Foreign banks are more efficient than local banks and this has resulted in the local banks having to introduce greater efficiencies into their operations to remain competitive.

6 CONCLUSIONS AND RECOMMENDATIONS

6.1 Summary

The key results of this study will be presented through a discussion of the research findings in terms of the four propositions that were qualitatively tested. Relevant findings from the literature will be included in the discussion.

6.2 Relevant findings

6.2.1 Proposition 1

International investment banks are being driven into South African banking markets in order to seek new-market opportunities in South Africa.

Foreign bank's expansion into South Africa is indeed being driven by the need to find and operate in new markets. South Africa poses as an immeasurably attractive destination for business opportunities. Its supply of abundant resources; globally sophisticated skills-base; sophisticated financial infrastructure; stable macro-economy; its re-integration into the world economy; engine of growth for Africa; its location as a springboard into the rest of Africa; economic integration with many foreign countries, are among the major factors confirming this phenomenon.

This is not the full story, however. Foreign banks are also following their customer base abroad in order to nurture their existing client base. Global clients and global banks go hand-in-hand, and hence opportunities for MNCs entering into SA are indirectly opportunities for those MNC's banks as they follow their clients abroad.

Foreign banks accrete value to their global network through re-affirming their global presence and riding the globalisation wave, capitalising and building on their brand, entrenching a footprint in Africa and carrying out their emerging market strategy.

Historically, the most important driver for entry was to capitalise on the increased liquidity resulting from deregulation and the increased opportunities that came with re-integration. Currently, the most important reason that foreign banks are entering the South African economy is access to opportunities offered in the rest of Africa, South Africa's re-entry onto the global radar and its improved ranking in global markets as a significant destination in which to invest.

Hence it can be concluded that Proposition 1 is **partially accepted** (foreign banks are entering SA to capitalise on new market opportunities), as following their customers abroad has been identified as equally as important for foreign banks. With customer following activities, banks now require additional business opportunities to lure them into a country, not just the opportunity to serve an existing client base.

6.2.2 Proposition 2

Foreign banks are using their position in South Africa as a springboard into the rest of Africa

Africa is perceived by many as a massive untapped market. The easiest form of entry is through South African borders. Some foreign banks have the intent to set up a physical presence in sub-Saharan or other parts of Africa, but the interest is mostly to operate remotely from South Africa. Africa represents an untapped market with significant opportunities but contains major risks in terms of infrastructure, lack of a stock exchange, and the high costs of doing business, amongst others. Foreign banks are mostly interested in developing and maintaining relationships with key contacts in African countries in order to facilitate large transactions, such as project finance deals.

Hence, proposition 2 is **accepted**.

6.2.3 Proposition 3

Foreign investment banks have a comparative advantage over domestic investment banks because they can draw on their parent company for additional funding and capital when needed.

Liquidity and access to parent company funding emerged as a major comparative advantage of foreign banks over domestic banks. Further to this response was international location and international experience, and the global reach, global brand, access to global clients and the global network that comes with it. A well-known global brand allows advantages when trying to win business, as well as in global ranking, which, in turn ensures easier and cheaper access to credit. International location ensures foreign banks can serve clients in almost any market and can service clients by providing a banking platform all over the world, i.e. one bank, one service.

Links with the home country gives foreign banks a myriad of support possibilities, be it funding or know-how. In mature banking systems with strong domestic banks, it is particularly hard for banks to find a competitive advantage through expertise or service. In this type of environment, the only niche expertise that many foreign banks can offer is their international experience, know-how and expertise, and links to their home country (Clarke e*t al*, 2003).

Foreign banks, additionally, have size and strength on their side when interacting internationally. This coupled with global brand and credibility, makes risk-taking ability an important advantage. Many foreign banks have their risk controlled out of their London (or home) office, allowing them to take on more sizeable and sophisticated deals. Furthermore, their global position allows them to leverage off the group's knowledge capital

Hence, proposition 3 is **accepted**.

6.2.4 Proposition 4

Foreign bank presence has led to an improved financial system infrastructure through the introduction of sophisticated financial instruments and techniques.

Foreign bank presence has indeed had a positive impact on the South African banking market. The major improvement appears to be they have broken the ‘big five banking cartel’ and altered the ‘laager’ mentality of the large South African banks. They have introduced healthy competition and greater efficiencies into domestic banking practice. Foreign bank presence in emerging economies leads to an improvement in the competitive environment since foreign banks bring competition to the local industry, which is typically made up of a banking cartel (Uiboupin, 2004).

However, there was unanimonity in the perspective that it is not foreign bank presence *per se* that has introduced sophisticated financial instruments and techniques, but rather it is the natural product of globalisation. For instance, it is happening in London as much as it is happening in South Africa. With globalisation and consolidation, the trade in products and skills between countries has become a simple and natural phenomenon.

As a result, Proposition 4 is **rejected** on the grounds that the impact is indeed positive but due to reasons other than those offered by Proposition 4.

6.3 Final comments

South Africa exists as a focal point of interest for FDI on the global radar. Since re-integration, the country has experienced a flood of new entrants which have had major positive implications for the local economy. During the latter part of the 1990s, foreign interest was mainly attributed to opportunities arising out of South Africa’s period of dormancy. In recent years, however, opportunities arise out of South Africa’s transformation to democracy; attractive investment environment such as low interest rates, inflation and high GDP; the improvement in economic variables such as the improvement in the balance of payments accounts and elimination of foreign debt, as well as the removal of barriers such as the gradual elimination of exchange controls; the sophisticated financial system offering niche market opportunities; and as it stands as an excellent destination in which to carry out emerging market strategies.

The outlook for future investors does not look as rosy as for those of the past. The South African market is relatively flooded with banks, foreign and local. The industry may see some further consolidation and the opportunities for foreign banks to enter and expand may only be possible through M&A rather than organic growth. This may be attributable to the relatively small client base over which all participants are fighting and the prospects of shrinking market share as current players and new participants fight for larger pieces of the same pie.

The landscape in the next five years will look the same in terms of the presence of the big five: the characteristics of the South African economy will ensure that the big five still remain the major players in the industry with foreign banks on the fringes operating in various niche markets. However, foreign banks will continue to be a major and increasing threat to domestic banks (Metcalfe, 2005). The big five will continue competing for retail business and investment and commercial banking, while foreign banks will compete in segments of the investment and commercial banking business. South African banks will also need to become familiar and comfortable with the impact of foreign management and organisational structures that span multiple geographies. Foreign banks are used to this operating method, and generally tend to have staff that have had far greater levels of international exposure.

The most important outcome of this research was the positive attitudes from all participants in the study as to the healthy state of business in SA, the healthy competition, the improvement in global standing of SA as a destination for FDI, and SA's offering of global standard companies which foreign banks are vying to win over.

6.4 Limitations of research

The majority of the respondents were based in Johannesburg and have an inherently South African perspective on the subject of foreign bank expansion into South African markets. A more representative sample (containing more foreign respondents) may have yielded different results.

6.5 Recommendations

The banking and capital markets industry in South Africa will continue to be transformed by increasing globalisation, advancing technology and changing demographics. Protecting and enhancing a firm's reputation as well as building investor confidence and trust will be key priorities going forward and foreign banks will do well to act on these priorities. The Basel II Capital Accord's requirement will greatly impact risk management's efforts in the industry.

For future and current foreign bankers, Corporate Banking has edged out Merchant and Investment Banking as the most competitive segment of the banking industry in South Africa, whilst competition in Internet banking appears to have moderated.

Foreign banks should take heed of the major drivers of change and the most pressing issues relevant to South African banking. Technology has been replaced by New Foreign Entrants as the major driver of change. While the most pressing issue overall in the banking industry is revenue growth, new compliance requirements and other regulations are equally as important. Compliance and regulatory constraints are seen as the greatest threat faced by banks at present.

Foreign banks should continue to invest in the segments of the capital markets in which they currently play. The most important future business segments for the industry as a whole are Treasury, Corporate Banking, Commercial Lending, Foreign Exchange, Capital Markets and Structured Products. Private Banking, Brokerage, Listings and Structured Finance will be less important for the future.

Foreign banks should continue to leverage the advantages they have from both a home market perspective and in terms of the overt support of the South African government, to build new banking franchises in South Africa and other African countries. Foreign banks operating in African markets should enjoy future upside as the markets continue to grow.

Finally, foreign banks are strategically positioned to have a profound influence on the future shape of the South African banking and capital markets. This power should be used responsibly to create growing and sustainable South African and African banking franchises that will benefit both the host countries and the source country.

6.6 Suggestions for further research

This study of the expansion of foreign banks' into South African markets is one of the first investigations of this nature in South Africa. This exploratory work lends itself to follow-up research. Suggestions for future research include:

- a quantitative study on the impact the expansion of South African banks have had on their host African countries;
- A comparison of expectations of investment on entry versus actual returns for foreign banks;
- determining the optimal management and organisational design structures for foreign banks operating in South African markets;
- A comparison of the profitability of domestic versus foreign banks in South Africa

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<u>APPENDIX 1</u>:

Questionnaire – in depth interviews; Adopted from Pomerleano & Vojta (2001: 31):

1. Please describe the process whereby foreign banks expand into South African banking markets.

2. What are the drivers of foreign bank entry into South Africa?

3. In your opinion are investment banks operating in South Africa using their position here as a springboard into the rest of Africa?

4. What do you believe the South African banking competitive landscape will look like in the next five years?

5. What comparative advantages do foreign banks hold over domestic banks in South Africa?

6. Has the presence of foreign banks led to increased sophistication of financial products and techniques in the banking industry? Please describe other relevant high-level implications for the South African domestic banking market.

APPENDIX 2: CONCEPT MAPS

Diagram 1 A

(Q1) Describe the process whereby foreign banks expand into SA markets

•Global footprint

•Globalization and the need for a global footprint are part of many banks growth strategies; growth strategies are either organic growth, or part of a M&A strategy

•Foreign bank internationalisation per se also driven by need for global footprint.

• Banks who have not historically had a global footprint see the need to consider internationalisation as part of their strategic intent; where there is more and better value for shareholders

•Banks want to follow their customers and become MNCs

•Niche markets and the mix of business in a particular country

•New markets and business opportunities

• M&A growth strategy is the most likely and omnipresent growth strategy;- banks buy operations which they need for their operational strategy in a particular country, - for instance, in Greece, HSBC bought Barclays retail; in UK HSBC bought Midlands bank the biggest retail bank in the UK; in Brazil, HSBC bought the 4th biggest bank, and in South Africa Barclays bought Absa for their retail strategy.

•It is sometimes just important to have a strategic fit in a country, even if you don't make money there, its important for some particular reason to have an operation due to synergies created in other areas. Banks take a long term view in deciding to enter a country, a 25-30 year view

•HSBC has three core, global product groupings: Retail ; Private banking and Consumer finance. The decision to go global hinges off which of these three the bank can pursue in a particular country. What niche, what mix of business determines if you want to have a presence in SA.

•International banks enter a country for 1 reason only – to make money regardless if the country is 1st or 3rd world. Local market opportunities one way or another provide the basis for this.

•Each country has a different strategy associated with its expansion and each destination country forms part of a segment of the overall strategy for expansion into emerging markets, the individual objective depending on what the country has to offer in terms of the bank's emerging market strategy elements

•Historically, banks expanded abroad to serve needs of existing clients, facilitate their banking needs and provide banking facilities. Following this, they banked other clients in that market and hence became multinationals; globalisation key in terms of a global network to cover client base.

•More recently, banks look at opportunities, eg Russia and lifting of iron curtain – to accrete value to the global network.

•Size of the FS sector

•Opportunities aligned to core competencies

•Infrastructure

•Who are the potential customers

•There are a few important determinants on whether a bank will enter a country:

• - Size of the FS sector

• - Who the customers could be

• - Are the offerings and opportunities in the local market aligned with the bank's core competencies; will they be able to fully utilize their core competencies

• - Does the local market have good infrastructure in terms of legal services, financial services, regulation & supervision, legislation

•On assessing which country and why, banks determine: what is the risk / return ration; who am I going to serve in this market; the state of the banking system; the regulatory environment; political environment; economic environment

Diagram 1 B

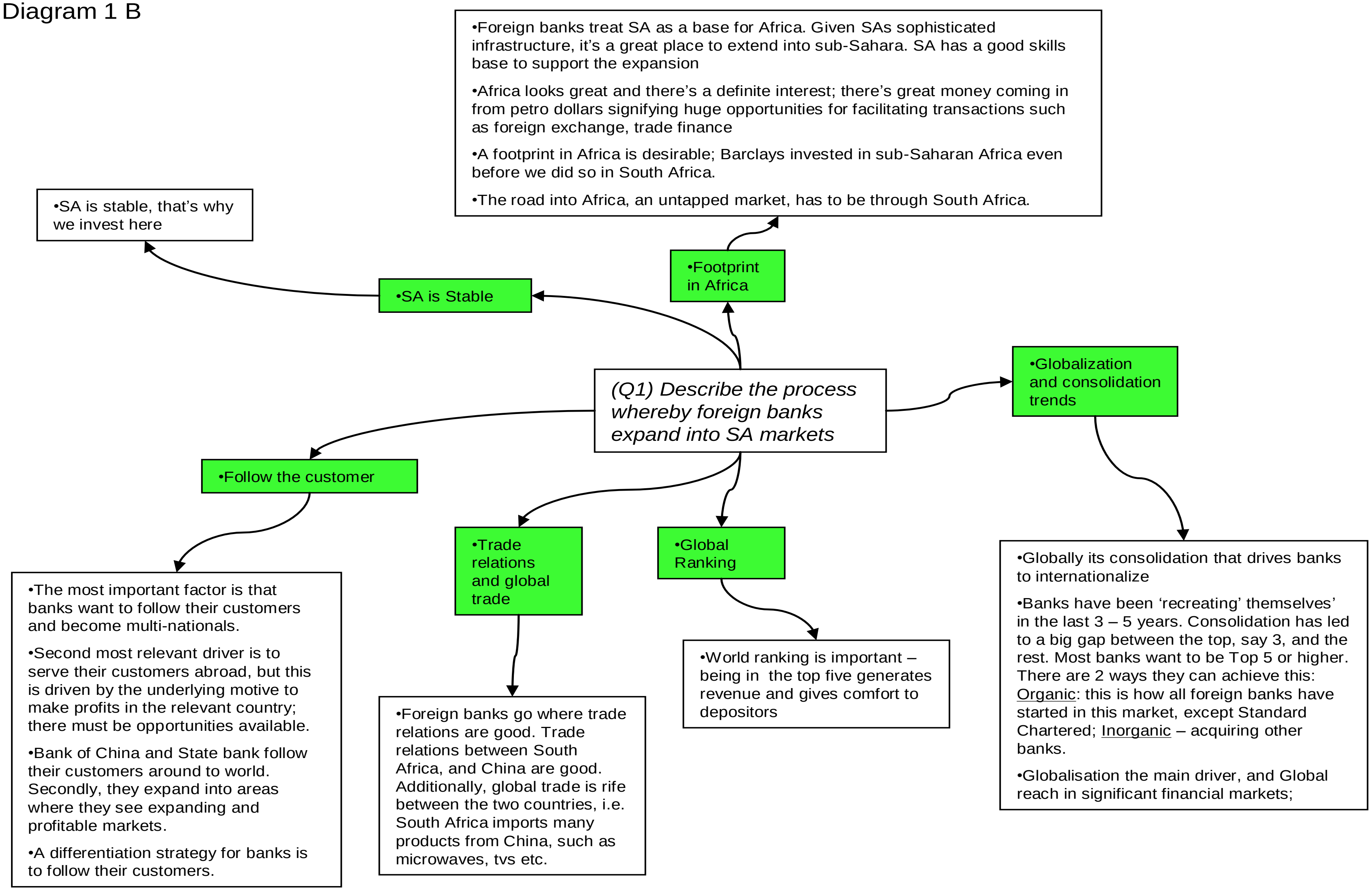

(Q1) Describe the process whereby foreign banks expand into SA markets
•SA is Stable
•SA is stable, that's why we invest here
•Footprint in Africa
•Foreign banks treat SA as a base for Africa. Given SAs sophisticated infrastructure, it's a great place to extend into sub-Sahara. SA has a good skills base to support the expansion
•Africa looks great and there's a definite interest; there's great money coming in from petro dollars signifying huge opportunities for facilitating transactions such as foreign exchange, trade finance
•A footprint in Africa is desirable; Barclays invested in sub-Saharan Africa even before we did so in South Africa.
•The road into Africa, an untapped market, has to be through South Africa.
•Globalization and consolidation trends
•Globally its consolidation that drives banks to internationalize
•Banks have been 'recreating' themselves' in the last 3 – 5 years. Consolidation has led to a big gap between the top, say 3, and the rest. Most banks want to be Top 5 or higher. There are 2 ways they can achieve this: Organic: this is how all foreign banks have started in this market, except Standard Chartered; Inorganic – acquiring other banks.
•Globalisation the main driver, and Global reach in significant financial markets;
•Follow the customer
•The most important factor is that banks want to follow their customers and become multi-nationals.
•Second most relevant driver is to serve their customers abroad, but this is driven by the underlying motive to make profits in the relevant country; there must be opportunities available.
•Bank of China and State bank follow their customers around to world. Secondly, they expand into areas where they see expanding and profitable markets.
•A differentiation strategy for banks is to follow their customers.
•Trade relations and global trade
•Foreign banks go where trade relations are good. Trade relations between South Africa, and China are good. Additionally, global trade is rife between the two countries, i.e. South Africa imports many products from China, such as microwaves, tvs etc.
•Global Ranking
•World ranking is important – being in the top five generates revenue and gives comfort to depositors

Diagram 2 A

(Q2) What are the drivers of foreign bank entry into the SA economy

•SA powerful engine of growth for African continent

•For a bank's emerging market strategy it fits well to be in SA

•SA is 1/3rd of Africa's GDP so by buying in SA, you are buying into a country which generates 1/3rd of a continent's growth.

•New markets and business opportunities

•South Africa looks good for investment for the next five years to the world cup – there is huge growth inevitable in this market, as can be deducted from the massive fixed investment in this country: Eskom and other infrastructure investments; Listing of JSE – this is a huge thing with potential huge impact. When this happens there will be expansion in the market which will increase liquidity

•BEE is also providing opportunity in terms of corporate finance deals

•FB home markets are overbanked

•Theres lots of FDI coming into the country and FBs want to tap into this

•SA houses global standard companies and critical global industries

•There are many sophisticated corporate businesses in SA, many global standard companies, i.e. SAB; customers demand sophisticated products

•DB enterred this country for the first time through acquiring an extremely successful local brokerage firms

•Driver is MNC's who are operating into SA; then the strategy is to "fill up" with local clients who of a similar nature to MNCs operating here, e.g. Sasol

•SA has vast supply of resources, skills and infrastructure

•SA has a highly sophisticated and leading financial infrastructure

•SA is a developing economy worth investing in, when comparing it to Brazil, etc

•The SA economy is good and the market for banking is good

•SA is a growing country, a growing economy

•SA is an interesting market, very well served, very mature.

•There is a growing trend where foreign operations in SA are providing their home country with functions such as back-office operations. Given SA's sophisticated infrastructure, skills base, language, culture and timezone, SA stands as an emerging offshore base.

•Re-integration into the world economy

•Deregulation of the stock market providing liquidity

•In 1994 we (Citibank) looked at coming back to SA as part of global strategy. SA posed as an interesting market, very well served; very mature. And with SA re-internationalising and reintegrating into the world economy, this presented many opportunities to explore

•SA is unique as it was dormant for so many years during which time it built up its infrastructure and is now re-internationalizing

•Most banks entered the SA economy after 1996 purely because of deregulation of the stock market which provided liquidity to the banking system. Liquidity in the banking system in SA rose from 4% to 40% within four years over that period. By definition, deregulation of stock markets causes liquidity to zoom up.

Diagram 2 B

(Q2) What are the drivers of foreign bank entry into the SA economy

•Utilising core competences

•It wasn't the intention initially in our (Barclays) strategy to enter SA to purchase Absa or enter the retail market; but ths became a resourceful opportunity to expand in certain areas of the business and to use its core competence in other areas

•SA stands as an emerging offshore base

•There is a growing trend where foreign operations in SA are providing their home country with functions such as back-office operations. Given SA's sophisticated infrastructure, skills base, language, culture and timezone, SA stands as an emerging offshore base.

•Regulatory, prudential and political drivers

•Its exactly like the WTO and GATS (General agreement on tariffs and trade) where trade has increased due to reducing tariffs, such is the SA banking landscape where there are now not many impediments to entry. The only thing is its high cost – R250m. We are actually inviting them to set up shop.

•The country is stable and is a great destinaion to carry out emerging market strategy

•Government and parastatals are active

•Regulatory controls is a huge driver, i.e. exchange controls in SA. Need a presence to be regulated by authorities. If want to operate in a niche market and want to operate in this niche in SA, have to be regulated here, cant do it remotely

•Follow the customer

•Expansion into SA is largely to do with being customer-focussed, particularly so in SA as it houses large number of HSBC's clients. Its nothing to do with risk diversification, this market is too small

•Important to note that no bank would expand if it wasn't for a positive impact on bottom line

•It's a clear client focus which drives expansion - Services & structures are tied into client need-meeting purposes

•Driver is MNC's who are operating into SA; then the strategy is to "fill up" with local clients who of a similar nature to MNCs operating here, e.g. Sasol

•Its crucial to nurture client relationships

• Clients are categorized as high end and other. In SA, 200 of HSBC's global clients in SA

•Strategy is to provide for local clients becoming MNCs. A lot of SA companies have outgrown the SA market and if they want to expand offshore, say to China, they would want to talk to a global bank who has the international presence, infrastructure, experience and offerings etc.

•"Global banks and global clients go hand in hand"

•Banks follow their clients – i.e. many European banks - their clients have set up shop here.

•Cultural proximity and historic relationships

•Some banks, such as Barclays have a cultural proximity to SA as well as latent brand strength from being affiliated with SA for over 100 years. There is a history between the two countries, SA and England, and ways of doing business are similar. SA also has many affiliations with the US, and hence banks such as Citibank are comfortable doing business here

•Historical relationships

•Diversification of income stream

•Barclays had become so UK dependent they had to alter their strategy for risk management purposes. Needed to generate 50% of their revenues from outside the UK.

•Chose SA for this strategy as have been in SA for 100 years prior to withdrawing in the nineties; are comfortable in SA, have a history, latent brand strength. With the purchase of Absa, they have created a large footprint and are the largest international bank in SA

Diagram 3

(*Q3) Are investment banks entering SA as a springboard into the rest of Africa?*

•No, foreign banks are not interested in accessing the rest of Africa through SA

•In Southern Africa, there is not enough for a physical presence, i.e. no stock exchange, high fixed costs, poor regulation and legislation etc

•Africa is on the radar but we have no imminent plans; growth into countries is driven a lot on the magnitude of the market.

•"No, not really. In Africa, no sophistication of products, products generally quite vanilla and pedestrian"

•"No, the rest of Africa is not the ultimate destination – how many of these countries are bankable? Have to look at credibility, reputational and market risk; eg reputational risk - Have to be careful with whom you deal as any poor / bad dealings in Africa could well impact the share price of the bank back home.

•Banks take a long term view in deciding to enter a country, a 25-30 year view *(and so SA is not seen as just a stepping stone)*

•Yes, SA is a springboard into Africa

•Barclays held a sub-Saharan presence first before the rest of Africa, and have now in effect "bought the springboard" which enhances the sub-Saharan presence and global presence. "Usually it's the other way around, SA is the springboard, but we did it backwards"

•Depends on which MNCs are in Africa as these would have to be large global companies with large market cap for a customer-following strategy to be worthwhile

•"Yes, foreign banks are using SA as springboard into Africa; our regulation is robust but free; South Africa has a good relationship with Africa through such bodies as the SADC etc"

•"These guys (foreign banks) actually ask the world bank, BIS, IMF and IFC where they should go and how they should get into Africa"

•Foreign banks treat SA as a base for Africa. Given SAs sophisticated infrastructure, it's a great place to extend into sub-Sahara. SA has a good skills base to support the expansion.

•Some invest remotely, some set up shop – No one size fits all. There are many running operations from here, through satellite offices

•Yes, SA is a springboard into Africa, but only to operate remotely

•Danger is that Africa is not a homogenous market. It is multicultural and all banks have to have different strategies to get into this market

•There are three banking needs in Africa to be addressed: -Retail provision; -Infrastructure; -Trade. Banks have to be careful to focus on one of these and not on all three.

•African securities are of increasing interest, but we will not make a presence there

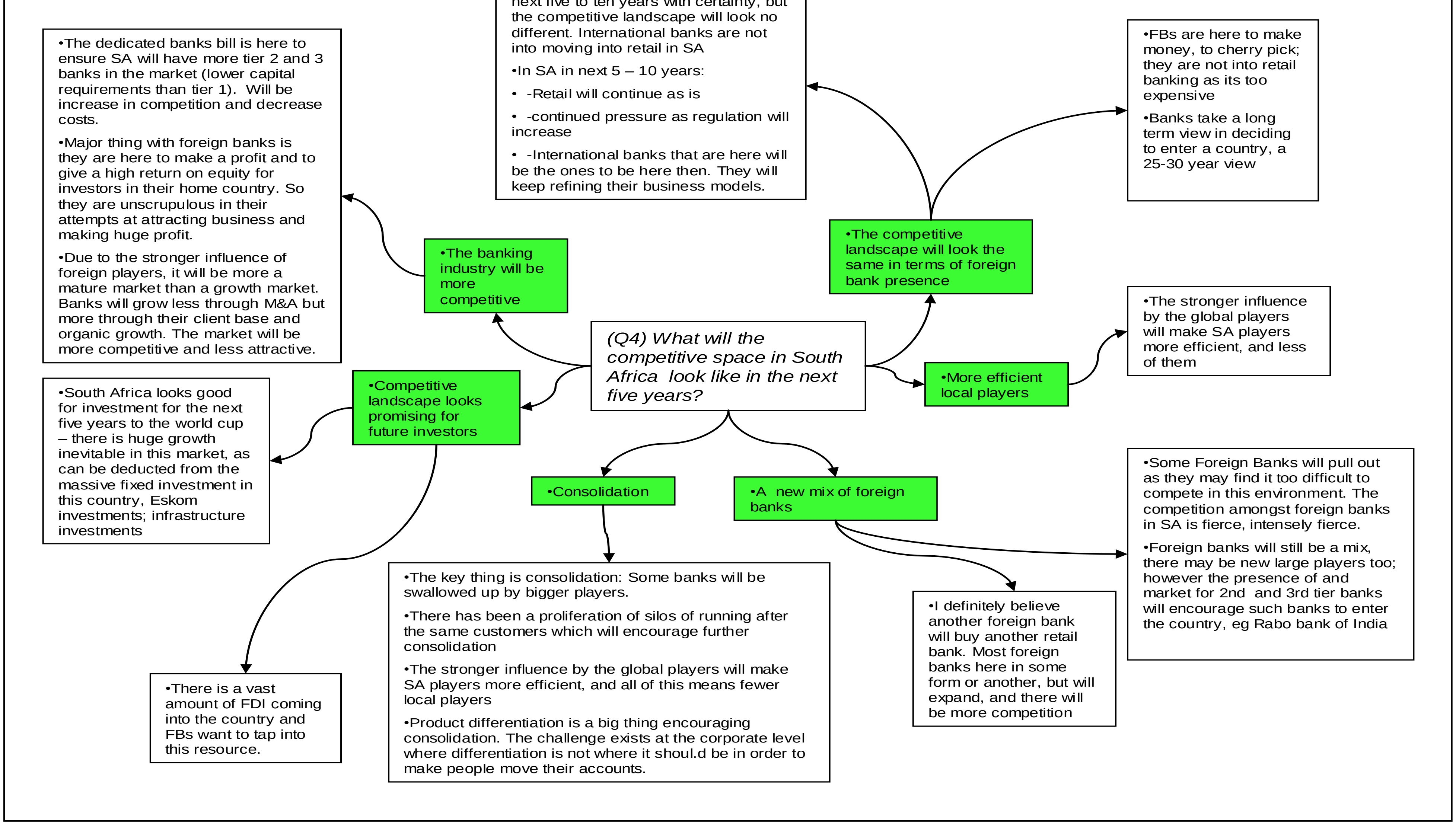
•In Africa, it does not make sense to have a physical presence with large infrastructure, but rather to have ongoing projects such as large financing deals, maintain relationships and networks to provide service from SA

•Everybody is looking to act in Africa. It's a springboard, it's a listening post

•In Africa, its too costly to set up shop, but operate there remotely from SA.

•Some invest remotely, some set up shop – No one size fits all. There are many running operations from here, through satellite offices

Diagram 4


(Q4) What will the competitive space in South Africa look like in the next five years?
•The banking industry will be more competitive
•The dedicated banks bill is here to ensure SA will have more tier 2 and 3 banks in the market (lower capital requirements than tier 1). Will be increase in competition and decrease costs.
•Major thing with foreign banks is they are here to make a profit and to give a high return on equity for investors in their home country. So they are unscrupulous in their attempts at attracting business and making huge profit.
•Due to the stronger influence of foreign players, it will be more a mature market than a growth market. Banks will grow less through M&A but more through their client base and organic growth. The market will be more competitive and less attractive.
•Competitive landscape looks promising for future investors
•South Africa looks good for investment for the next five years to the world cup – there is huge growth inevitable in this market, as can be deducted from the massive fixed investment in this country, Eskom investments; infrastructure investments
•There is a vast amount of FDI coming into the country and FBs want to tap into this resource.
•The competitive landscape will look the same in terms of foreign bank presence
•Foreign banks will remain in SA for the next five to ten years with certainty, but the competitive landscape will look no different. International banks are not into moving into retail in SA
•In SA in next 5 – 10 years:
• -Retail will continue as is
• -continued pressure as regulation will increase
• -International banks that are here will be the ones to be here then. They will keep refining their business models.
•FBs are here to make money, to cherry pick; they are not into retail banking as its too expensive
•Banks take a long term view in deciding to enter a country, a 25-30 year view
•More efficient local players
•The stronger influence by the global players will make SA players more efficient, and less of them
•Consolidation
•The key thing is consolidation: Some banks will be swallowed up by bigger players.
•There has been a proliferation of silos of running after the same customers which will encourage further consolidation
•The stronger influence by the global players will make SA players more efficient, and all of this means fewer local players
•Product differentiation is a big thing encouraging consolidation. The challenge exists at the corporate level where differentiation is not where it shoul.d be in order to make people move their accounts.
•A new mix of foreign banks
•I definitely believe another foreign bank will buy another retail bank. Most foreign banks here in some form or another, but will expand, and there will be more competition
•Some Foreign Banks will pull out as they may find it too difficult to compete in this environment. The competition amongst foreign banks in SA is fierce, intensely fierce.
•Foreign banks will still be a mix, there may be new large players too; however the presence of and market for 2nd and 3rd tier banks will encourage such banks to enter the country, eg Rabo bank of India

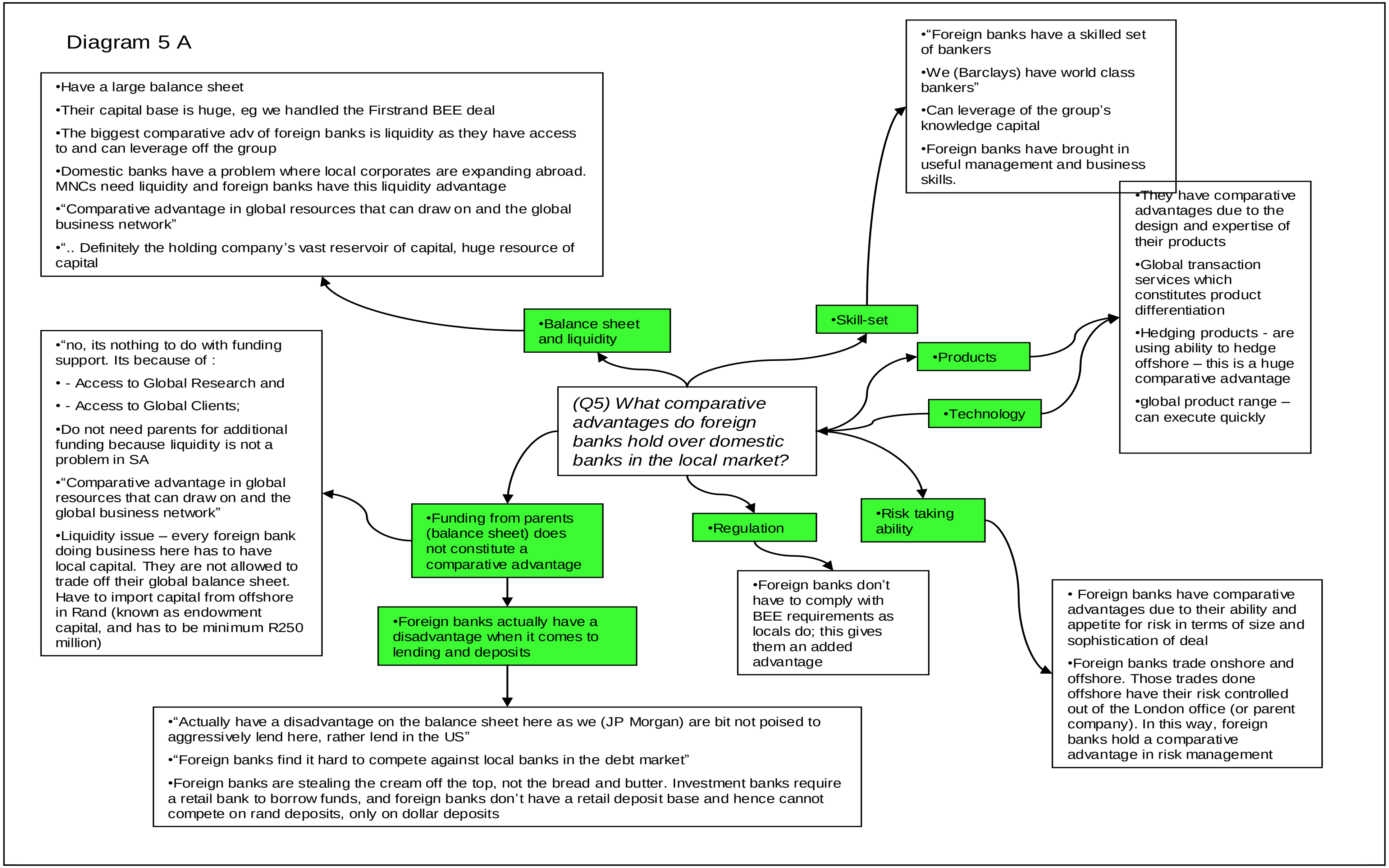


Diagram 5 A
(Q5) What comparative advantages do foreign banks hold over domestic banks in the local market?
•Balance sheet and liquidity
•Have a large balance sheet
•Their capital base is huge, eg we handled the Firstrand BEE deal
•The biggest comparative adv of foreign banks is liquidity as they have access to and can leverage off the group
•Domestic banks have a problem where local corporates are expanding abroad. MNCs need liquidity and foreign banks have this liquidity advantage
•"Comparative advantage in global resources that can draw on and the global business network"
•".. Definitely the holding company's vast reservoir of capital, huge resource of capital
•Skill-set
•"Foreign banks have a skilled set of bankers
•We (Barclays) have world class bankers"
•Can leverage of the group's knowledge capital
•Foreign banks have brought in useful management and business skills.
•Products
•Technology
•They have comparative advantages due to the design and expertise of their products
•Global transaction services which constitutes product differentiation
•Hedging products - are using ability to hedge offshore – this is a huge comparative advantage
•global product range – can execute quickly
•Funding from parents (balance sheet) does not constitute a comparative advantage
•"no, its nothing to do with funding support. Its because of :
• - Access to Global Research and
• - Access to Global Clients;
•Do not need parents for additional funding because liquidity is not a problem in SA
•"Comparative advantage in global resources that can draw on and the global business network"
•Liquidity issue – every foreign bank doing business here has to have local capital. They are not allowed to trade off their global balance sheet. Have to import capital from offshore in Rand (known as endowment capital, and has to be minimum R250 million)
•Foreign banks actually have a disadvantage when it comes to lending and deposits
•"Actually have a disadvantage on the balance sheet here as we (JP Morgan) are bit not poised to aggressively lend here, rather lend in the US"
•"Foreign banks find it hard to compete against local banks in the debt market"
•Foreign banks are stealing the cream off the top, not the bread and butter. Investment banks require a retail bank to borrow funds, and foreign banks don't have a retail deposit base and hence cannot compete on rand deposits, only on dollar deposits
•Regulation
•Foreign banks don't have to comply with BEE requirements as locals do; this gives them an added advantage
•Risk taking ability
• Foreign banks have comparative advantages due to their ability and appetite for risk in terms of size and sophistication of deal
•Foreign banks trade onshore and offshore. Those trades done offshore have their risk controlled out of the London office (or parent company). In this way, foreign banks hold a comparative advantage in risk management

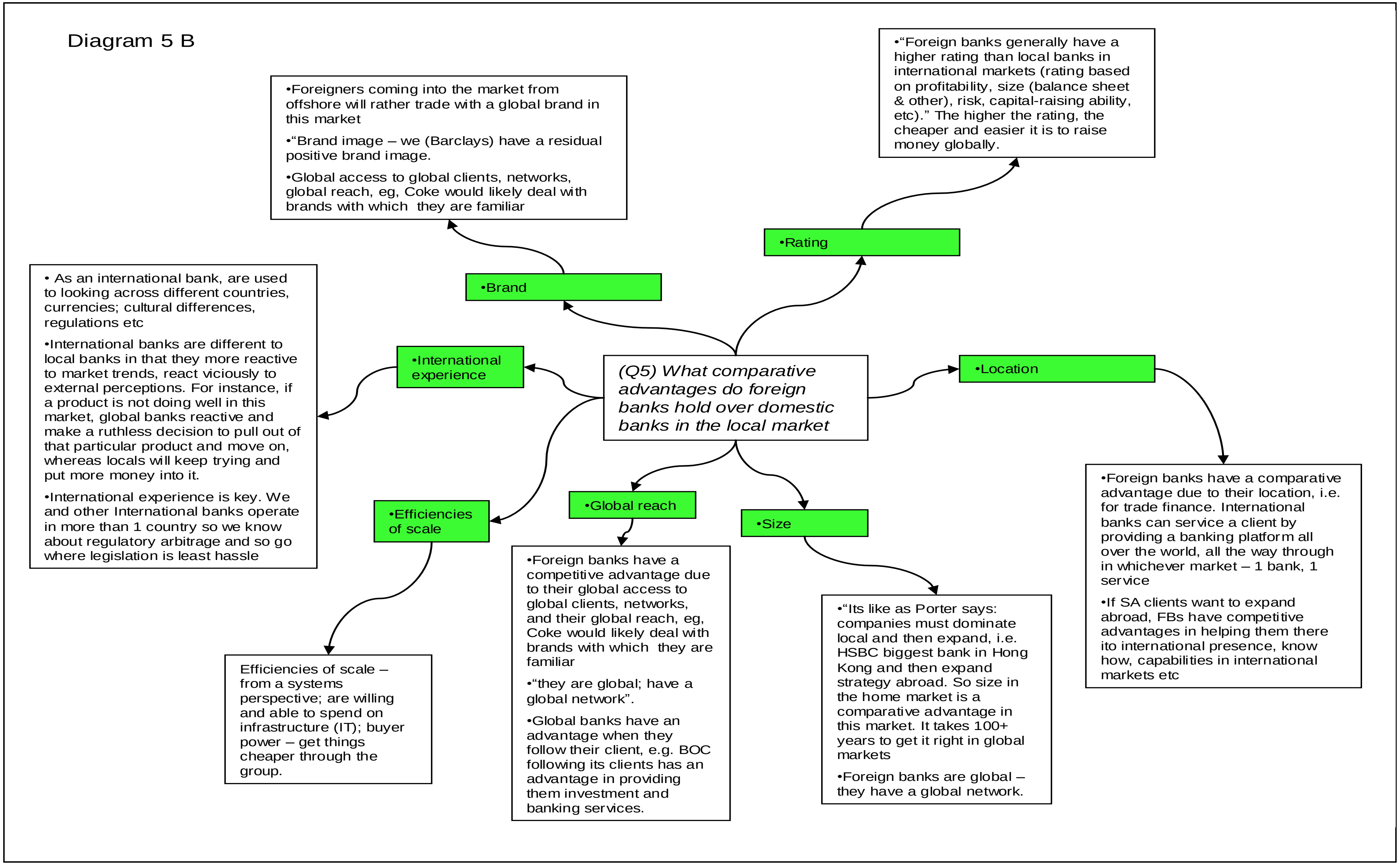


Diagram 5 B
(Q5) What comparative advantages do foreign banks hold over domestic banks in the local market
•Brand
•Foreigners coming into the market from offshore will rather trade with a global brand in this market
•"Brand image – we (Barclays) have a residual positive brand image.
•Global access to global clients, networks, global reach, eg, Coke would likely deal with brands with which they are familiar
•Rating
•"Foreign banks generally have a higher rating than local banks in international markets (rating based on profitability, size (balance sheet & other), risk, capital-raising ability, etc)." The higher the rating, the cheaper and easier it is to raise money globally.
•International experience
• As an international bank, are used to looking across different countries, currencies; cultural differences, regulations etc
•International banks are different to local banks in that they more reactive to market trends, react viciously to external perceptions. For instance, if a product is not doing well in this market, global banks reactive and make a ruthless decision to pull out of that particular product and move on, whereas locals will keep trying and put more money into it.
•International experience is key. We and other International banks operate in more than 1 country so we know about regulatory arbitrage and so go where legislation is least hassle
•Location
•Foreign banks have a comparative advantage due to their location, i.e. for trade finance. International banks can service a client by providing a banking platform all over the world, all the way through in whichever market – 1 bank, 1 service
•If SA clients want to expand abroad, FBs have competitive advantages in helping them there ito international presence, know how, capabilities in international markets etc
•Efficiencies of scale
Efficiencies of scale – from a systems perspective; are willing and able to spend on infrastructure (IT); buyer power – get things cheaper through the group.
•Global reach
•Foreign banks have a competitive advantage due to their global access to global clients, networks, and their global reach, eg, Coke would likely deal with brands with which they are familiar
•"they are global; have a global network".
•Global banks have an advantage when they follow their client, e.g. BOC following its clients has an advantage in providing them investment and banking services.
•Size
•"Its like as Porter says: companies must dominate local and then expand, i.e. HSBC biggest bank in Hong Kong and then expand strategy abroad. So size in the home market is a comparative advantage in this market. It takes 100+ years to get it right in global markets
•Foreign banks are global – they have a global network.

Diagram 6 A

•"Absolutely Foreign Banks have had an impact; they have broken the cartel; added competition; brought technology to the market which has benefited the whole of SA."

•Foreign banks have introduced a lot of competition, fair competition is good, and has led to benefits such as lower client costs; sophistication in product design.

•There has been an impact through the change in through investment banking in local economy, i.e. margins driven down in the equity brokerage industry.

•The impact is positive and is well overdue. Competition is good as a result, as, for too long there has been the laager mentality. Complacency has been part of the game.

•Introduced healthy competition

(Q6) What has the impact been of foreign banks moving into South Africa?

•Taken market share

•Foreign banks have taken market share from locals, they've done well in this market. Foreign banks have a deeper penetration in certain products, eg equity products, International banking and treasury. Foreign banks have also deepened their service to international South African companies, by serving them abroad as well as at home.

•A large impact has been market share –" on the JSE 4 out of top 5 are foreign banks"

•Introduced new technologies

•Liquidity and access to capital

•Keeps customers happy

•FDI and infrasructural investments

•Foreign banks bring in liquidity into the system and access to capital for market participants

•Customers have more choice, reap the benefits from greater efficiencies and wider product offering

•Need global banks for large infrastructural projects, i.e. Gautrain could not be an idea, a real project if it wasn't for the foreign banks big balance sheets.

•Infrastructure and technology is fuelled by foreign banks

•FBs are however better structured for those big deals, i.e. can take on greater market risk; credit risk; have larger balnce sheets, have better access to capital; have an established branch network; have got the right people

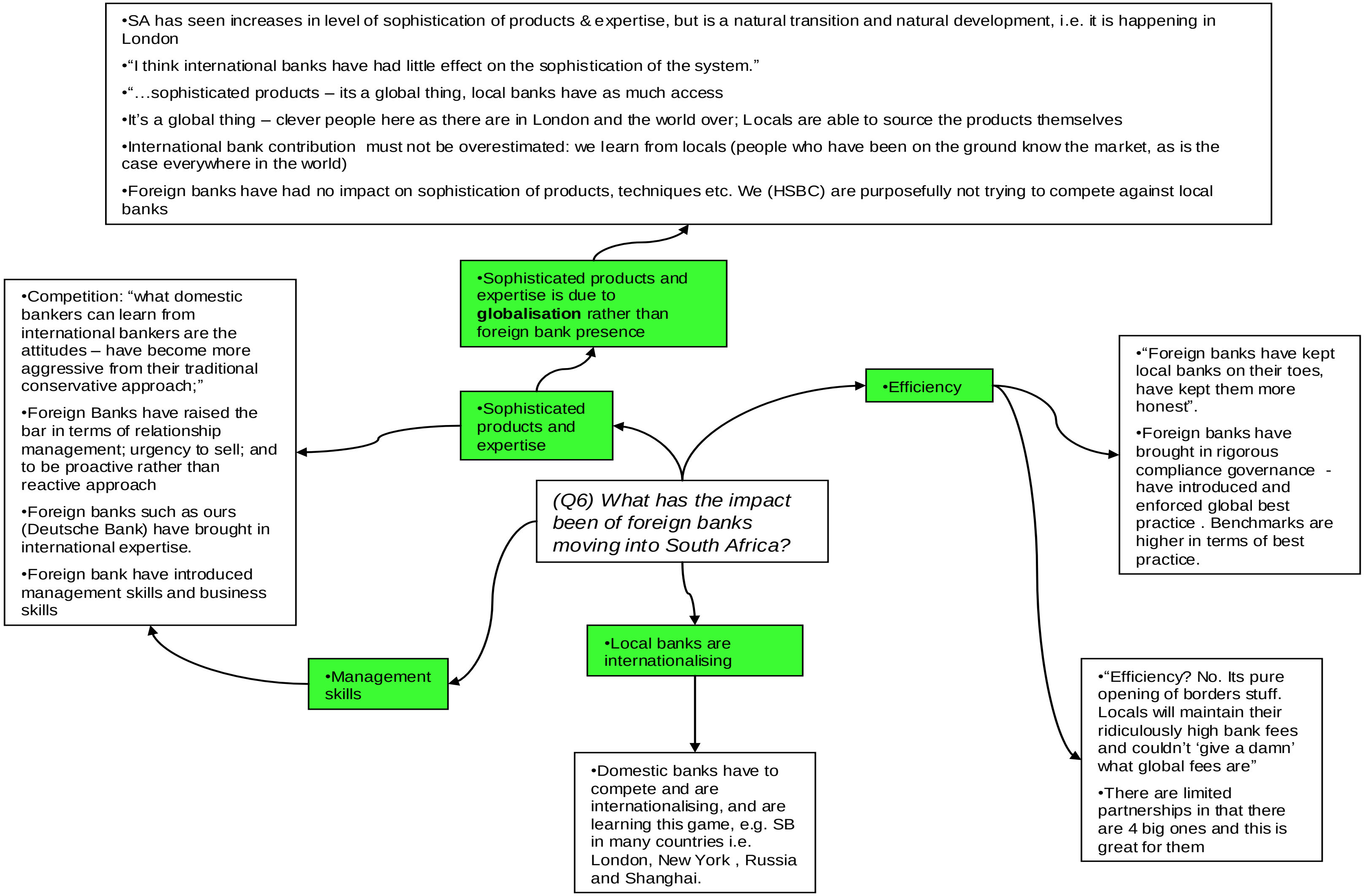
•FBs invest huge resources of capital – ie.. in Jhb and Pretoria, there is major building industry going on, and ALL or most of these projects are being financed by FBs in conjunction with other parties to the contract

•Presence of foreign banks has diversified the sources of capital for local industries

•Interest rates are much lower than in SA so their loans are much more attractive than SA

•These companies have large capital base and can take on much more riskier clients and projects, i.e. CITI vs Absa, Citi can take on collateral of 80% versus Absa 100%.

Diagram 6 B


•SA has seen increases in level of sophistication of products & expertise, but is a natural transition and natural development, i.e. it is happening in London
•“I think international banks have had little effect on the sophistication of the system.”
•“…sophisticated products – its a global thing, local banks have as much access
•It’s a global thing – clever people here as there are in London and the world over; Locals are able to source the products themselves
•International bank contribution must not be overestimated: we learn from locals (people who have been on the ground know the market, as is the case everywhere in the world)
•Foreign banks have had no impact on sophistication of products, techniques etc. We (HSBC) are purposefully not trying to compete against local banks
•Sophisticated products and expertise is due to **globalisation** rather than foreign bank presence
•Competition: “what domestic bankers can learn from international bankers are the attitudes – have become more aggressive from their traditional conservative approach;”
•Foreign Banks have raised the bar in terms of relationship management; urgency to sell; and to be proactive rather than reactive approach
•Foreign banks such as ours (Deutsche Bank) have brought in international expertise.
•Foreign bank have introduced management skills and business skills
•Sophisticated products and expertise
•Efficiency
•“Foreign banks have kept local banks on their toes, have kept them more honest”.
•Foreign banks have brought in rigorous compliance governance - have introduced and enforced global best practice . Benchmarks are higher in terms of best practice.
(Q6) What has the impact been of foreign banks moving into South Africa?
•Local banks are internationalising
•Management skills
•Domestic banks have to compete and are internationalising, and are learning this game, e.g. SB in many countries i.e. London, New York , Russia and Shanghai.
•“Efficiency? No. Its pure opening of borders stuff. Locals will maintain their ridiculously high bank fees and couldn’t ‘give a damn’ what global fees are”
•There are limited partnerships in that there are 4 big ones and this is great for them