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Locational concentration and institutional diversification: Evidence from foreign direct investments in the banking industry

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ABSTRACT

We study locational concentration and institutional diversification strategies in the context of foreign direct investment based on Dunning's eclectic paradigm in the banking industry. We report that locational concentration and institutional diversification strategies can enhance multinational bank return independently and simultaneously. Further, we document that locational concentration increases operational risk, while an institutional diversification strategy reduces this risk for a multinational bank. Our findings suggest that even when concentrating in a limited number of geographic locations, it is preferable to select more institutionally dissimilar countries. Overall, we conclude that multinational banks can achieve better performance by focusing on either locational concentration or institutional diversification, or a combination of both.

1. Introduction

The foreign direct investment (FDI) strategy of a multinational enterprise (MNE) aims to utilize economies of scale and scope, overseas market resource access and exposure, synergies from cross-border production networks, speedy replication of R&D technology, and specific business models to enhance firm performance.[1] Dunning (1988, 1993, 2000) use an OLI eclectic paradigm to explain how MNEs can take advantage of ownership-specific (O), location-attraction (L), and internalization (I) factors across national boundaries to drive their FDI strategies. Because of the monopolistic power of an MNE's global network (Buckley & Casson, 2002; Dunning & Rugman, 1985; Hymer, 1976), the scope and scale of FDI influence MNE performance.[2] Moreover, studies find that the geographic dimension in terms of the scope and scale of FDI should be examined together with other dimensions of diversification (Kim, 1989; Kim, Hwang, & Burgers, 1989; Kogut, 1985; Sambharya, 1995). Several recent studies further identify that the specific nature of FDI geographic configuration is important in MNE location strategy (Berry,

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[1] See Bartlett and Ghoshal (1990), Dunning (1988, 1993), Grant (1987), Kobrin (1991), Kogut (1985), Porter (1990), and Teece (1986).

[2] See Allen and Pantzalis (1996), Contractor, Kundu, and Hsu (2003), Daniels and Bracker (1989), Geringer, Beamish and daCosta (1989), Gomes and Ramaswamy (1999), Grant (1987), Han, Lee, and Suk (1998), Hitt, Hoskisson, and Ireland (1994), Jung (1991), Kim and Lyn (1987), Kotabe, Srinivasan, and Aulakh (2002), Qian (1997), and Ruigrok and Wagner (2003).

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2006; Goerzen & Beamish, 2003; Pantzalis, 2001; Vachani, 1991). Specifically, Oh and Contractor (2012) suggest that it is essential to consider FDI geographic proximity with respect to the home country. However, Tallman and Pedersen (2012) conclude that the literature shows inconsistent results between the scope and scale of FDI and how geographic selections are made; both factors contribute to MNE locational strategy. The two strands of literature in OLI model and FDI location choice seldom apply to the international banking industry. Hence, it is not clear if the international banks exhibit similar perspectives as described in the literature.

In general, MNEs operate in imperfect international market contexts (Hymer, 1976), which leads to the question of how MNEs can take advantage of imperfect market conditions in concuring location strategy. We use Dunning's theoretical foundation of location-specific advantages to explore how location strategy can optimize MNE monopolistic power by organizing operations within contexts of market imperfection in the banking industry across countries. We focus on the banking industry, for two reasons. First, FDI studies on location strategy seldom focus on multinational banks. Second, as explained in Section 2.5 below, multinational banks are a good fit for our scope of study.

Specifically, we examine two geographic FDI strategies in the banking industry: locational concentration and institutional diversification. A locational concentration strategy refers to the market share of a bank's FDI in a host country. This is a measure of market penetration or commitment by the multinational bank to a host country. An institutional diversification strategy measures the general diversification effort of a multinational bank in the execution of its FDI. We measure this by counting the number of FDIs by a bank headquartered in a developed (developing) country into a developing (developed) country. Developed and developing countries have very different institutional characteristics. An institutional diversification strategy, then, measures the extent of a multinational bank's use of the institutional features offered in its home country to lower the risk of its FDI in host countries.

We contend that an FDI strategy of locational concentration can enhance returns of multinational banks that use location-specific endowments by maximizing their monopolistic power in host countries. Intuitively, when a multinational bank is deeply committed to a specific host country, it moves its resources and effort into that country to develop and materialize the monopolistic power of its banking operation. *Ceteris paribus*, such a bank can enjoy a good return from its investments due to its monopolistic power. However, such a locational concentration strategy increases operational risk due to heavy resource commitment in a small set of host countries. For instance, if a bank has a high concentration of its FDI in a specific host country, an unexpected economic shock in the host country could adversely affect the overall profitability of the bank.

We argue that an FDI locational strategy based on host-country institutional diversification can enhance return and reduce operational risk across volatile environments. A multinational bank learns from different institutions across different host countries, and it can internalize differential market imperfections. Institutional diversification allows a bank to offset an adverse economic impact in one host country with a favorable economic impact from another host country. Such diversification enables a bank to learn from different markets to develop best practices to enhance its performance across different host countries. We use data from the top-100 multinational banks from 2002 to 2007 to validate this argument.

Our findings suggest that international banks benefit from both locational concentration and location-based institutional diversification strategies when OLI advantages are fully integrated and utilized. As expected, both FDI location strategies are positively associated with return on assets (ROA) in the banking industry. Institutional diversification strategy is negatively correlated with operational risk, while locational concentration strategy is positively correlated with operational risk. When we further examine the moderating effect between locational concentration and institutional diversification, we find that the two strategies can make the relationship between FDI location strategy and international bank performance stronger and institutional diversification can lower operational risk.

We make two contributions to the literature. First, by re-visiting location-specific advantages in Dunning's OLI eclectic paradigm as our theoretical underpinning, we show that FDI locational concentration and institutional diversification strategy can enhance return for international banks. Institutional diversification is an important element in lowering operational risk when a locational concentration strategy increases operational risk. Second, our results suggest that location-specific advantages are important in the relations between a multinational bank's FDI scope, scale, and geographic type on the one hand, and its operational risk on the other hand. Our findings suggest Dunning's OLI model is applicable to international banks in their locational concentration and institutional diversification effort.

This paper proceeds as follows. Section 2 presents a background context and our hypotheses. In Section 3, drawing on conventional MNE theory, we test MNE location-specific advantages in our international banks' location strategy context. We also describe the research methods. Section 4 presents our results and addresses contributions and implications for international bank location strategy. Finally, in Section 5, we set forth our conclusions.

2. Literature review and hypotheses development

2.1. International banking literature

There are voluminous studies on international banking but yet few studies examine FDI location strategy among multinational banks. Hence, we only highlight several strands of recent international banking literature. The first strand of literature focuses on bank performance in specific countries to provide insights from different banking systems. These studies generally leverage the country characteristics to highlight uniqueness of banks in a country. For instance, Batten and Szilagyi (2012) examine international lending and borrowing among banks located in UK and US and study how the flows