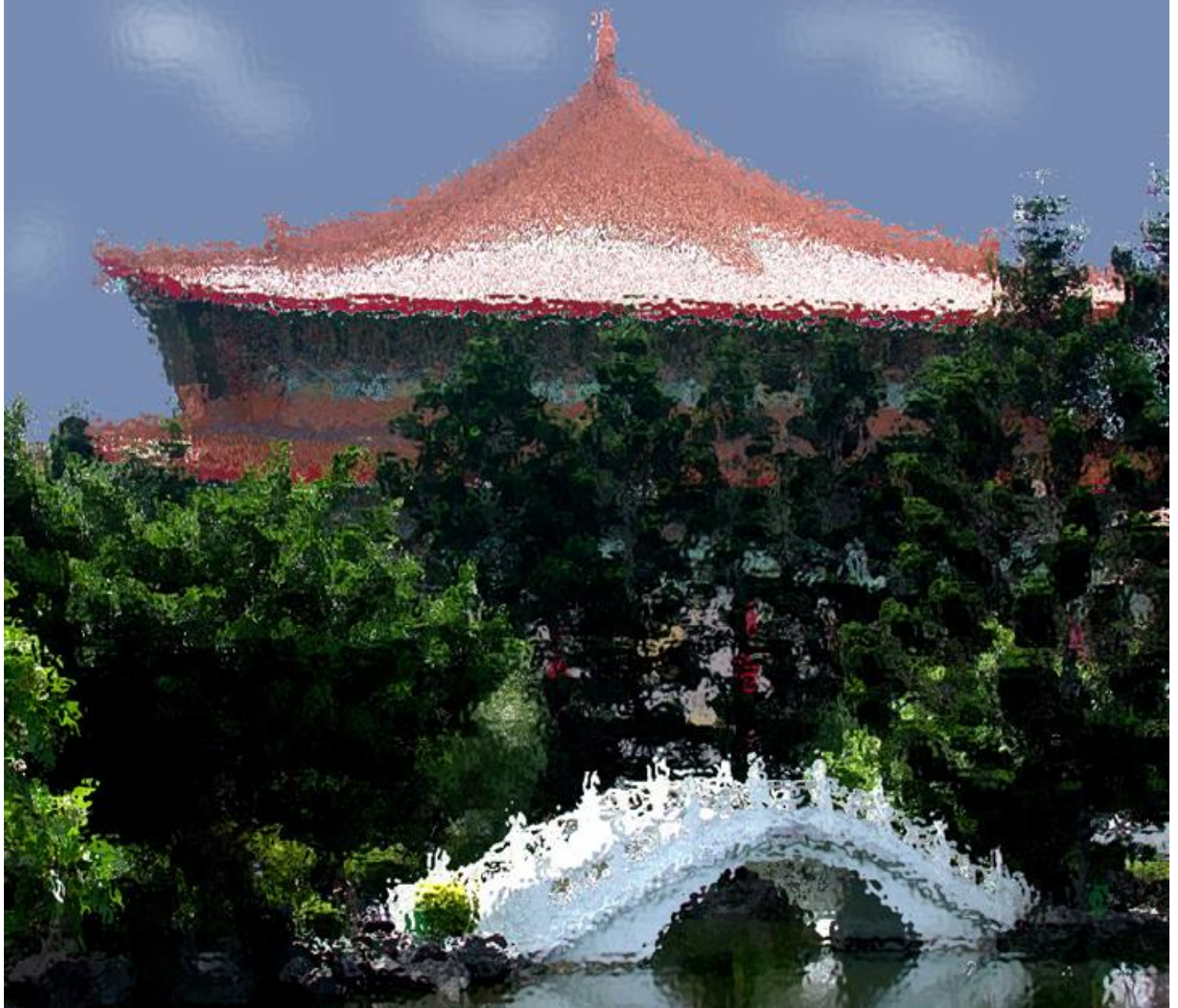


Leaving Home

Is there a case for Asian expansion for
Australian banks and insurers?



Leaving home: Is there a case for Asian expansion for Australian banks and insurers?

**A joint project of The Centre for Corporate Change,
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About the Authors

Professor Timothy Devinney is a Professor at the AGSM and Director of the Centre for Corporate Change. Before joining the AGSM he held positions on the faculties of The University of Chicago, Vanderbilt University and UCLA and has been a visiting faculty member at numerous universities in Europe and Asia. He has published six books (the most recent being *Managing the Global Corporation* (with J. de la Torr  and Y. Doz, 2000) and the forthcoming *Knowledge Creation and Innovation Management* (with D. Midgley and C. Soo)) and more than fifty articles in leading journals. Timothy's qualifications degrees include: BSc (Magna Cum Laude – Psychology and Applied Mathematics), Carnegie Mellon University; MA, MBA, PhD (Economics), University of Chicago.

Owen Young is currently a doctoral candidate at the AGSM where he is researching the internationalisation of financial services firms. Prior to this research, he was a consultant for 10 years at McKinsey and Company and A.T. Kearney, focused primarily on financial institutions. This experience included 4 years in New York and 4 years in South East Asia working largely across Singapore, Malaysia, Thailand and Indonesia. Owen's qualifications include a B.E. with first class honours and an MBA with Distinction, AGSM.

Danny Huang is a Director in investment banking at Rothschild, focussing on financial institutions. He has advised some of Australia's largest banks and insurers, including cross-border assignments in Asia, and has had over ten years advisory experience. Prior to Rothschild he practiced as a corporate lawyer. Danny's qualifications include honours in Economics and Law from the Australian National University where he was a National Undergraduate Scholar.

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Executive Summary

Australian banks and insurers face a high quality strategic dilemma. On one hand, improved business performance and strong balance sheets provide the capability to explore and execute substantial M&A based growth strategies, with the potential to reshape the landscape of Australian financial services. However, there is a perceived struggle to find suitable opportunities, either domestically or (increasingly) offshore, which leverages the firm's competitive advantages and presents an acceptable risk/ reward profile.

Clearly, the main banks and insurers need not seek inherently risky inorganic growth – indeed, some (notably Westpac and St George) are reaping the rewards of championing “stick to your knitting” strategies. But observers looking forward to the shape of financial organizations and the competitive landscape to come increasingly appreciate that there will be a point where low hanging fruit will increasingly be found on higher branches, that new entrants will continue to nip away at existing core businesses (which has occurred with home mortgages, and is occurring with retail deposits), and that long term shareholder value creation may require substantial investment in new ventures.

The dilemma may be straightforward, but real hurdles to significant inorganic growth exist, in addition to possessing sufficient managerial and financial resources:

- Domestic growth by the main players in Australia is circumscribed by competition concerns; further, the price expectations for many other assets are currently too rich for potential acquirers to justify;
- Offshore growth is never straightforward, and more so in financial services, where regulatory and political considerations can be as important as commercial issues. Particularly in many parts of Asia, the method of market entry, partner selection and the reliability of financial reporting are potential deal blockers;
- Shareholder support cannot be assumed, particularly for offshore initiatives. Significant care must be taken to explain the merits of a transaction (often involving an educative process), meeting investor demands for near term investment performance whilst allowing investment in long-term projects.

This paper adds to the debate on the issues that the main Australian banks and insurers need to consider in order to explore and implement a meaningful offshore strategy. The paper focuses on Asia given its size, prospective growth and proximity. Insights from over twenty interviews with leading executives and market commentators with recent and current Asian experience, have, together with analysis of precedent and primary data, been synthesized into “Ten Lessons” which we present as necessary conditions for successful internationalisation.

These “Ten Lessons” are:

1. *Provide a Superior Offering:* You need transferable competitive advantages to overcome the “home ground advantage” of local competitors and international competitors entering that market
2. *Build Enabling Assets and Capabilities:* A competitive advantage by itself is not enough. Firms need to develop assets to support the internationalisation process
3. *Commitment, Commitment, Commitment:* Firms need to invest with a long term view and accept that this may require large and ongoing capital investments
4. *Modus Operandi:* It is not just where you enter but how you enter
5. *Know Your Marital Partner:* When partnering (joint venture/alliances), partner selection and governance is key
6. *Focus:* Don’t overextend to too many markets
7. *Don’t Send the B-team:* Send the best, not just the “available”
8. *Diversity is King:* Insufficient locals and too many expatriates spoil the broth
9. *Be Prepared for Significant Organisational Change:* International operations will transition through several growth stages that require changes in structure, processes, people and culture
10. *Keep Your Hands on the Wheel:* There is no such thing as excessive vigilance when it comes to controls on finance, operations and organization

Although these lessons appear, in the first instance, to be applicable in most international expansions, their importance is made all the more salient by the wide diversity of the cultures, economic development, societal composition and regulatory environments in Asia.

1. Introduction

The major Australian banks and insurers face a high quality strategic dilemma. On one dimension, the announcement of record profits and dividends for investors are the rewards from fourteen consecutive years of economic growth, and more than a decade of transformation in financial service operations.

However, there is increasing consensus that revenue and profit growth will slow. According to Alan Moss, CEO of Macquarie Bank, “the last ten years have been special in Australia. Credit growth and growth in the stock market have exceeded growth of the whole economy in this time”. But as noted by Gail Kelly, CEO of St. George Bank, “we are going to see a greater level of difficulty in sustaining growth. The next period will definitely be more competitive”.¹

There are clear recent signs of increasing competition:

- Home mortgage lending – not only have non-bank financial institutions encroached on a traditional bank patch, but its delivery (through brokers) has forced banks to develop a “competition/ cooperation” strategy, borrowing from recent learning in wealth management and the telecoms industry.
- Retail deposits – the major banks increasingly have to respond to aggressive newcomers like ING and HBOS to protect cheap sources of funding and their retail customer base.
- Non-life insurance – as the non-life insurance industry moves through its cyclical peak, some insurers are becoming increasingly aggressive on pricing to maintain market share.
- New product development – most financial institutions continue to develop new products, for example as lead generators (e.g. high interest deposit accounts), develop a new market (e.g. non-conforming loans), or to take advantage of demographic trends (e.g. reverse mortgages).

The combined effect of increasing domestic competition amongst the major players, a new breed of aggressive niche players (which may be part of global groups, like GE, ING or HBOS), together with questions on the sustainability of Australia’s fourteen year run of economic growth, suggest that there must be a tipping point where meaningful investment in offshore projects has merit as part of an institution’s overall allocation of capital.

Asia is increasingly seen as an appealing investment destination, with its weight of population, burgeoning middle class and higher prospective long-term economic growth. Banks such as ANZ and the Commonwealth have embarked on essentially portfolio-style investments in selected countries, and Insurance Australia (IAG) has stated that it aims to invest up to around \$300 million in Asia in 2005.

But the sums involved in total are small relative to the \$200 billion market capitalisation of the major Australian banks and insurers. Is this due to a lack of opportunity? An inability to obtain shareholder support? A result of history or overly cautious boards? Or is it insufficient managerial depth and appetite to take on risky projects with long-term and uncertain pay-offs, pay-offs that are outside the time horizons of most investment managers and option plans.

These are all blunt questions that boards, management and shareholders need to ask themselves. This paper presents an overview of the key factors in operation today that suggest that Asia, for some players, represents a golden opportunity for profitable and logical expansion. Using primary economic data and more than 20 interviews with leading executives throughout Australia and Asia, we present a picture of the financial services landscape that should help executives think logically, simply and effectively about the opportunities in Asia.

¹ Australian Banking and Finance 2004

2. The Logic for Asian Expansion

2.1 Introduction

The rationale for the major Australian banks and insurers to explore an Asian strategy can be stated simply – it includes:

- The perceived opportunity set in Asia, driven by economic size and growth of the addressable market;
- A cyclical slowdown in credit growth and insurance premium growth in Australia;
- The relative scarcity of M&A opportunities in Australia;
- The proximity of Asian markets and the increasing political and economic ties between Australia and our closest neighbours; and
- The expertise of Australian managers relative to their developing Asia counterparts.

These and other factors combine to “push” and “pull” strategic thinking towards Asian opportunities.

2.2 Factors driving Asian expansion

“Australian banks are probably going to run out of growth drivers if they just remain in the country; maybe not in the next three, four or five years, but getting close to that. The Australian banks are almost locked into a hot-house with the Four Pillars policy. What they’ve done here is good, but any company that wants to keep growing shareholder returns has to keep looking at the next step, and that’s why looking at the closest market to them, Asia, is probably one of the most sensible horizons for them on a medium-term view.”

Jonathan Reoch, ABN AMRO banking analyst.

Size and prospective growth of Asian markets

For the large Australian banks and insurers, the size and prospective long-term growth profile of the Asian markets (exemplified by the billion plus markets each in China and India, and their growing middle classes) are obviously attractive. These large markets with relatively low product penetration and long-term growth forecasts in the high single digits offer significant growth potential relative to Australian domestic opportunity. The table below captures a snapshot of the perceived potential in key Asian markets relative to Australia and select OECD economies:

Exhibit 1: Overview of Selected Asian Countries

| | GDP (bn current US\$) | Forecast Real GDP growth 2005 (percent) | Population (m) | Life Insurance Premiums / GDP (percent) | Card / cards per 1000 people |
|----------------|-----------------------------|--|-------------------|---|------------------------------------|
| Japan | 4,326 | 1.4 | 127 | 8.6 | 659 |
| China | 1,410 | 8.4 | 1,288 | 2.3 | 18 |
| South Korea | 605 | 3.3 | 48 | 6.8 | 2,200 |
| India | 599 | 6.1 | 1,064 | 0.7 | 7 |
| Taiwan | 286 | 4.3 | 23 | 8.3 | 2,526 |
| Indonesia | 208 | 5.4 | 214 | 2.3 | 53 |
| Hong Kong | 159 | 4.6 | 7 | 6.4 | 1,306 |
| Thailand | 143 | 5.2 | 62 | 2.3 | 54 |
| Malaysia | 103 | 5 | 25 | 3.3 | 178 |
| Singapore | 91 | 4.8 | 4 | 6.1 | 773 |
| Philippines | 81 | 5.1 | 82 | 0.9 | 51 |
| Australia | 518 | 2.9 | 20 | 4.4 | 945 |
| United States | 10,882 | 3.7 | 291 | 4.4 | 1232 |
| United Kingdom | 1,795 | 2.5 | 59 | 8.6 | 2256 |

Source: World Bank, Economist, Swiss Reinsurance, IMD World Competitiveness Yearbook

Slower prospective system growth

The corollary of the relative attraction of the larger and faster growing Asian market is the slower prospective system growth in Australia.

In banking, credit growth is forecast to slow from the highs of recent years to rates in line with historical norms. In insurance, premiums for non-life product lines are at cyclical highs, with pressure already being noted in commercial lines by some of the listed insurers in the most recent result season. Whilst wealth management remains the brightest spot for long-term growth for many Australian banks and insurers (due to demographic factors, compulsory superannuation and favourable tax treatment), margin pressures across the board and recent macro-economic uncertainties have tempered the more optimistic forecasts.

In a recent analysis of the contribution of growth expectations to share price of the top 100 Australian companies, only two, Macquarie Bank (19th) and AMP (50th), were in the top 50. The major banks were definite laggards with National (64th), Westpac (70th), ANZ (84th) and Commonwealth (85th). The insurers did not fare much better (QBE ranked 66th, IAG ranked 72nd, and Promina ranked 83rd)². This ranking has broader implications given financial institutions amount for one-third of the market capitalisation of the ASX.

Relative scarcity of M&A growth opportunities in Australia

The relative scarcity of material M&A growth opportunities in Australia is reasonably well understood – competition concerns (most notably the Four Pillar policy in banking and a historically high market concentration in non-life insurance and life insurance) and relatively high asset prices are two of the more often cited barriers.

² Port Jackson Partners, *Growth Expectations*, December 2004.

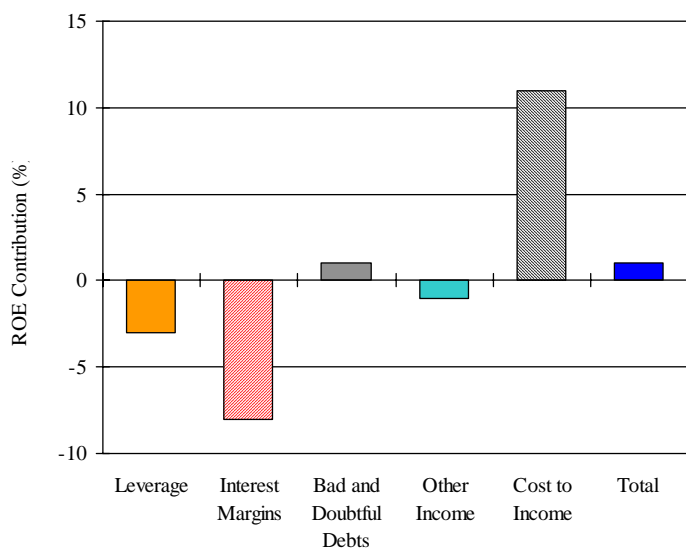
An indication of the major banks not pursuing significant inorganic growth is their recent history of record dividend payments, which have grown at a higher rate than earnings, rather than investing substantially in new sources of growth. For example, the big four Australian banks earned a collective \$11.1 billion in 2004, representing a 9% growth rate over the last ten years, or some three times GDP growth. Dividends paid to shareholders have grown by 12% per annum over the same period, driven by an increase in payout ratios from around 60% to 75%.

Substantial earnings and increasing dividend payouts are an indication of the latent financial firepower that is available to the big banks. Perhaps as a result, their historic high rates of return could curb the appetite in their decision to pursue significant inorganic investment options that may well be earnings dilutive over the short to medium term.

Earnings growth through cost efficiencies likely to moderate

An obvious answer to how banks could maintain their earnings growth is to continue the initiatives that have delivered that growth to date. Over the period from 1998 to 2003, the Reserve Bank of Australia calculated that almost all the improvement in bank returns were due to improved cost efficiencies, largely matching the equal and opposite effect of declining interest margins. (It is interesting that bank strategic response has been more “defensive”, rather than the delivery of new products and services, but that is beyond the scope of this paper.)

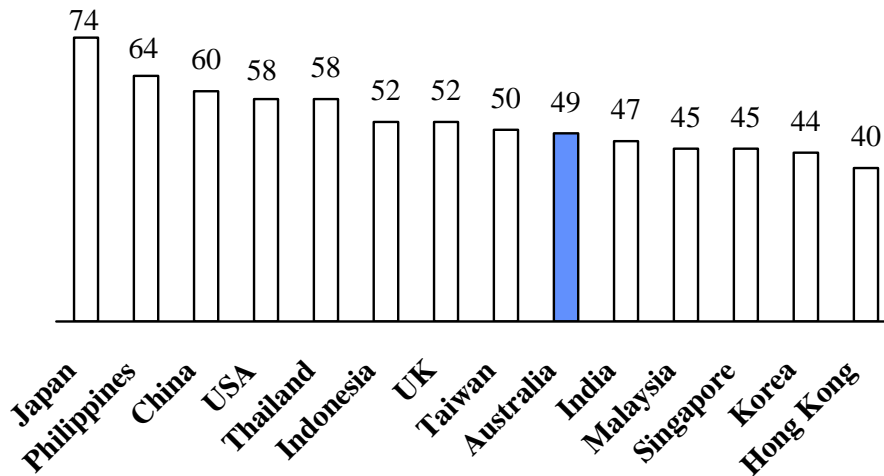
Exhibit 2: Contribution to Change in Return on Equity for the Five Largest Banks, 1998–2003



Source: Reserve Bank of Australia, *Financial Stability Review*, September 2004

Continued significant reliance on cost improvements for future profit growth is unlikely to be sustainable over the longer term. Subject largely to technology and business process advancements, there are natural limits to cost efficiency programs – indeed, Australian banks are already amongst the most efficient in the OECD world, and compare favourably with our Asian neighbours.

Exhibit 3: The Cost-to-Income Ratios of the Five Largest Banks by Market (in percent)³



Source: *The Banker*, AGSM analysis

The likelihood that further cost reduction will provide significant growth is highly unlikely and certainly no panacea to the growth expectations dilemma facing the major banks.

Proximity of and increasing importance of trade flows with Asia

The size and growth rate of Asian markets as the destination for Australian exports provides the most common rationale for Australian financial institutions to expand in the region - the “follow the customer” strategy through trade-related financing and insurance.

Australian firms are increasingly active in Asia – countries in the region represent seven of the ten largest export destinations for Australian companies (by value), with Japan and China being the top two destinations. In 2004, approximately 70% of the merchandise exports to the top ten destinations went to Asian countries. In comparison only 12% went to the USA and 6% went to Europe, with the remainder going to New Zealand.

Relative sophistication of Australian financial institutions

Australian financial institutions need to offer something other than capital to compete successfully in Asia. As noted by Bruce Rolph, Director, Global Strategy, Citigroup, “it’s not financial capital – the US, Europe, Japan and China have heaps of capital. What we [Australia] can offer is human capital without the historical baggage of the UK, US or Europe.”

One of the problems that purely Australian financial institutions faced in trying to compete in the US and UK is that they possess little competitive advantage in products or processes; in other words, they have little to offer that does not already exist (or could be replicated easily) in these markets. This is evidenced by research by Ross Levine who shows that banks expanding internationally usually under perform relative to their home market if they enter developed markets, and out perform their home market if they enter developing markets⁴. Essentially, he shows that foreign banks have lower

³ Excludes CBA who had a cost-to-income ratio of 65% and was embarking on a large cost reduction program to reduce its cost structure significantly.

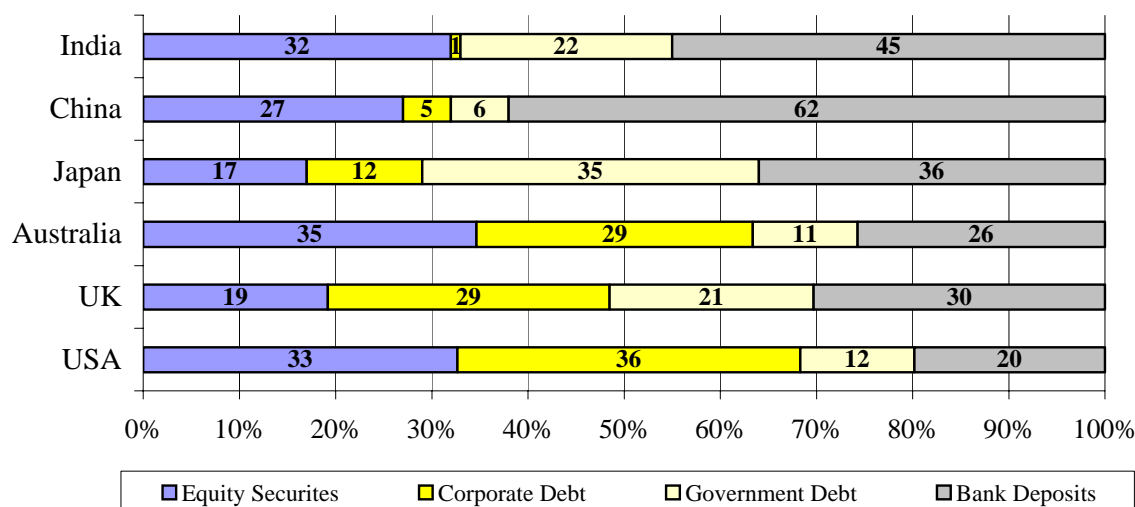
⁴ Levine, R. (1996), “Foreign Banks, Financial Development and Economic Growth,” in C. Barfield (ed.), *International Financial Markets*, Washington, D.C. AEI Press.

interest margins and profitability than domestic banks in developed economies, with the opposite holding true in developing economies. Hence, from an Australian banking perspective, the most attractive opportunity exists, statistically speaking, in the developing markets.

One sign of market sophistication is the level of consumer finance. In lesser-developed markets, the banking system tends to receive consumer deposits and lend to corporations, sometimes with direct or indirect incentives against consumer lending. Hence, this shows up in figures indicating little in the way of consumer finance. For example, in China and Thailand consumer loans represent about 11% of total bank loans, in Malaysia the figure is 32% while in the UK and Australia the figures are 52% and 60% respectively. Similarly, credit cards have low penetration in many Asian markets. While there is approximately one card per person in Australia, there are only about two cards per 100 people in China and only seven cards per 1,000 people in India⁵.

Another measure of financial system sophistication is the reliance on bank deposits versus other forms of financial investment. Exhibit 4 shows the composition of financial stock for several markets including China and India. What is apparent is the relatively under-developed corporate debt securities markets in China and India and the over-reliance on bank deposits. Also the government debt market is relatively undeveloped in China. This data shows some obvious opportunities for foreign financial institutions skilled in these fields.

Exhibit 4: Composition of Financial Stock for Selected Countries



Source: McKinsey, Australian Bureau of Statistics, AGSM

2.3 Key issues to consider

Threshold strategic and tactical considerations

Whilst the rationale for Asian expansion is sufficiently strong for it to be on the strategic agenda for major Australian banks and insurers, it is not without its issues and risks.

At the risk of oversimplification, we have characterised these into two themes – first, the threshold issue as to whether the firm has the capability to credibly consider and execute an international strategy (akin to a “strategic” assessment), and secondly, whether it has the ability to manage the risks and rewards of such a strategy (a “tactical” assessment).

⁵ IMD (2002) *World Competitiveness Yearbook*, Lausanne.

- Assessment of the firm's ability to consider and execute a cross-border initiative

Cross-border initiatives require a different mind-set to in-market initiatives, where rationalization can often be a sufficient condition for a transaction to occur. Does the firm have the financial resources and managerial talent to assess, price and execute a cross-border initiative? Does the firm have a superior product or service, not just relative to domestic providers but, as is the case in the more attractive Asian markets, also relative to global providers? Can that competitive advantage be pressed home within a timeframe acceptable to shareholders and with the resources that the firm can call upon?

Given the fundamental nature of these questions, we are not surprised that a majority of the Top Ten lessons for successful internationalisation we have gleaned from our research and analysis relate to this threshold issue.

- Assessment of the risk/ reward matrix from a cross-border initiative

The rewards from a cross-border initiative are often harder to identify and quantify than a domestic initiative, with material returns often measured in years rather than quarters. Risks are often significantly higher in cross-border financial services investments, with different regulatory and reporting environments, and the political importance and scrutiny attached to financial systems, all of which are in addition to the task of tackling different markets, customers and business methods faced by any firm venturing outside their home markets.

This suggests that successful foreign forays need a higher level of focus and investment discipline, at both the assessment and execution phases. This has significant implications for the firm in seconding executives to lead and execute such projects, and how the skills required for this changes as the firm develops and grows its offshore business.

Given the strong human economics dynamic that long-term strategic planning requires, it is not surprising that half of the Top Ten lessons for successful internationalisation relates to human resourcing issues for these projects.

Australia-specific issues

Asian markets represent an abundance of growth opportunities that are potentially exploitable with the skills, resources and capabilities available within the Australian financial services community. However, Australian institutions have not, in large part, established meaningful beach-heads in Asia – why do the Australian institutions appear reluctant to invest in these markets, or to accept the position of late starters? From our research, it is apparent that there are two major inter-related issues:

- Australian financial institutions generally do not have a track record of successful international expansion and hence are missing critical “complementary assets and capabilities” necessary for successful internationalisation; and,
- Australian investors are overly concerned about potential losses from further expansions into perceived risky markets.

The first of these issues is related to the knowledge, people and systems necessary to become an international player and, as we will show, can be solved by the firms themselves. The second is a characteristic of the Australian investment community that will not be solved by any one firm and will be a constraint that must be managed.

The next section describes a series of “lessons learned” that will form the basis of a “path to internationalisation” by which these overarching issues can be addressed.

3. Lessons Learned—A Path to Successful Internationalisation

The insights in this paper have been gleaned from candid interviews with executives who are, or have been, “Asia hands”. Many of these executives obtained their Asian exposure through Australian and international financial services firms, but we broadened our interview set to include Australian industrial firms which to date have had a deeper experience to date in Asia than their financial services counterparts. As a counterpoint to management’s “coal face” experience, we also include insights from fund managers and investment analysts to provide shareholder and market perspectives.

What follows is an encapsulation of the major lessons that arise from these discussions. These are not meant to be the only issues that boards and management need to consider when examining an Asian strategy. What we do argue, however, is that these lessons form the **necessary requirements** for successful international expansion.

The lessons span five general categories with some representing more than one area: (1) the product/service offering to the market; (2) the assets in support of the process of internationalisation; (3) the attitude of the top management team to international expansion; (4) the form of the expansion; and (5) the ongoing management of the international operation. Each of the ten lessons will be covered individually. They are summarised in Exhibit 5.

Exhibit 5: Ten Necessary Conditions for Successful Internationalisation

1. *Provide a Superior Offering:* You need transferable competitive advantages to overcome the “home ground advantage” of local competitors [and international competitors entering that market]
2. *Build Enabling Assets and Capabilities:* A competitive advantage by itself is not enough. Firms need to develop assets to support the internationalisation process
3. *Commitment, Commitment, Commitment:* Firms need to invest with a long term view and accept that this may require large and on-going capital investments
4. *Modus Operandi:* It is not just where you enter but how you enter
5. *Know Your Marital Partner:* When partnering (joint venture/alliances), partner selection and governance is key
6. *Focus:* Don’t overextend to too many markets
7. *Don’t Send the B-team:* Send the best, not just the “available”
8. *Diversity is King:* Insufficient locals and too many expatriates spoil the broth
9. *Be Prepared for Significant Organisational Change:* International operations will transition through several growth stages that require changes in structure, processes, people and culture
10. *Keep Your Hands on the Wheel:* There is no such thing as excessive vigilance when it comes to controls on finance, operations and organisation

Lesson 1: The Superior Offering—Overcoming the Liability of Foreignness

“There is a home town advantage possessed by incumbents due to knowledge of the market, local contacts and the ability to hire the best local people.”

Tony Berg, Former CEO of Boral and Macquarie Bank

Tony Berg’s point highlights two critical factors for successful internationalisation. First, you need to have superior products, services and/or processes that can be offered into the market. By “superior” we mean not just something that is good for the home market but is also good for the new market as well. It must be superior in the eyes of the new market, not the old market.

For example, when Associates First Capital Corporation Ltd.⁶ entered the Indian market, it misread the market and over invested in technology that was simply not valued by the market. They implemented an expensive technology platform (including digital workflows) that enabled a quick turnaround for credit approvals without realising that this was not important to the local market. Indian consumers tend to comparison shop on loans and were less concerned about turnaround time. Associates never penetrated the local market culture - they thought that what worked in the US would work in India.

Secondly, not only must this offering be superior it must be sufficiently superior to compensate for the “liability of foreignness”—all of those additional costs that a firm operating in a foreign market incurs that a local firm does not experience. Zaheer and Mosakowski⁷ grouped these liabilities into:

- **Spatial costs:** transportation and coordination over a distance
- **Unfamiliarity costs:** lack of market knowledge of market and political networks
- **Host country environment costs:** differential government treatment of foreign firms and local customers preference for local firms
- **Home country environment costs:** regulatory requirements imposed by home country regulators

The relevance of these liabilities is seen in Miller and Parkhe’s study of foreign banks in thirteen countries.⁸ They found that a liability of foreignness existed in commercial banking and manifested itself in the fact that:

- 1) Foreign banks were, on average, less efficient than domestic banks
- 2) In general, foreign banks from more competitive countries were more efficient than foreign banks from less competitive countries
- 3) Foreign banks from more competitive countries were competitive with local banks in less competitive countries

The relevance of this for Australian banks is clear. The relative competitiveness of home versus host countries should be a consideration in the location of a financial institution’s international operations. To put it another way, a financial institution’s best prospects of overcoming this liability of foreignness is to select a country that has a less developed or less competitive market than its home market. **For Australian financial institutions this implies that they should be more focussed on the lesser-developed Asian markets rather than the more developed US and European markets.**

To overcome the “hometown” advantage, a competitive advantage is needed but not just any competitive advantage. The advantage must be one that is valued and transferable to the foreign market. For example, the key valuable local competitive advantages of Australian financial institutions, such as branch networks and brand name, are not readily transferable to foreign markets.

⁶ A diversified finance company that provided consumer and commercial finance, with a presence in 14 countries with over 29 million customers worldwide, subsequently acquired by Citigroup in late 2000.

⁷ Zaheer, S. and E. Mosakowski (1997) “The Dynamics of The Liability of Foreignness: A Global Study of Survival in Financial Services,” *Strategic Management Journal*, **18**: 439–464.

⁸ Miller, S. and A. Parkhe (2002), “Is There a Liability of Foreignness in Global Banking? An Empirical Test of Banks’ X-Efficiency,” *Strategic Management Journal*, **23**: 55–75.

On the other hand, in 1990 Macquarie Bank entered a gold futures alliance in South Africa that was based on Macquarie's world-class capabilities in gold futures; these capabilities were not market dependent. Similarly, their infrastructure securitisation business is based on leading edge capabilities that can be applied in a host of circumstances in a host of countries.

The competitive advantage that Australian financial institutions can bring to Asian markets relates primarily to management skills—e.g., product management and credit management—and processes that have translated into high productivity as shown in their low cost-to-income ratios. As revealed by Jonathon Reoch, Banking Analyst at ABN-AMRO,

“Australian banks can bring some things to Asia but it is not a balance sheet. There are very targeted opportunities ... management experience, ... good knowledge in terms of products and how to sell products to consumers, particularly the cross-selling between banking and wealth management — something that has not been done successfully in Asia — and control over credit processes — in less-developed markets you’ find that’s usually the biggest impediment to performance.”

Increasingly, however, as US and European financial institutions develop their own international strategies which includes significant Asian expansion, Australian firms must ensure that their offerings are at least as attractive as the offerings from global competitors. In this context, Australian firms could exploit advantages such as market proximity, and a non-confrontational negotiation approach.

Lesson 2: Build Enabling Assets and Capabilities

“In the developed world there is a conceit that is concealed — We are going to transport our competitive advantage into developing markets. We are taking our expertise and technology and showing them how to do business. I have found that brains are pretty well dispersed. It is a recipe for disaster if you approach developing markets with a home market mentality. There is a saying that foreigners enter a market with money and the locals have the street smarts and then over time the locals end up with the money and the foreigners with the street smarts.”

David Skinner, CEO, New York Life (Hong Kong)

Relying solely upon a perceived competitive advantage without addressing the need for developing the assets and capabilities to operate at a distance is unlikely to succeed. The liability of foreignness implies that foreign firms operate at a disadvantage and need some compensating advantage. However, even this is not enough. Firms that are expanding internationally need to have assets and skills to support the specific act of international capability transfer. In other words, not only must I have an advantage, I must be able to get that advantage to the new market successfully. OCBC bank, a major bank in Singapore, has recognised this need:

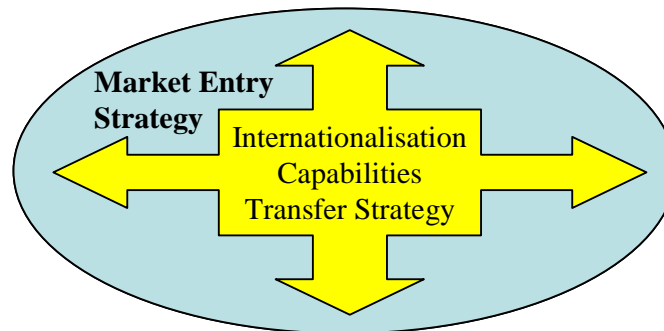
“OCBC is being cautious. We have recognized that we don’t have the management skills to operate internationally as one organization. Under the new CEO, ex Citibank, we have formalized this into a ‘one-bank’ strategy. This involves having to learn how to operate internationally; and it’s tough, you need to have a range of skills to operate internationally. These skills include how to operate in different cultures; e.g. Japan versus Australia.”

Howard Morris, Chief Technical Advisor, OCBC

As noted by Jack Chemello, Banking Analyst at BT, this is a requirement with which “even Citigroup and HSBC have struggled to make headway”. The difficulty with developing international capability transfer skills is that they are only learned by doing. The implication is that firms seeking to expand internationally need to develop a strategy within a strategy. The first strategy relates to understanding where the market opportunities are, the second strategy is how to develop the skills and capabilities to transfer what we do well into these markets including the ability to deal with local regulators. This is presented schematically in Exhibit 6. The implication is that the greater the ability to transfer capabilities internationally, the greater the market entry possibilities. Hence, firms that spend all of

their time developing what David Skinner called their ‘conceit’ of advantage are doomed to fail simply because they do not have the complementary skills to transplant these advantages into foreign markets. The greater these complementary skills are the greater is the number of markets into which any advantage can be transferred. Hence the success of a company like HSBC is not just based on being a good bank, but being able to develop the ability to move that “good bank” into other locations.

Exhibit 6: Market Opportunities are Limited by Internationalisation Capabilities



Macquarie Bank is a good example of an Australian financial institution that has successfully developed these capabilities. Their model appears to be built on five pillars:

- **Lead from the coal face:** international opportunities are largely identified and implemented by the business units rather than a central group removed from the markets
- **Focus on advantages:** Macquarie Bank is opportunity driven rather than country driven. This puts emphasis on justifying the firm’s competitive advantage that allows it to take advantage of a specific opportunity
- **Motivated skilled people:** International opportunities are seen as proving grounds for the next generation of leaders. This builds critical internationalisation skills rather than assuming that the best local managers will be the best international managers
- **Strong centralised processes:** Tight processes for investment approval, performance reporting, risk management and brand management exist with the involvement of experienced senior executives. This insures that all opportunities are benchmarked.
- **Learning from mistakes and others:** Information sharing is critical and “mistakes are tolerated”. Business units have documented history and lessons learnt from post-mortems of past efforts

As an indication of Macquarie’s success to date in internationalisation, earnings from its offshore businesses have grown from 21% of total income in 2000 to 33% of total income in 2004.

Lesson 3: Commitment, Commitment, Commitment

Firms need to be committed to internationalisation in terms of both timeframe and capital. Timeframes can be long and frustrating – it took ING over 10 years to get its first China life insurance licence. This only represented the right to do business in China and it would still require significant time and effort to obtain any meaningful profits.

“The amounts of capital required to meaningfully operate in some of these markets, particularly China and India can be large. Asia is not for the faint hearted or faint of wallet. If you only have a little extra cash—do not go to Asia.”

David Skinner, CEO, New York Life (Hong Kong)

firms fail to realise is that their local advantage is based on not just superior assets but superior assets at scale. The domestic performance of the major Australian financial institutions is based on the scale of commitment to the Australian market made over many decades. To believe that a similar rationale does not hold with respect to new market entry, at least in an identified business line or substantial market, is not rational. Australian firms will be competing not just against domestic companies but also large multinational full service providers (like Citigroup) and Category killers (like GE Capital) that have significantly greater scale than Australian firms. It is important to assign and focus sufficient resources to be able to compete in the target markets against these firms.

The more risky, volatile nature of many Asian markets requires higher levels of capital (often higher than regulatory requirements in that market) than similar sized businesses in Australia. In addition, credit information and quality is often poor, implying that loss reserves and capital adequacy requirements need to be higher. Capital requirements are further increased by the need to support a growing business. This invariably results in large capital requirements with low profitability over the first few years.

Executives are faced with a conundrum: to pursue long-term growth opportunities they need to incur lower returns in the near term. In an investment environment plagued by short-termism and risk averse behaviour, this can be a significant deterrent, not only for the decision to go international but to successfully internationalise once the choice to move overseas is made. Invariably, executive teams respond by trying to limit their exposure, inevitably starving the new market of the capital and resources necessary to make the foray successful. As Jonathan Reoch of ABN AMRO indicates:

“The maximum an Australian bank could spend on a (foreign) acquisition in a year in one fell swoop would be about \$500 million. I think if it’s any more than that then you start to get into difficulties in terms of shareholder acceptance.”

This can result in firms engaging in sub-scale international investments. Such a reaction, although appearing rational, may doom the investment in an environment where scale is critical. As this natural psychological limitation is unlikely to go away, the strategic implication is that commitment to the strategy is crucial as it may require multiple tranches of targeted investment to build the necessary scale to be successful.

“Firms need to match capital to timeframe — spread their capital commitments out along a lifetime of investment rather than have a big upfront investment. For example, IAG in China have to date committed \$200m to \$500m capital but timed this over a 10-year period. We are comfortable with this; we can see milestones and capital tied to milestones”

Andrew Waddington, Insurance Analyst, BT Financial

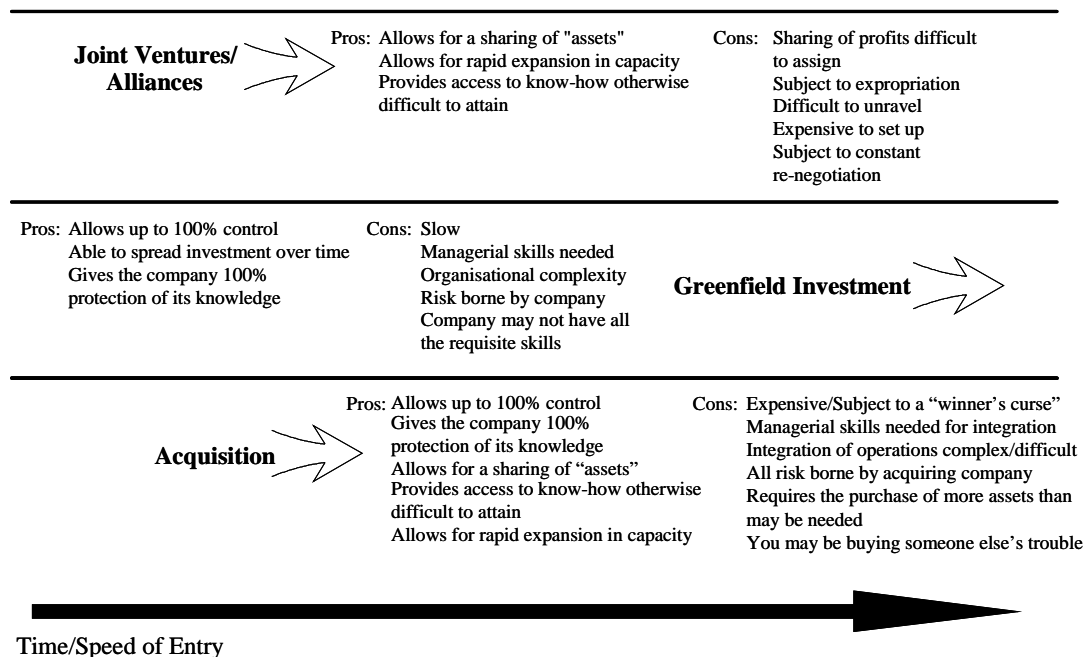
Ultimately, the commitment to the strategy is related not just to the initial investment but the ability to weather the storm over the medium term. Tony Berg’s experience at Boral reveals this:

“When entering a new country, you have to pay the price. Good assets only tend to be available at the peak of the business cycle. Therefore, when buying assets you often end up buying in the peak and have to bear the inevitable downturn. CSR’s business in US was a disaster in the early 90’s— it was haemorrhaging cash but they stuck with it through the business cycle and now have a fantastic business with a large network. Boral Plasterboard in Asia is a similar experience. During the 1997 Asian crisis it had tremendous losses, but is now doing well.”

Lesson 4: Modus Operandi—Know How to Enter

The major entry options for Australian financial service firms include building local operations from scratch (or Greenfields), acquisitions and joint venturing/alliances. Each of these represents a trade-off between capital requirements, speed of entry, ownership/control and operational risk. In some markets, (e.g., in China or Vietnam) joint venturing is the dominant option, as local regulations require it. An acquisition will typically give the quickest path to a reasonable level of scale in the market. Greenfield investments are less prevalent due to licensing requirements and the time required to build a meaningful presence. Exhibit 7 shows the options and many of their pros and cons.

Exhibit 7: Market Entry Approaches—Pros and Cons



A Greenfield approach can be less risky from a capital perspective — the assets are built by you — but it can be resource intensive and take a long time to get scale. On the other side of the ledger, the investment can be spread over a much longer period of time. In the Asia Pacific region, ING preferred Greenfield investments to acquisitions. This was driven by the lack of available attractive acquisition targets and their desire to avoid inheriting unforeseen organisational problems. Ultimately, ING believed that Greenfield investments were the best way to build long-term shareholder value as they ensured operational integration and were no less subject to market/country risks. Their initial strategy in Asia was to start two Greenfield operations per year focusing on the most attractive markets. This ultimately proved to be too aggressive due to insufficient international capability transfer assets and resources to support simultaneous establishment and early stage growth in several markets. According to Phil Shirriff, former CEO, ING Asia Pacific, the two critical issues for Greenfield investments are to:

- 1) Have the patience and capital to bear losses for 5-8 years, and
- 2) To avoid trying to build organically "on the cheap".

Initial capital losses go with the territory of Greenfield investments as recruitment and training is expensive and revenue and profit growth is slow, invariably lagging the building of assets. Also, because such investments must replicate the competitive advantages in products/services and processes/systems that the parent firm holds (and need to be transferred into the new market) this is unlikely to be done without substantial investment.

capabilities and strategic assets that each partner possesses. This usually takes the form of a product or management process capability for the foreign partner and the local market presence and understanding of the local partner. However, the local partner must bring more to the table than simply “local knowledge”. As the ING example shows, their success with Greenfield investments was due to their ability to buy (or recruit) local knowledge and integrate it into their own operations. The local partner needs to have other distinctive operational and strategic advantages to be valuable to the alliance.

For example, DBS decided to enter into a credit card joint venture in Thailand with Shin Corporation rather than rely upon organic growth. Shin Corporation (that owns AIS, the largest telecom company in Thailand) brings complementary assets and capabilities; strong marketing capabilities, quality local management, and a large Thai customer base. DBS brings financial skills and operational capabilities (including credit card processing that will be centrally conducted in Singapore) that match up nicely with Shin’s local marketing assets. An added benefit (at least temporarily) is that Shin Corporation is controlled by the family of the Prime Minister, Thaksin Shinawata.

Acquisition can be a tempting entry method. It can be quicker and provides some immediate scale and local staff. Many Asian markets possess a number of inefficiently scaled banking operations, inviting opportunities to acquire a skilled workforce and established customer base. However as with any acquisition, the availability of quality assets at a reasonable price is questionable. The key question is “why are these assets for sale if they are so ‘valuable’?”

If there is a history lesson from the activities of Australian firms internationalising it is that the firms invariably do not build to sufficient scale quickly enough. As revealed by Jack Chemello of BT Financial, investors are currently quite wary of large-scale acquisitions in international markets that potentially replicate mistakes of the past:

“Don’t undertake large acquisitions — you end up buying the wrong culture or bad assets. You don’t want to acquire someone else’s problems. For example, when ANZ was considering Thai Military Bank, the bank looked cheap. But we saw huge problems with asset quality and branches mainly located in rural locations. It smelt pretty bad and there was a strong push back from investors.”

The entry mode needs to match the underlying strategy and not be made simply to avoid investment or compensate for a market or organisational weakness. The current preferred entry approaches involve lower risk methods of obtaining market information before committing large amounts of capital. These approaches include joint venturing with a local partner, entering a market for a few years before any major acquisitions are made and an approach based on a series of small incremental acquisitions that serve as “low cost probes” and also allow them to learn how to internationalise more effectively. Although “staggered investments reduce risk and commitment and smaller investments coordinated with a local player are preferred” (Jack Chemello, BT Financial) by investors they may or may not be the best option for the firm as they may not meet the scale and speed requirements for being a successful player in the local market.

Invariably, successful internationalising firms used a mixed strategy. Some firms choose venturing first to be followed by large-scale acquisitions or organic growth. Others may choose small-scale Greenfield investments to be followed by larger scale investments. Either way the mode of entry must align with the need to learn how to internationalise, the need to know whether your advantage fits with the market, and the need to know what mode of entry works best with what your firm is attempting to achieve. As Karthik Subramanyam of DBS outlines:

“You may want to get a feel of the waters by trying organic growth for a short period of time before making the big acquisitions. Making the acquisition in the local market may be straightforward but managing it could be challenging if you don’t clearly understand how to run the business. The trick in learning how to run the business is to go for organic growth for a short period of time. Sure, it can’t be a long-term strategy but it helps you get a good handle on the local culture.”

Lesson 5: Know your Marital Partner

“A partner will never look as good as the first day that you meet them. There is a tendency to select partners on the basis that they will have you.”

David Skinner, CEO, New York Life (Hong Kong)

As we noted earlier, partnering through joint ventures or alliances is a good way of overcoming some of the difficulties in entering a new market, particularly the lack of knowledge of the business customs, regulatory environment, locals' aversion to dealing with foreigners, etc. Unfortunately, partnerships and alliances do not have a stellar performance record and there are many more examples of unsuccessful than successful partnerships. Two key areas where partnerships fail are differences in strategic objectives and lack of attention to governance issues.

“You need to ensure that you have the same objectives as the partner, not just similar objectives.”

Samantha Mark, DBS (Singapore)

Differences in objectives can include factors such as the time horizons of the partners and the attitude toward profitability, capital investments, product quality, customer treatment and staff treatment. As an example, New York Life (NYL) has entered into a bancassurance arrangement with Siam Commercial Bank in Thailand that has been very successful. This is due in large part to the fact that the partners have similar expectations in terms of product quality, time horizons and product profitability. In contrast NYL's experience in Indonesia was anything but a marriage made in heaven. Their partner was a major pineapple seller with no financial industry experience and was concerned solely with what it could extract financially from the venture in a short a period of time. The partner's vision was based on the idea of running the business on a shoestring (apparently in line with how pineapples are produced). New York Life wanted a well-capitalized operation (in line with its corporate philosophy). The venture was a 50:50 ownership split with no ability to break impasses that resulted from the differences in objectives; ultimately paralysing the organisation and dooming it to failure. As Skinner notes,

“We were naïve. He had good support from the government and we believed our own press clipping s— if we entered we would be successful”.

What the New York Life example highlights is the importance of governance issues and the need to address these issues upfront. It is so fundamental that it must be part of the initial strategy. Partners will not, almost by definition, have the same goals and disputes must be expected, controlled and adjudicated.

Other firms have had mixed experiences with joint ventures, according to Phil Shirriff, ex CEO, ING Asia Pacific:

“You do all the work and you get half of the profits... To ensure that your partner can contribute to the venture, they should have capital, be able to assist you in managing relations with regulatory bodies, be prepared to let the you run the business and understand the timeframe of expected profits – if allowed, JV partners can be demanding”

As Phil Shirriff indicates, decision-making authority does not necessarily have to follow the joint venture ownership structure. For example, Leighton Holdings presents a case where decision-making control does not follow the ownership structure. Leightons prefers to have day-to-day control as this is what drives quality and efficiency and is embedded with how they choose to operate all their ventures.

“In JVs, we prefer to act as the leader even if we have less than 50% share. We need to have control. Very rarely would you be satisfied if you didn't have control.”

John Faulkner, former Managing Director of Leighton Asia

Similarly, AMP has entered into a joint venture in India that separates ownership from management. AMP has 24% ownership while the Indian partner has the remaining 76%. They have a management agreement that recognises that there must be a leader and a follower, not a 50:50 arrangement with respect to managerial control. Their partner granted AMP management leadership for day-to-day decisions as AMP had the industry knowledge. The partner was not in financial services but had a good name, reputation and experience with several international JVs with US companies. To date, this arrangement is reported to be working well.

Lesson 6: Focus—Don't Overextend to Too Many Markets

A common misconception is to treat Asia as a single country with similar business practices and culture. In fact, despite the dominance of the Chinese in the commercial sectors of many Asian countries, there is a huge variation in business practices, regulations, culture and languages across Asia. Trying to use the same approach for each market can be disastrous.

Obviously, if your approach needs to be tailored to each market, this will result in higher complexity and there will be potentially higher capital requirements. As most Australian financial firms have limited resources for international expansion then it is logical to not overextend into a large number of markets. Jonathon Reoch of ABN-AMRO suggests that five investments are probably sufficient for most Australian firms.

"You would probably want in total five major investments and probably a maximum of five countries within that as well. Anymore and you're starting to push your limits in terms of understanding different banking markets, you've got to expect different markets to have different regulatory considerations. It would be a hell of a lot of management time spent on understanding."

Eon-CMG life, Colonial's joint venture with Malaysia's Eon Bank, illustrates some of the problems with being over-extended. The strategic rationale for the investment was based on a combination of Colonial's international division's strategy to establish a broad footprint in Asia — Colonial's strategy to build bancassurance — and opportunism — Colonial had an existing license in Malaysia. Colonial sought a joint venture with a local bank to increase its distribution capabilities in Malaysia. According to former Colonial staff, the effort was a failure. Colonial and Eon's stake was eventually sold in July 2002 to Tower-Ed Sdn Bhd, as part of the CBA strategic review of the international operations inherited with the acquisition of Colonial State Bank. With the benefit of hindsight, the failure was not unexpected and can be attributed to:

- 1) **A lack of scale.** The business was too small to attract attention and resources from Australia.
- 2) **A failure to transfer skills.** Although the CEO was appointed by Colonial almost no processes were transferred from Australia;
- 3) **A lack of commitment.** The investment was not a priority. With other acquisitions going on at the same time in Australia (e.g., Prudential and Legal & General) there was little attention given to Malaysia.
- 4) **The market wasn't ready.** The Malaysian consumers were not ready to buy insurance products from a bank and any advantages from expensive systems were unlikely to be seen until scale was achieved.
- 5) **Leadership.** The first CEO had been out of Australia for a long time and didn't have strong connections back to head office. The second CEO was not very experienced and expected to learn on the job.

At the time, Colonial had international operations in many countries including Hong Kong, Vietnam, Malaysia, Fiji, New Zealand, Philippines, and Thailand. The international division was occupied with establishing beachheads in new countries, once the beachhead was established, the operation became someone else's responsibility.

Even this somewhat innocuous point has complexities. Is China one market or several? How many markets make up India? How do you compare countries where economic activity is concentrated in one capital city — e.g., Thailand — with those with a diverse spread of economic activity? The key point is that Australian financial institutions need the resources both capital and human to support their internationalisation efforts. Over time as internationalisation assets are developed, more markets can be operated simultaneously but in the near term focus is good.

Lesson 7: Don't Send the B-team

One of the consequences of being overextended or not having developed internationalisation assets is that good staff are in short supply. This can result in some business units being reluctant to release the best domestic staff to international operations — they prefer to keep them focused on the main business at home. As a consequence, firms often send borderline staff on offshore projects that can adversely affect the outcome of the effort.

“The B-team will build a legacy that will be hard to change—a downward path of destruction. An A team ensures that the best processes will be implemented in the best way.”

Ian White, Ex-Financial Controller, AMP Asia

This is a common issue, as the Colonial-EON joint venture illustrated. There are other examples of Australian firms sending staff that are in the redeployment pool or recently retired to support new international expansions. Allan Moss, Managing Director at Macquarie Bank, has observed that many firms send their B-teams to Asia, however, Macquarie sends its A-team with one third of its revenue now coming from off-shore⁹.

AMP has recently sought to overcome this issue. In its recent joint venture in India, AMP avoided sending a B-grade team by having strong leadership support. The CEO spoke to his direct reports and required support for the Asian Business Units. Furthermore, AMP discussed the number and tenure of expatriate managers with its Indian JV partner and established a process for leveraging resources from both partners that was documented upfront and understood. A clear mechanism and budget existed for people and process transfer from Aust to India. The buy-in from the top executives enabled the best people to be released. The defined processes ensured transparency and that return dates were clear for the key staff that were seconded to the joint venture.

Lesson 8: Diversity is King - Balance Locals and Expatriates

Lesson 7 argues that the quality of the team must be first rate; indeed, perhaps even more “capable” than a senior management team at home. Lesson 8 addresses the issues of the diversity of that team. Tony Berg describes one of the problems of over-reliance on expatriate managers:

“When firms expand internationally, they tend to send a lot of people and end up with a lot of expats. The cost of an expat can be more than double the equivalent cost in Sydney. Labour is often the biggest cost in financial services. How do you think you can make money when your labour costs are 2X or more than your Australian rates and local competitors?”

Firms undertaking international expansion need to balance the use of local and expatriate managers to ensure cost competitiveness, market understanding and to attract the best local talent while retaining connections with head office and maintaining the capability of transferring critical knowledge into the new market. Local managers have the advantage of understanding the local business environment and culture while expatriates provide the internal company connections and understanding of the firm's business practices and culture. Invariably firms need to balance locals and expatriate to get the best outcome, it is just not correct to fully localise management.

⁹ Australian Financial Review, Thursday 31st March 2005 p.61

desired result. GE Capital is a pertinent example. It has been able to successfully build businesses primarily operated by local managers. In India, GE sent in “one man and a dog” to set-up their Indian consumer finance operation. He was a long term GE employee with an Indian heritage. He understood the company culture and the Indian culture. His mandate was to set-up the local operation in twelve months by employing local staff and then leave. He hired the top line managers and ensured that they were acculturated with the GE culture via participating in global forums and reviewing GE success stories. A very rapid transition to local managers occurred.

GE’s success in the credit card market has been spectacular. Citibank hit a million cards in India in 1995-1996 after almost 100 years of operation in India. In comparison, GE entered in 1998 and hit a million cards in India in 2002. GE was able to adapt quickly. The key to their success was their strategy of not focusing on the highly penetrated major metropolitan areas. Instead they signed a partnership agreement with a bank with 20,000 branches in India that provided rapid distribution.

Similarly, the CFO of Korea First Bank, Ranvir Dewan, was able to conduct a major overhaul of the bank’s finance area with the help of only one other outside hire and some consultants for specialist tasks. He was able to find skilled individuals within the bank’s existing employee base to drive the change program.

The error of over-reliance on expatriates is not restricted to Western firms. DBS, the largest bank in Singapore, found that geographic proximity did not result in an understanding of the local Thai culture. DBS relied primarily on expatriate managers from Singapore to run its Thai operations, with very limited success. In contrast, GE Capital’s subsidiary in Thailand was operated chiefly by local management and was ultimately a superior performer.

Employing locals in senior positions can provide a better understanding of cultural issues including the culture of local investors, partners, staff and clients. Phil Shirriff, former CEO, ING Asia Pacific strongly believes that understanding culture is a critical success factor for operating in Asia:

“Its critical that you understand the culture, not just the national culture but also the culture of the business – its very easy to talk about the culture but you really need to understand it – if you get it wrong it will work against you. The issue is that it can take a fair while to get your head around the cultural drivers”

The lesson here is that skills and capabilities must not only be transferred but they must be absorbed by the new operations and integrated with local culture, products, services and processes. Citigroup also uses a model that focuses on getting locals into senior levels quickly including into the Country CEO position. Expatriates are used primarily for specialist skills and to provide training. Bluescope Steel follows a similar approach. Expatriates are used only for skills that do not exist in the local pool. The overarching objective is to develop local people to run the business; a case in point is Bluescope’s Malaysian operation that has 2-3 expatriates out of total of 160 employees.

Lesson 9: Successful International Growth Will Require Significant Organisational Change

As the international operations grow, the firm’s structure, processes, people and culture will need to evolve. Often firm’s that have recently embarked on international expansion adopt an organisation structure that includes divisions for the major domestic business units and a separate international division. The international division includes country-based sub-units. While this structure can be ok for the early stages of internationalisation when the firm is primarily concerned with the issues of which market to enter and how, it soon runs into problems when the focus is more on growing a substantive business. Key skilled employees are not released from the domestic business units to support the international business. The international business must therefore rely upon extensive use of consultants or external hires to provide subject matter expertise. The problem is that these individuals do not have the history with the firm to have the firm based knowledge or contacts in the home market to ensure that the firm’s skill based competitive advantage is transferred to the new market.

product or geographic based form ie. business lines with country sub units or country divisions with business sub-units. Over time this can further evolve to matrix based reporting relationships. The exact form of the organisation structure is dependent on factors such as the diversity of the product range and the scale of operations in each country. For example, a large-scale operation in a specific country may warrant a country manager while several small-scale operations may be managed under the auspices of the relevant business unit.

Similar issues are present for management processes, people and culture. Each element needs to evolve from a narrow domestic market focus to a multinational approach to a more global orientation over time. In the case of many Australian firms the current focus is still at the early primarily domestic with an international division stage. At best they are Multi-domestic in orientation rather than Multinational.

A common mistake can be to overburden the newly formed international operation with the extensive corporate reporting and other requirements. The new operation may not have the available resources to deal with these requirements and needs to have a level of flexibility to adjust to local conditions. To address these issues, AMP established an AMP Asia division that included a regional office between corporate office and local operations. Its role was to reduce the impact of overly burdensome corporate requirements.

“Its role was to soften corporate requirements from AMP to better meet start-up requirements and to protect from overly burdensome Western risk management requirements which often assume a mature business in a mature market.”

Ian White, Ex-Financial Controller, AMP Asia

Similarly Principal International, the international subsidiary of the Principal Financial Group, a major US financial services firm, has a regional office in Hong Kong. Most of their international operations operate through joint ventures with local partners. The role of the regional office is to manage the relationships with these partners and to balance the needs of the US corporate head office with the local partners needs. Most of Principal's partners are “800 pound gorillas” in their own markets and are no pushovers. The regional office needs strong negotiating and interpersonal skills. Expatriates are used primarily for longer term planning issues — they know the corporate head office and can communicate and negotiate better with them. Asian managers tend to be used to deal with the locals - they understand the market better and can be more sensitive to cultural norms.

This structure makes sense for the geographically diverse but relatively narrow product range of Principal International. Compare this with the very broad product and geographic diversity and large scale of Citigroup. Over time Citigroup has been continually changing and experimenting with its organisational structure and management processes to more effectively manage its far-flung operations. Matrix based reporting lines have been quite prevalent in these structures.

Lesson 10: Keep Your Hands on the Wheel—The Need for Rigorous Performance Reporting and Controls

Surprisingly, there can be a tendency to not control a foreign operation as tightly as a domestic one. Invariably this arises as a combination of small-scale operations, located a long way from home and operating with limited resources. However, it is this small scale and lack of on the ground resources that can lead to greater risks and potential disasters. Take the well-known example of Barings in Singapore where a single trader (Nick Leeson) was allowed to be responsible for the settlements on his own trades. In February 1995, this resulted in a US\$1.3 Bn of losses and Barings ended up being sold for £1 to ING.

The reporting lines for the business and the control sides of the operation need to report to one person at some level in the organisation. With many small-scale country operations it can be tempting to have this level within country. The lack of independent control can result in a Barings-like experience. Although this may seem like little more than common risk management practice and something that would very obviously become common knowledge since the Barings episode, this is anything but the truth. As recently as 2002, Allied Irish experienced losses of US\$690 million in its North American operations due to unauthorised trading. These trading losses had gone un-noticed for 5 years. In this case, independent back-office staff oversaw the trader's activities and yet he was able to persuade them to circumvent normal procedures.

In the late 1980s and early 1990s, Crédit Lyonnais expanded aggressively across Europe, Asia, Africa and Latin America. However, it was unable to control its operational costs and the quality of credit risk management. This led to losses of about FFr 20 Bn from 1991 to 1994, resulting in a change of CEO and a curtailing of its international operations. This example also supports the point of not over-extending the banks internationalisation assets to many regions and countries.

Other firms have been more successful in maintaining performance reporting and controls over their international operations. GE Capital uses a mobile cadre of well-trained managers to audit the operations of acquired entities and imposes strict credit controls in lending. UBS ensures that it does not lose local market understanding by offering managerial positions to the senior management of the companies it acquires and quickly integrates the acquired companies' systems, processes, policies and roles and responsibilities and introduces its own performance reporting and control systems.

Macquarie bank has instituted controls on its offshore offices including frequent management visits and more frequent internal audit reviews than experienced by its domestic units. Senior local staff have received risk management training in Sydney. Much of risk management and payment controls have been centralised in Sydney. A Global Market Exposure Report, a two-page report of all market risk, is produced daily and provided to the heads of trading groups, the head of risk management and the CEO.

It's not just the typical market, credit and operational risks that need to be monitored and controlled. As corruption is endemic in some Asian countries, it can be viewed by local managements as a normal way of doing business. This tendency is not restricted to local national managers; expatriates can, over time, "go native" and engage in local practices as an easy way of getting out of some situations.

Once a foreign company engages in corruption, it can be seen as an easy mark by the locals and met with continual demands for additional pay-offs. Policies, processes and systems need to be in-place to prevent corruption and promptly manage any incidences that may occur. As Phil Shirriff of ING points out:

"Don't get into corruption – it will come at you from everywhere – even today its still out there. To avoid corruption, you need to clearly define values, governance and desired culture and train and audit them constantly."

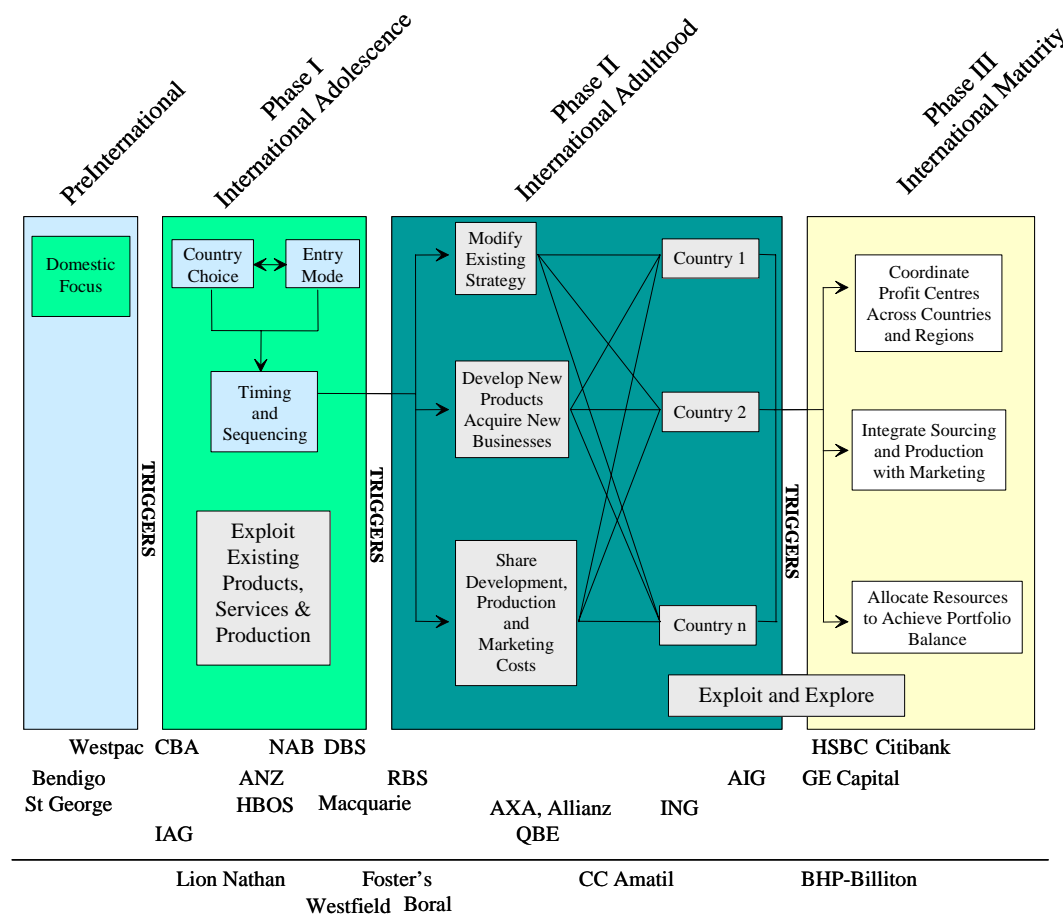
The ten lessons learned are not exhaustive of all issues that management needs to address when expanding internationally, however, the list does highlight some of the key areas from the initial strategy development, execution and on-going management of the international process.

4. A Model of Internationalisation

As described in the previous section, our work has identified ten necessary conditions for Australian financial firms to consider in an Asian expansion strategy. We have also developed a model for internationalisation that provides an overarching framework for how to think about the major issues and activities that need to be addressed in order to successfully internationalise. This section describes the internationalisation model.

Willie “The Actor” Sutton, the famous 1930s New York bank robber, was once asked why he robs banks. His response was: “Because that is where the money is”. One can answer the question of overseas expansion in a similar vein: companies expand into foreign markets because there is money to be made. There may be a host of other reasons — some logical, some seemingly made up on the fly — but the logic of follow the money predominates. From the standpoint of management making an overseas expansion decision, that investment must be considered relative to all other possible investments available to the firm. However, this oversimplifies the rationale to a certain degree. Johnson and Vahlne point out in a seminal work in international business that the process of internationalisation requires considerable learning on the part of the organisation.¹⁰ In addition, the rationale for different types of international expansion change as the organisation evolves and grows internationally. According to Johnson and Vahlne, firms internationalise through a staged process that is loosely represented in the schematic in Exhibit 8.

Exhibit 8: A Stage Model of Internationalisation



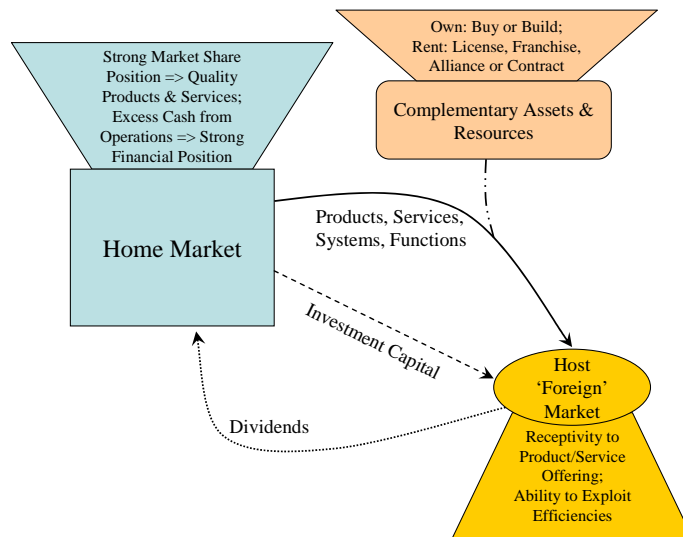
¹⁰ Johanson, J. and J.-E. Vahlne (1977) “The Internationalisation Process of the Firm: A Model of Knowledge Development and Increasing Foreign Market Commitments,” *Journal of International Business Studies*, 8(1): 23–32.

Hiding behind the internationalisation process model is an assumption that managers are risk averse and do not “bet the bank” when expanding overseas. The internationalisation process is one of dynamic expansion, learning, more expansion, more learning and continual reorganisation of organisational processes, functions and structures. Early in the process, firms tend to look for markets that allow it to expand existing operations and products with minimal change. It is only later in the process that firms seek to truly learn and innovate in foreign markets directly. The hallmark of internationalisation is that it is an evolving process; the creation of a multinational enterprise (even one with limited regional pretensions) takes considerable time to achieve. This is well articulated by Howard Morris of OCBC in Singapore:

“There’s an expression called, Crawl, Walk, Run. Some CEOs want to go straight to Run. Everything I’ve observed in the industries I’ve worked in have says Crawl, Walk, Run — start small and manage the scale of your investment so that if it does abort then you can contain it. It’s sufficiently big that you learn, and then you can make a conscious decision to go onto the next step.”

At one level the internationalisation process model is simplistic and it is not without its critics. However, it points out some of the necessities of internationalisation that is relevant to this report and allows us to compartmentalise some of the issues nicely. It also is a clear window on the international strategies of Australian financial institutions. To show this we have plotted the major Australian financial corporations along with a peer set of American and European counterparts. In addition, we indicate the position of a number of other Australian corporations. What this shows is that Australian financial institutions are, speaking generally, relatively immature in terms of internationalisation process orientation. The same cannot be said of other major Australian corporations of similar scale; many of whom are internationalising (and have internationalised) quite extensively.

Exhibit 9: Internationalisation via Home Market Exploitation



If we examine Exhibit 9 we see a slight variant of the process model that emphasises the main points. We will focus first on four of these: 1) the availability of ‘quality’ products and services and/or production processes; 2) a secure home base; 3) receptivity of the products and services and/or production systems in the foreign (host) market; and, 4) the availability of complementary assets that facilitate international transfer.

Successful early internationalisation requires that the firm have a product/service that is of the required quality and one that is relevant to the consumers in the host market. Additionally, when production or direct service delivery is required in the host market, this must be consistent with the local market capabilities and norms and represent significant improvements on local processes. In addition, a secure home base is required to relieve the firm of many direct financial constraints while, perhaps more importantly, making available the managerial and organisational slack to devote resources to the new overseas venture. Finally, the internationalisation process differs from domestic expansion in that it requires complementary assets and resources to be successful. These include individuals knowledgeable in local culture, regulations, organisational systems, and so on. The two most commonly highlighted complementary resources are those associated with product/service adaptation for the local market and those associated with international management itself. For the internationalising firm, the major issue with complementary assets and resources is “how are they acquired?”

One example of this has been highlighted in the case of Principal Insurance in Hong Kong described in Lesson 9. Principal Insurance overcomes cultural complexities by having a mixture of expatriate and local managers. The regional office team in Hong Kong understands Asia and most of the international operations operate through joint ventures with local partners. The job of the regional office is to manage the relationships with these partners. The regional office needs to balance the needs of corporate head office in the US with the needs of the local partners. An example more directly relevant to the financial services industry in Australia is seen in AMP. AMP has placed a regional office between corporate office and international operations. Its role is to act as a buffer between AMP corporate requirements and the flexible start-up requirements in new international markets. The both examples emphasise the need to allow for flexibility and adaptability of core systems to local cultural, managerial and market needs.

As noted in our lessons, many international expansions fail because of an unwillingness (rarely an inability) to commit the needed capital, physical and organisational resources to make the foray successful. Invariably this boils down to financial conservatism reflected in “staged underinvestment” and a tendency to make small and inappropriate steps. Effectively this amounts to managerial risk aversion and the internationalisation model has a lot to say about what this means to the typical path firms take when internationalising. It goes without saying that as the market in which a firm expands differs from those in which it currently operates all points in the system become strained. The likelihood that the product being offered will be accepted in the new market without any alteration is lower. The relevance of home market processes and systems becomes less relevant and managerial experience is less likely to be useful. All this means greater reliance on complementary resources external to the firm and greater alternation to the value chain components and the products and services. Naturally, risk averse managers question whether or not the “fit” between the firm’s strengths and its opportunities is sufficiently tight to warrant substantial investment. The least experienced firms and those with “bad” international experiences are most likely to feel the mismatch is just too great.

One of the implications of a desire to avoid risk and a need to exploit product, service and production strengths is that a firm’s path to expansion is based on geographic, socio-economic and political similarity. It is no coincidence that NAB’s international expansion was to the New Zealand, UK and USA. Equally rational was DBS’s aim to become a regional bank with a focus on South East Asia and Hong Kong. However, such an expansion path is not without risks. Although the exploitation potential is large, the firm develops a false sense of security about its ability to truly internationalise – its ability to be successful in markedly different countries. Hence, one might ask what was so different in NAB’s operating in New Zealand and its operating in Tasmania – both are islands off the mainland of Australia. Although the firm picks up some international experience, that experience is not sufficiently different to put it into a position to move into a more exploratory stage of expansion.

For firms that break through this initial phase of foreign market expansion, the nature of the game changes. First, as the number of markets in which one operates increases, the necessity of structuring the organisation differently rises. It is a misnomer that multinationals are per se more efficient than their local competitors. Successful multinationals MUST be more efficient than local firms because if they were not they would be little more than a collection of local firms with a costly international management structure. Successful multinationals therefore must be sufficiently profitable over and above local competitors to pay for their overhead as multinationals.

Older multinationals move from exploitation of home market assets to exploration and exploitation of network assets. They become less reliant on complementarity assets and resources that lay outside its sphere of ownership and influence. What this means is that more successful multinationals create systems that allow for learning and innovation in one market to be more efficiently exploited, at scale, in many markets. This is shown in Exhibit 10 and revealed in the case of GE Capital as expressed by the Karthik Subramanyam, Managing Director, DBS in Singapore.

“GE Capital seems to have understood Thailand better than the some of the closer neighbours did-considering their significant successes in the retail finance business; so geographic proximity doesn’t give you any advantage. It’s the ability to be able to understand the very local flavour of the business. Just because you’re from Singapore doesn’t give you any advantage to be able to work in Thailand because they’re two entirely different markets that are probably unconnected. GE Capital has developed the skill set to understand new markets. They have developed the ability to understand the local culture and operate the business locally – they don’t rely on expatriate managers to run these businesses.”

Exhibit 10: Internationalisation at Later Stages of Organisational Maturity

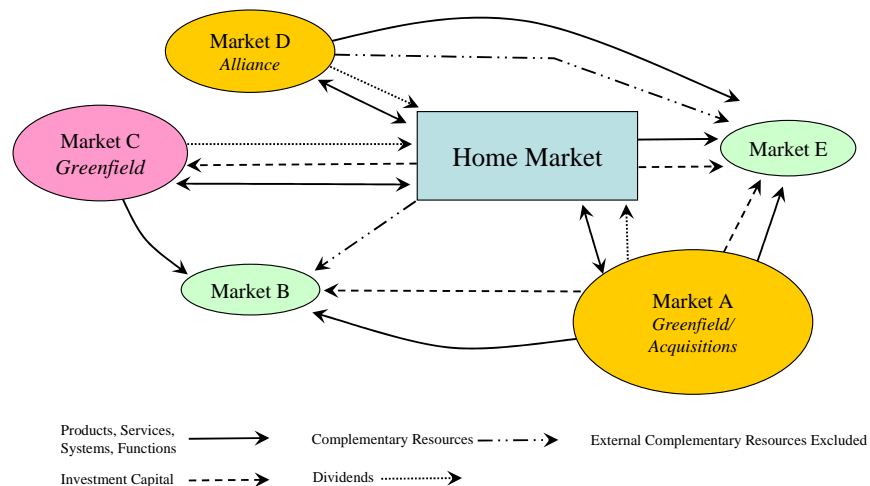


Exhibit 10 shows a firm where Market A is now larger than the original home market (as might be the case for a company like Philips in the Netherlands). Markets C and D are next in size. Markets B and E are newer developing markets. What is represented is a structure where cash resources, capital and product resources and complementary resources are moving from established successful markets to both new developing and established markets. This is most obvious in the fact that capital is moving from Market A to Markets B and E and complementary resources are moving from Market D to Market E. What is more telling, however, is that product, services and systems are moving from Market A to not just other markets but also to the home market. The role of the home market has moved from a dominant position to a gatekeeper and Headquarters monitoring role. Citibank is a classic example of the more mature multinational and their Asian operations reveal this. Citibank’s strategy of “functional specialization” for location of processing centres implies that processes are distributed to the most appropriate location with Data Centres located in Singapore, Trade finance in Penang, Finance in Manila and Treasury/Financial markets in Sydney.

5. The Final Word

The key lesson from this discussion is that **successful internationalisation is a process of learning, adjustment and adaptation** that occurs in real time with real money with real people. In this sense each situation is unique but this does not mean that the logic of the development from local champion to international player is not without its rules and checkpoints. What the internationalisation model shows is that what a firm can achieve at each stage is limited by their development to date and their development today is a function of their development yesterday. Quick internationalisation is difficult not because it is risky but because it requires skills that build on prior skills and experience – an incremental approach. As these develop, they serve to expand the possibilities. The implication is that firms **need to develop not just internationalisation strategies (or growth strategies) but strategies for developing the capabilities to develop internationalisation strategies—what we call the S(S) approach.** This allows firms to avoid a step-wise and near sited expansion that amounts to little more than a “first this country, then this country, ...” approach to internationalisation that may appear strategic but is little more than organisational Brownian motion that stalls when the first roadblock appears. In addition, the S(S) approach is organic in the sense that it recognises that the limits of internationalisation are not external but internal and that the firm needs to think 5–10 years ahead as its opportunities are limited by its skills at exploiting what arises, not in finding opportunities that randomly appear in the environment. Finally, the S(S) strategy is naturally adaptive. Because it is based on building slack and diversity into the organisational system, it accepts that the organisational requirements will change as more opportunities are internalised.

For Australian financial service firms thinking of expanding in Asia the roadmap is clear. An S(S) approach is needed that looks not only for opportunities today but puts in place a process whereby the capabilities and skills are being developed as part of the expansion effort. In addition, opportunities for growth are not only opportunities for growth but also opportunities to learn how to learn as well as learning what is necessary to be successful in any single market. Asia provides clear prospects for Australian firms seeking growth but the true success will accrue to those that seek a platform in Asia rather than short sightedly seeking simply greater immediate returns to shareholders.

Appendix A: List of Interviewees

| Name | Position |
|---------------------|--|
| Rex Auyueng | Managing Director & CEO Asia, Principal International |
| Tony Berg | Ex CEO Macquarie Bank, Ex-CEO Boral Ltd |
| James Brindley | CEO, Lion Nathan (China) |
| Mark Cain | Vice-President, Business Development, Asia, Bluescope Steel |
| Brad Camer | Regional Director, Asia, Southcorp |
| Jack Chemello | Banking Analyst, BT Financial Group |
| Bill Clarke | General Manager, Corporate Affairs, Southcorp |
| Ranvir Dewan | CFO, Korea First Bank |
| Christian Drysdale | Associate Director Strategy, Macquarie Bank |
| John Faulkner | Ex-Managing Director, Leightons Asia |
| Samantha Mark | Corporate Office, DBS Bank, ex-Colonial State Bank |
| Howard Morris | Senior Technical Advisor, OCBC (Singapore) |
| Jonathan Reoch | Banking Analyst, ABN-AMRO |
| Bruce Rolph | Director, Global Strategy, Citigroup |
| Phil Shirriff | Director ING Australia, ex CEO ING Asia Pacific |
| Greg Simitian | Head of Strategy, Macquarie Bank |
| David Skinner | Chief Executive, Asia Region, New York Life |
| Karthik Subramanyam | Managing Director, DBS, ex GE Capital, ANZ Grindlays, Standard Chartered |
| Ian White | Ex Financial Controller, AMP Asia |
| Andrew Waddington | Insurance Analyst, BT Financial Group |
