# Intangible assets, multinational firms and joint ventures

## the case of financial services in developing economies

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**Intangible Assets, Multinational Firms and Joint Ventures: The Case of Financial Services in Developing Economies**

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**Summary:**

This note illustrates a recent empirical phenomenon, which warrants a re-examination of the intangible asset theory of multinational enterprises (MNEs). It analyses two case studies of financial services: credit cards and insurance products in a developing economy. The case studies show that in the case of joint ventures between local firms, and MNEs in a developing economy, it is a large local bank that provides the brand name while MNEs provide the back-end (tangible) technical-support. The analysis also brings forth fresh insights on the issue of joint ventures, especially in the context of financial services in an emerging economy.

**Key words**: Intangible assets; capital market imperfections; joint ventures; financial services; emerging economies

## Introduction

One of the highly influential streams of literature on multinational investment has been the theory of intangible assets pioneered by Hymer (1960), and Kinderlberger (1969) and further developed by scholars such as Caves (1971), Dunning (1988), Buckely and Casson (1976) and several others. Hymer made a distinction between portfolio and direct investment and rejected the capital-arbitrage hypothesis for explaining foreign direct investment (FDI). He argued that for a firm to conduct foreign production they must possess some kind of firm-specific ownership advantages, such as superior technology (patent), brand name and marketing which provide it with an advantage over local firms in the host country. The decision to invest in a foreign country is essentially a decision to control some firm-specific proprietary asset rather than transact it via the market. Whether a firm will exploit that advantage through licensing or FDI depends on the type of advantage and the degree of market imperfections (appropriability) in the host market. The higher the degree of market imperfections, the greater will be the need to control the asset through direct investment. Income earned is higher for the foreigner than for the local entrepreneur because of an advantage in intangible assets. Although differences in cost of capital might add to the valuation of this potential stream of earnings, however, this theory primarily asserts that direct investment occurs when the foreign firms can earn a higher income stream than local firms.

On the other hand, Aliber (1970) addressed the question of why firms finance their assets in their domestic currencies in terms of the ability of firms from countries with strong currencies to raise capital more cheaply than those in countries with weak currencies. This, in turn, enables them to capitalize their expected income streams at different rates of interest. Aliber (1993) also argued that the key factors for explaining the pattern of foreign direct investment involves capital market relationships, exchange risk and the market preferences for holding assets denominated in selected currencies. These factors can explain why FDI from some countries is higher than from others and these relationships have explanatory power for the pattern of foreign direct investment. Aliber's thesis is that home country firm's capitalize the same stream of income at a higher rate than that of host county firms because the market attaches different capitalization rates to income streams denominated in different currencies. Foreign investors are attracted to securities denominated in the currency of the rapidly growing country. However, Aliber's theory has been less influential in explaining FDI than the intangible asset theory.

There has been a large body of empirical work providing evidence to support the intangible asset theory. A review of this literature can be seen in Caves, (1996) and Dunning, (1994). Generally, the MNEs' advantage in intangible assets, such as global brand names and technology, tends to be more dominant in developing economies than in developed economies because local firms in developing economies are underdeveloped. Secondly, MNE have to adopt higher levels of internalization to protect intangible assets with public goods properties because market imperfections are more dominant in developing economies (Lall and Siddharthan, 1982; Patibandla, 2002).

One of the extensions of internalization is the issue of joint ventures. If we assume that there are no government policy restrictions on equity levels of multinational enterprises (MNEs) in the host developing economies, joint ventures with local firms would take place if the local partner has complimentary assets in relation to the intangible assets of MNEs. The complimentary assets of MNEs and local partners in a host developing economy can be observed in the following terms: a MNE has intangible assets in a brand name, and technology, and a local partner has local institutional knowledge and distribution networks. For newly entering MNEs, the country-specific institutional knowledge is highly necessary in transition and developing economies in which prevailing market institutions are complex and different from matured capitalist economies. In entering these markets, MNEs can overcome their disadvantage of lack of country-specific institutional knowledge by forming joint ventures with local firms. In these ventures, MNEs provide their global brand names and well-tested new technologies and products while local partners provide their experience with local institutions and distribution networks (Patibandla, 2002).

In this note, two case studies are analyzed which defy the above characterization of the joint ventures: a local partner in a developing economy provides the brand name, while MNEs provide basic back-end technical support in financial services. A part of the explanation is provided from the capital market imperfections theory of Aliber. Secondly, a new perspective on the intangible asset theory is brought forth especially in the context of certain unique characteristics of financial services in developing economies. The case studies refer to the joint ventures between a large Indian bank, the State Bank of India and the GE Capital in the credit card business and Cardiff in the insurance market.

**The Case of the Joint Venture between the State Bank of India and GE Capital**

In early 1998, two joint ventures between a large Indian bank, the State Bank of India (SBI), and a globally established MNE, GE Capital were formed to market, issue and service credit cards under the name "SBI Cards". One was "SBI Cards & Payment Services", which markets and distributes SBI Cards in India. The other was "GE Capital Business Processes Management Services", which handles the technology and processing needs of SBI Cards in India. This venture leverages the brand equity, customer relationship and wide network of SBI with GE Capital's technology, processes, risk management, retail marketing and service capabilities to offer card products that offer value-for-money supported by high quality service. In this joint venture, the brand name that has been used belongs to the Indian bank while the MNE provides the technical support.

**The State Bank of India**

The State Bank of India (SBI) is the oldest and largest commercial bank in India. The bank's 194-year history dates back to the formation in 1806 of the first of the three presidency banks of Bengal, Bombay, and Madras, and their subsequent amalgamation into the Imperial Bank of India in 1902. It was transformed into the State Bank of India in 1955 when it was taken over by the Indian government. To mobilize capital both from low and high-income groups, the government of India promoted the bank all over the country. In 1994, the Indian government reduced its stake by floating shares to the public. However, the Central (the Reserve) Bank of India owns 59 percent of SBI's equity. At present, SBI is the largest commercial bank in India, with total assets of US $ 67.71 billion, total deposits of US $ 52 billion and made net profits of US $ 344 million in 2001. It has a countrywide network of 9,019 branches and employs about 214,845 people. It commands one-fifth of deposits and loans of all scheduled commercial banks in the country.

SBI is the founder and a flagship member of the SBI Group which is a giant commercial and investment banking group that dominates the Indian scene with its eight commercial banking associates and four subsidiaries, encompassing more than 13,000 branches. They account for 27.23% of the aggregate deposits and 30.38% of total advances in India's domestic banking sector. The bank's subsidiaries handle merchant banking, mutual funds, home financing, factoring, credit cards, etc.

**GE Capital in India**

GE-capital is the financial services arm of the General Electric conglomerate. GE Capital Services is a global diversified financial services company with 28 distinct businesses. With assets of US $300 billion in 1998, its net earning reached US $3.8 billion and the company achieved a 23.5% return on equity. Its businesses are in the areas of equipment management, consumer services, mid-market financing, specialized financing and specialty insurance and include global operations in Europe, Asia and Latin America. With assets aggregating $18 billions in terms of credit card receivables, GE Capital Services issues a range of credit cards across the globe. The company's credit card issuance figure is approximated at over 70 millions.

GE Capital Services India was established in October 1993 as a wholly-owned subsidiary of GE-capital Services. It is one of the largest capitalized financial services companies, with a combined, estimated asset base of Rs. 35 billion and a credit rating of AAA (SO) by CRISIL and Duff & Phelps (highest safety). It has two types of operations in India: one caters to the Indian financial markets and the other encompasses the back-end technical support units for its global operations. The motivation behind the latter operation is to take advantage of low cost skilled and semi-skilled workforce, proficient in English, found in India for its global operations. GE Capital's Indian market focus includes consumer finance, commercial equipment finance (including truck financing) and commercial finance.

GE Capital's Business Process Management Services (GE Capital International Services) was established in India as a wholly-owned subsidiary in 1996 to assist client organizations in maximizing speed and efficiency of current internal and external processes with cost, quality and service advantages. The company has established its remote processing centers in India in Gurgaon (near Delhi) and in Hyderabad in southern part of India to cater to its expanding remote processing services business. It has also established a Decision Science Center in the city of Bangalore, which is responsible for developing predictive tools and models for all aspects of customer management. The center provides back office processing services to GE companies in the US, Europe and Asia Pacific.

**The SBI and the GE-capital Joint Venture for Credit Cards**

In early 1998, two joint ventures between SBI and GE-capital were established to market, issue and service bankcards under the name, "SBI Cards". One was the SBI Cards & Payment Services, which distributes SBI Cards, and the other was GE Capital Business Processes Management Services, which handles the technology and processing needs of SBI Cards in India. This branch aims to leverage the brand equity, customer relationship by combining the countrywide network of SBI with GE-capital's technology, processes, risk management, retail marketing and service capabilities. GE Capital holds 60 percent while SBI holds the rest of the equity stake in this joint venture. The new company will have an initial capital base of Rs. 1000 million. The SBI card will operate on the Visa network initially, but later on the Master Card settlement systems as well.

When the SBI-GE venture was launched in 1998 there were an estimated 2.5 million cards in circulation in India, with foreign banks such as Citibank accounting for 40 percent, and Standard Chartered, HSBC, and ANZ claiming a chunk of the rest. These banks have concentrated their card business on high-income groups in a few large metropolitan areas. The credit card market at the end of the nineties was very nascent with high growth potential. In 2001, the market was estimated to be at 5.5 to 6 million credit cards growing at 20-25 percent annually (Business Line, Jan 26, 2002).

With its countrywide banking network of approximately 14000 branches, SBI targeted middle-income groups, most of who were already its customers. The company under-priced its credit card annual fee at Rs. 500, compared to the industry average of Rs. 750. Then- it leveraged its backend operations with GE Capital to ensure that applications were processed within two weeks to beat the industry norm of five weeks. The annual fees would be waived for any card delivered after two weeks of application. Within 16 months of the launch, SBI Cards achieved a customer base of 0.25 million in 25 cities. In 2000, 0.9 million cards had been issued covering about 41 large and small cities across the country.

The back-end technical processing support of GE Capital facilitates fast and efficient bill processing, which reduces the incidences of customer default. In the credit card business, high incidence of default results in the lemon problem of adverse selection. The SBI-GE Capital joint venture of combining SBI's brand-equity and countrywide network SBI with GE Capital's backend processing support speeds up the service and bill collection. This also helps in providing and charging highly competitive service and interest costs on credit card use that, in turn, suits the middle-income groups well.

**The SBI-Cardiff Joint Venture in the Insurance Markets**

Another case study that has some similar features to the SBI and GE Capital joint venture is the joint venture between SBI and the French multinational firm, Cardiff in the Indian insurance markets.

The public sector firm, the Life Insurance Corporation of India monopolized the Indian insurance market, until the year 2000 when market was opened up to private firms. Several leading state-run banks in India saw a major opportunity to leverage their vast branch network through entry into the insurance sector when it was opened up to private participation. During this period, banks entering the insurance markets gained ground in India. The model of providing a packet of financial services together and at one-shop started to take root.

As mentioned previously, the State Bank of India has the largest established network of branches and banking customers in India on which it could leverage to provide insurance products. However, it had no experience or innate knowledge of the insurance business, which forced it to search for a partner. After negotiating with several MNEs including the French firm, Cardiff, GE Capital and the Dutch-Belgian financial group Fortis, SBI finally selected Cardiff as its partner for entering the Indian insurance market. A major the reason for this choice was the Cardiff's extensive experience in providing insurance through banks, having pioneered the concept of 'Bancassurance'. The insurance activity is fully integrated into the banking activity with appropriate sales support and marketing techniques.

Cardiff Insurance firm is part of the French group, BNP Paribas, which already had a presence in the Indian banking sector. Cardiff was created following the diversification of its parent as the insurance arm of Paribas in 1973. The insurance business grew rapidly, with the company selling products through other banks. Cardiff has developed over 100 different partnerships with financial and other institutions in 23 countries, and distributes insurance products through bank branches, independent financial advisors and non-traditional mediums such as direct marketing and telemarketing.

SBI established the joint venture, the "SBI-Life Insurance" with Cardiff in mid of 2001. Cardiff owns a 26 percent equity stake while SBI holds the rest. Cardiff, will play a silent role in the partnership although it will play a key part in devising products for the joint venture that are specifically targeted at bank customers. The joint venture in India is marketed under SBI's brand name, SBI-Life Insurance, but not by the brand name of Cardiff.

Through this joint venture, SBI intended to provide a number of products to suit different segments of the population in the Indian market, given its large network of branches and banking customer base in the country. Cardiff functions as a wholesaler, product developer, pricing and systems and training expert. According to Cardiff's management, the name that the Indian customers would identify with would be that of SBI, while the Cardiff's name would appear in the small print, similar to the case of the joint venture between SBI and GE-capital in the credit cards market. SBI Life Insurance will sell banking-related products devised by Cardiff, such as life insurance-linked credit insurance and unit-linked products. These products will be sold over the SBI counters to customers using the SBI name. SBI, in conjunction with its credit card business with GE-capital and its insurance business with Cardiff, provides customized insurance products for its cardholders (Business Line, January 25, 2001)

**The Implications**

In these joint ventures, it was a local bank in a developing economy that provided the intangible asset of brand name while the MNEs provided the back-end services. In the case of SBI and GE Capital joint venture, GE-capital provided the back-end (low-technology) technical support while it was the SBI's name that was marketed on the credit cards. Also the MNE took the majority equity stake of 60 percent in the joint venture. The knowledge intensity exemplified by GE Capital's backend transaction processing center does not exhibit significant intangible asset properties and can be seen as a tradable asset. In other words, any firm with access to capital can undertake these operations. Although, GE Capital's experience with financial services in the global market is a useful asset for SBI in the joint venture, this can be acquired by

SBI without much difficulty. Furthermore, SBI could outsource the back-end support to GE Capital or other firms within India instead of forming joint ventures.

In the case of the SBI and Cardiff joint venture in the insurance market, the partners combined two of their firm-specific intangibles. SBI provided the intangible asset of its brand name and a tangible asset of its branch network. Cardiff provided its expertise in making and selling insurance products through banks, which can be treated as having a degree of intangible asset properties.

A part of the explanation can be drawn from Aliber's theory of capital market imperfections. As mentioned before, GE Capital has the majority equity stake in the joint venture at 60 percent. GE Capital invested in an "Income earning Asset" in venture in terms of back-end processing and technology. GE's investment in this joint venture in India could provide higher future returns than in the US, as the Indian market is at nascent stage and growing at a high rate. Secondly, the capital costs for GE Capital are lower than for SBI, as it could tap into both global, and its internal capital markets more efficiently than a bank from a developing economy. The capital costs in terms of the real interest rates in the US and Western Europe range between 4 and 5 percent while they are around 10 to 11 percent in India (Reserve Bank of India, 1999). In other words, the investment in India will earn a higher stream of returns for GE Capital than in the US. GE's capital cost advantage and its existing back-end technical support helps SBI to get access to low-cost and high quality back-end services. This, in turn, facilitates provision of the services at competitive prices, which helps SBI to compete more effectively with local and multinational banks in the country than could on its own.

The pertinent question is then why the MNEs, GE Capital and Cardiff did not use their brand names and go for an integrated venture instead of forming a joint venture with the SBI? A plausible answer is that SBI has a large established network of branches and a significant customer base across the country. Over the years, it built up strong brand equity with its customers particularly the middle-income group (the middle class). The middle class market for credit cards and insurance products has higher growth potential than higher income groups.

Secondly, the financial services market has certain unique characteristics, which makes it different from other services and manufactured goods. The incidence of high agency costs associated with moral hazard and adverse selection is more dominant in the financial markets than in the other markets. The depositors need to have confidence in the bank to deposit their savings. Banking customers may have higher confidence in a local bank than in a foreign bank, especially when the government protects the local bank. Furthermore, the adverse selection outcomes or costs of defaulting by credit cardholders and in the insurance markets are higher, larger the number of cardholders and subscribers for any single bank (financial institution) is. This, in turn, may discourage foreign banks to cater to the large section of middle class customers in India especially when market institutional conditions are underdeveloped. On the other hand, SBI with its large network of branches and experience with local customers in conjunction with the back-end technical processing of GE-capital is able to reduce the adverse selection costs. In essence, the intangible assets pertain to the local bank with its country specific brand name and institutional experience while the MNE provides back-end technical support with a capital cost advantage.

The issue of joint ventures between MNEs and local firms in the host country is basically an extension of the internalization issue along the lines of Williamson's (1985) transaction cost theory. If savings costs of production are higher than transaction cost through joint ventures, joint ventures are profitable (Kogut, 1988). In Williamson's theory, agents invest in assets specific to a transaction after they enter into a contract. In other words, assets are acquired after the contracts are formulated, and opportunism takes place when one of the agents gets locked into an asset specific to the transaction. On the other hand in the resource-based view of the firm (Penrose, 1959; Teece, 1982), different firms (agents) possess different (physical and human capital) assets prior to a contract (joint venture). If the assets possessed by two agents are complimentary, there is an incentive for joint venture. [2]

In the case of the SBI and GE Capital joint venture, GE Capital did not have to invest large sums in the relation-specific assets, as it could leverage upon its existing back-end-processing infrastructure in India. On the basis of the existing infrastructure, it added employees to cater to the technical processing side of the venture. These employees can be re-deployed to other uses or fired without much costs or difficulty if the collaboration breaks down. SBI invested in marketing and building the brand name of the credit card, mostly among its large number of depositors. In the immediate short term, the hold-up problem is more for

[2] The modern property rights theory (Grossman and Hart, 1986 ) is similar in that- there is an incentive for agents with different assets to form a joint venture if the joint output is higher than each agent going on its own.

SBI than for GE Capital because if GE Capital denies the back-end technical support, the consequent costs for SBI could be high. However, in the medium term, SBI can find other partners for outsourcing or it can set up its own back-end processing units as this services is tangible and tradable rather than a firm specific intangible asset.

In the resource-based view of the firm, there is no proper theoretical explanation for why two competing firms in any given industry end with up different types of and complimentary assets. One of the possible extensions of the resource-based view of the firm- that two firms belonging to an industry may possess different type of assets- could be that they are born in and compete in different market institutional environments (Williamson, 1999; Patibandla, 2002; Madhok, 2002). In the present case, SBI has acquired its intangible assets in the form of a brand name specific to India and a countrywide banking network having operated in India for a long period. GE-capital has derived its capital cost advantage and its technical back-end processing technology from operations in its home country. These different assets of SBI and GE Capital exhibited complimentarity, which led to the joint venture between them. However, GE Capital's intangible asset of its brand name in the credit card business in the US is not valid in the Indian market as illustrated above.

The long run stability of this joint venture depends on several factors. If SBI is able to tap into global capital markets more efficiently in the future, GE Capital's capital cost advantage of the collaboration will dissipate. If GE Capital is aware of this possibility, it will be reluctant to invest large capital in the relation-specific assets. This, in turn, may result in an outcome similar to the predictions of the property rights literature- asymmetric incentives for increasing investment among the partners may arise when the market grows. This may result in the breakdown of the joint venture.

This note has shown that in the presence of strong incumbents in large developing economies, global brand names of MNEs as intangible assets may not be effective, especially at the initial entry period. A few previous studies, (Dawar and Frost, 1999; Patibandla, 2002) have illustrated how a few local incumbent firms in developing economies compete with global giants quite effectively in the case manufacturing industries. This note has illustrated the importance of local reputation as a brand name in the case of financial services by taking into account some of the distinct features of financial markets. The strategic implications are that MNEs have to combine their tangible assets such as capital cost advantage and technical support systems with intangible assets of expertise in providing services. They need to seek local partners with country-specific brand names and networks as an entry mode strategy in the financial services. However, in the long term the joint ventures may not survive as local firms can acquire the tangible assets through the markets, especially if global capital markets are integrated. Furthermore, MNEs themselves may be able to build country-specific brand names over a time through their experience and presence in the local markets for sustained period.

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