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LIABILITY OF FOREIGNNESS IN GLOBAL COMPETITION? FINANCIAL SERVICE AFFILIATES IN THE CITY OF LONDON

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This study was inspired by the observation that foreign financial service firms operating in the City of London do not suffer the liability of foreignness to the extent suggested by theory. To examine the reasons for this departure from theory, the study advances a theoretical framework that distinguishes between three types of advantages that together account for the competitive performance of MNEs relative to that of indigenous firms. Empirical analyses of a sample of 296 foreign financial service firms in the City of London show that in this particular context major sources of competitive performance are the firm-specific advantages and the advantages of multinationality, where British firms may not necessarily possess an advantage over foreign firms. An examination of the validity of the findings, in order to assess the extent to which this situation is unique to the City of London or rather signifies a more general trend that requires theoretical modifications and extensions, is emphasized as a major task for future research.

> There is great potential to enliven current theory and to develop new insights if theorists search for and work with inconsistencies, contradictions, and tensions in their theories, and in the relationships between them.
>
> (Poole and Van de Ven, 1989: 575)

INTRODUCTION

The theories of international business and management provide two, somewhat related, reasons for expecting that firms based in a locationally advantageous home country would outperform their foreign counterparts in their national markets. First, foreign firms face additional costs, arising from their unfamiliarity with and lack of roots in a foreign environment (Kindleberger, 1969; Hymer, 1960/1976), what Zaheer (1995) named the 'liability of foreignness' (hereafter LOF). A number of studies established the existence and persistence of the LOF in various industrial and geographical contexts (Zaheer, 1995; Zaheer and Mosakowski, 1997; Miller and Parkhe, 2002; Shukla and van Inwegen, 1995; Mezias, 2002). These studies have illustrated the advantages gained by indigenous firms due to their easier access to local information and knowledge, and have shown the higher transaction and information costs incurred by foreign firms. They have also documented the implications of these asymmetries for the relative performance of foreign and indigenous firms competing in the same environment.

The second reason for expecting national firms to be more competitive within their home country is proposed by the theory of the origin of the MNE competitive advantages. This theory

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suggests that national firms enjoy favorable access to the assets of their home country and use these to develop competitive advantages that are deprived from foreign firms investing in their country (Dunning, 1979; Hu, 1992; Nachum, 1999). Thus, when a home country is locationally advantageous, national firms would be the first to benefit from these advantages. Empirical studies have documented a close link between the location advantages of home countries and the type and nature of the competitive advantages of national firms (Whitley, 1992; Kogut, 1993; Thomas and Waring, 1999; McKendrick, 2001).

In this study I seek to examine one setting that is inconsistent with these theoretical arguments: financial services in the City of London. It appears as if nationality of ownership does not provide the benefits that theory predicts in this context, and foreign firms do not seem to suffer a liability associated with foreignness. Foreign firms are more profitable, grow faster, and survive longer than British-owned firms operating in this environment (British Invisibles, 2000; Augar, 2001). I seek to identify the possible reasons for this departure from what theory predicts and to draw their implications for further theoretical development. Rather than treating the case of financial services in the City of London as a theoretical inconsistency and an exception to the rule, I attempt to use it to develop a more encompassing theory that takes into account this exception (Poole and Van de Ven, 1989). The essence of this theoretical development is the acknowledgement of the possibility of the non-existence of the LOF, and the introduction of a theoretical framework that enables one to analyze systematically the circumstances that may lead to such an outcome.

A better understanding of the dynamics of foreign operation in the City of London, which have eliminated the power of the LOF, and an assessment of the validity of this situation beyond this specific setting, has important implications for the further development of the theory of the LOF, as part of the more general theory of the MNE. The assumptions that foreign activity is associated with additional costs arising from the unfamiliarity with the foreign environment, and the need for some compensation mechanisms to overcome these costs, have been fundamental in the development of international business theory since Hymer's initial contribution. Establishing that such liabilities of foreignness may not exist in all circumstances, and identifying their causes and the conditions under which they are expected to be more pronounced, has important implications for the understanding of the nature of foreign operations, the differences between foreign and domestic investments, and the determinants of the international competitiveness of MNEs. It also has fundamental bearings for the debate on the impact of nationality and the persistence of the home-based advantages in global competition.

In the next section, I sketch briefly a picture of the dynamic competitive position of British- and foreign-owned firms in the City of London and in global competition over the last decades. The following section is devoted to the introduction of a theoretical framework that distinguishes between different types of advantages that together shape the competitive performance of MNEs. A set of research hypotheses is generated to specify the expected strength and direction of the differences between foreign- and British-owned firms in relation to each of these advantages. Hypotheses are also advanced regarding the expected impact of a number of moderating variables on the link between the possession of these advantages and the LOF. These hypotheses are tested in the following section on a sample of foreign financial service firms in the City of London. The paper concludes by discussing the implications of the findings for firms and for further theoretical development. It is argued that under certain circumstances the LOF may not exist, and directions are outlined for the subsequent modifications of the theory of the MNE needed to accommodate these circumstances. I suggest that a major task for future research would be to establish the validity of the findings in different industrial and geographical contexts. This would provide a basis for understanding whether this particular case represents a trend, and hence requires modification of existing theory (Eisenhardt, 1989), or rather is a unique event.

FOREIGN- AND BRITISH-OWNED FIRMS IN THE CITY OF LONDON

British financial service firms dominated world markets for centuries. This position was related to certain location advantages of Britain that supported and sustained the development of strong

competitive advantages of firms in this sector (Jones, 1993). In particular, their strength in the nineteenth and first half of the twentieth centuries rested in large part on the British economic and political preeminence, and on the strong position of the pound as the major world currency. They were the first financial service firms to establish foreign operations, and they held the dominant position in the then global market for decades. No other country matched the number of overseas operations of British financial service firms (mostly banks) before the Second World War (Jones, 1993).

In the decades following the Second World War, however, British financial service firms lost much of their dominant position in world markets to firms of other nationalities. While British banks dominated the overwhelming majority of foreign assets controlled by multinational banks until the Second World War, their shares shrunk continuously to less than 5 percent in the early 1990s (Jones, 1993). In insurance, the combined number of foreign operations owned by British firms in the 1960s was larger than that of its major competitors combined. Today their share of international business is smaller than that of all the major competitors in this sector (Sigma, 2000).

Not only has their position in international markets been continuously deteriorating, but British financial service firms have even lost their position in servicing the financial and commercial needs of firms in Britain to foreign firms. The literature suggests operationalizing the theoretical construct LOF by the comparative performance of foreign- and domestically owned firms operating in the same environment (e.g., Zaheer, 1995). Two measures commonly used are survival (Zaheer and Mosakowski, 1997) and profitability (Zaheer, 1995). Analyzed according to these criteria, of the City firms that went out of business between 1975 and 2000, 214 were British and 99 foreign (Nachum, 2000b).[1] The profit margins of British and foreign financial service firms in the City were 0.132 and 0.147 respectively (Nachum, 2000b).

Two closely related reasons are commonly cited to explain this decline of British-owned financial service firms: the deteriorating position of the British economy in the world economy, a result of the gradual loss of the British Empire in the decades following the Second World War, and the related decline of the pound as the dominant currency of international transactions (see, for example, Rose, 1994a, 1994b; Michie, 1992).

Neither of these, however, has affected the position of London as a global financial center. From the 1950s onward, as Britain was losing its dominant economic position, London moved from being a financial center based on Britain's dominance of foreign trade and investment to one that functions as a world financial center. The character of activity taking place in London has changed from one relying on the pound to one that relies on multi-currencies, and London developed a position as an international financial center through its attraction to business in non-pound currencies. The rise of the Eurocurrency markets since the 1960s further encouraged the transformation of London into an international financial center. Radical deregulatory reforms in the 1970s and 1980s—including the abolition of exchange controls in 1979, the Big Bang liberalization of the Stock Exchange in 1986, generation of business through privatization, deregulation, and liberalization of the building societies' activities—have further increased London's attraction to foreign financial service firms, and enhanced its position as an international financial center. These developments have been documented in great detail in a large number of studies (see Cobham, 1992; Budd and Whimster, 1992; Michie, 1992; London Business School, 1995; Morgan, 1997, among others). London thus came to exercise a role in international financial markets that contrasts sharply with the poor economic performance of British-owned financial service firms, both in London and overseas (see Figure 1).

If London indeed possesses such considerable location advantages, as the sheer amounts of foreign activity concentrated in the City suggests,[2] why are British-owned firms not the first ones to take advantage of them? What factors enable foreign firms to overcome the LOF (Zaheer, 1995; Zaheer and Mosakowski, 1997; Miller and Parkhe, 2002; Mezias, 2002) and outperform their local counterparts? Most importantly, how unique is this

[1] These data underestimate the number of British firms that went out of business, because for the most part they have been targets for take-over by foreign firms (*London Economics*, 1995). These take-over cases are not included in these data.

[2] London's performance in terms of market shares is taken as an overall indication of its location advantages. Actual performance is often used as a proxy for the existence (or otherwise) of location advantages (e.g., Nachum, 1999).

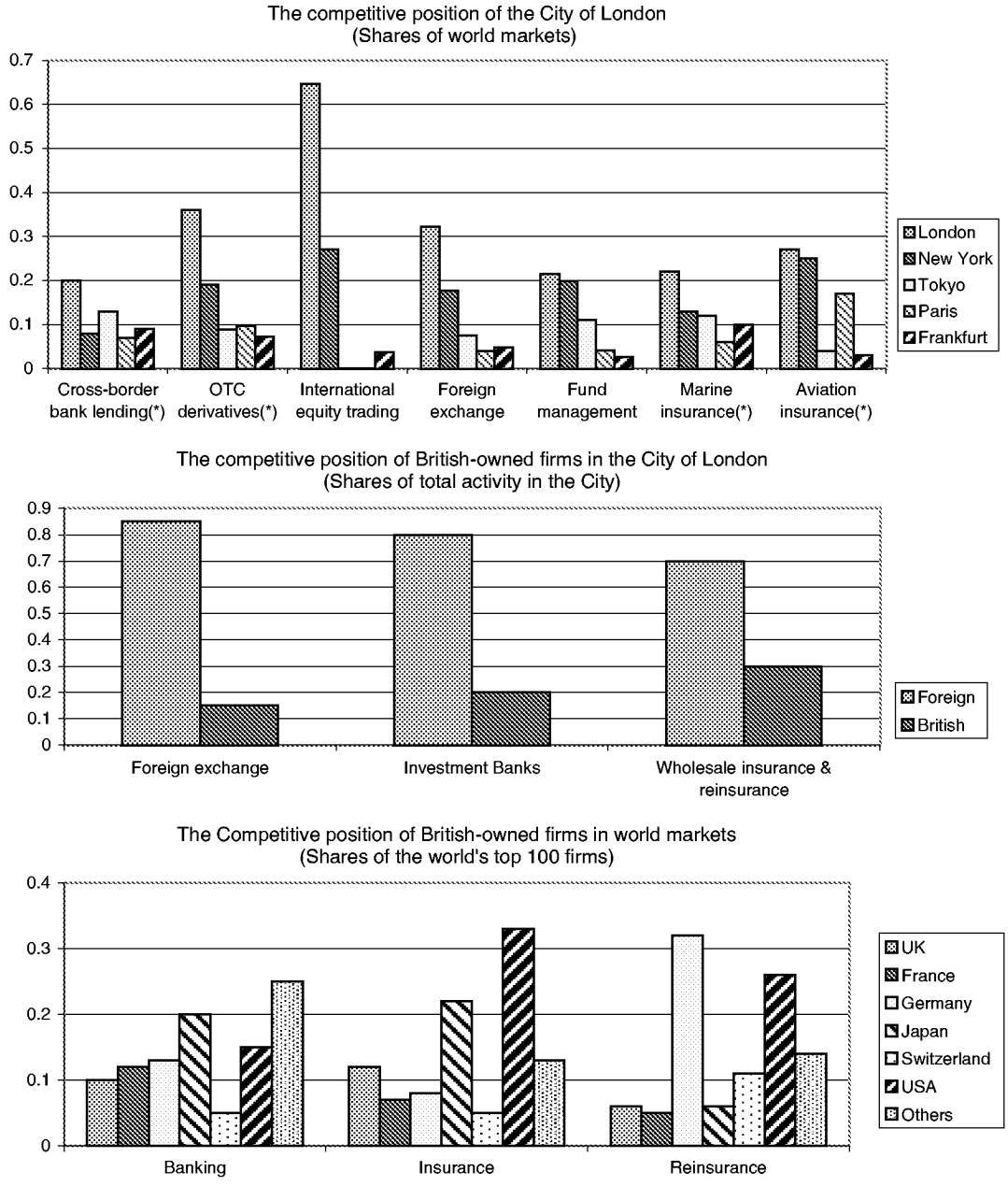

Figure 1. The competitive position of the City of London and of British-owned financial service firms, selected financial services, 1999–2000. (Sources: *British Invisibles*, *The Banker*, *Business Insurance*, *ReAction*, *Corporation of London*, *London Stock Exchange*)

case and what are its implications beyond those related specifically to the City of London? Does it imply that nationality does not matter in this sector? Or in global competition in general? Or rather that there is some specific weakness of British-owned firms in their inability to take advantage of their privileged access to the advantages of London as a location for financial services activity?

In the next section, I introduce a theoretical framework that distinguishes between various types of advantages of MNEs, which are assumed to affect the strength of the LOF, and advance research hypotheses related to the expected impact of foreignness on them. I also hypothesize on the impact of a number of the moderating factors on the link between these advantages and the LOF.

THEORY AND HYPOTHESES

The theory of the MNE's advantages implicitly or explicitly distinguishes between several types of advantages that together shape the competitiveness of MNEs. These are the firm-specific advantages (that arise from the possession of certain intangible capabilities); the multinationality advantages (the advantages associated with multinational activity per se); and the home-based advantages (that arise from the exclusive access of firms to the resources and conditions in their home countries). The possession and strength of these advantages determine the competitive position of MNEs. I argue that the strength and extent of the LOF will vary for each of these advantages.

Firm-specific advantages

Drawing on industrial organization theory, Hymer (1960) was the first to acknowledge implicitly the need for some proprietary advantages as a necessary condition for foreign activities. These advantages are based on the possession and use of certain intangible assets, such as patents, trademarks, management skills, etc., which enable the firm to reach high levels of technical or price efficiency (Caves, 1996). These intangible advantages of MNEs are the mechanisms that foreign firms use to compensate for the lack of access to local resources and for the additional costs associated with doing business abroad. They are mobile geographically and are transferred internally within the MNE across national borders. Hymer was explicit in acknowledging that these are the areas in which foreign firms have advantages that are superior to those of local firms, and these enable them to compete successfully in foreign countries. Formally:

> *Hypothesis 1a: Foreign firms outperform British-owned firms in the firm-specific advantages, and these advantages eliminate the LOF.*

Advantages of multinationality

Dunning accepted the need for the firm-specific advantages, of the industrial organization tradition, and added to these the advantages that arise from multinationality per se (see Dunning, 1993, for a comprehensive summary). While the former are required for the competitive success of any firm, regardless of the geographic scope of its activity, the latter are confined to multinational firms, and arise directly from the ability to benefit from the cross-border dimension of activities undertaken under common governance. They are associated with the coordination of multiple and geographically dispersed value-added activities, the ability to access resources in different locations, obtain information from multiple environments, spread risk, and benefit from economies of scale and scope arising from large-scale production. Foreign firms investing in the City, all of whom are by definition part of international networks, possess more of these advantages than their British-owned counterparts, some of whom only operate locally. Formally:

> *Hypothesis 1b: Foreign firms outperform British-owned firms in advantages of multinationality, and these advantages eliminate the LOF.*

Home-based advantage

The theory of the MNE states that in addition to the competitive advantages that distinguish individual firms from their national and foreign competitors, MNEs also possess advantages that arise from their favorable access to the resources of their home countries (Dunning, 1979; Hu, 1992; Nachum, 1999). For example, countries with a highly skilled labor force will facilitate the development of technological capabilities of national firms; those with an abundant supply of cheap labor will encourage the development of advantages related to labor intensity. The bundle of competitive advantages of an MNE thus consists of competitive advantages that are partly shaped by the resources of the home country and those resulting from the strategic behavior of firms, which may not be directly related to the characteristics of their home countries.

Hymer is explicit in emphasizing that national firms enjoy favorable access to the resources of their home countries, arising from reasonable and unreasonable preferences by employees and investors towards their own country firms. More recent research has shown that foreign firms are at a considerable disadvantage here and that their ability to build their competitive advantages by accessing assets abundant in other countries via foreign investment is limited (Nachum, 2000a; Thomas and Waring, 1999). Hence, we can expect

national firms to possess more of the advantages that arise from the utilization of the resources of their home countries.

The case for expecting the home-based advantages to give firms superior advantages over foreign firms is particularly strong when the country concerned is locationally advantageous in comparison with the home countries of the investing firms. The advantageous locational assets provide national firms a strong basis for competitive advantages that foreign firms do not have. Given the considerable location advantages of London *vis-à-vis* the majority of the home countries of the firms investing in London, we can expect British-owned firms to outperform foreign firms in London in the home-based advantages. Formally:

Hypothesis 1c: British-owned firms outperform foreign firms in the home-based advantages, and these advantages strengthen the LOF.

The relative importance of the various advantages

The nonexistence of the LOF in the City of London may suggest that in this particular context the firm-specific advantages and the advantages of multinationality are more important for competitive success than those arising from access to the home-based advantages. Hence, the advantages provided to British firms from their favorable access to the latter cannot compensate for the superior advantages of MNEs in terms of the firm-specific advantages and advantages of multinationality.[3] Formally:

Hypothesis 1d: The firm-specific advantages and the advantages of multinationality possess more explanatory power for the relative performance of foreign firms vis-à-vis British firms than the home-based advantages.

Moderating variables

The literature on the LOF acknowledges a number of moderating variables that are likely to affect the strength of the LOF. Using the distinction between the different types of advantages introduced above, I link these moderating variables with specific elements of competitive advantages on which they may have impact.

Duration of foreign operation

There appear to be two different reasons for the LOF to weaken over time as a function of the duration of foreign operation. First, some of the additional costs associated with foreign operation tend to diminish over time. Hymer (1960/1976) distinguished between two types of costs incurred by firms investing in foreign countries: the costs of acquiring information on foreign markets, and those incurred as a result of discriminatory policies of local governments, consumers, and suppliers. While the latter may not change over time, the former are likely to diminish, as firms become more familiar with the foreign environment. Over time, foreign firms are likely to get easier access to the resources of the host country and develop their competitive advantages based on them, in a manner similar to local firms. A number of empirical studies have confirmed these theoretical arguments and have shown that the differences between foreign and domestically owned firms tend to diminish over time (Mezias, 2002; Zaheer and Mosakowski, 1997; Tschoegl, 1987).

The second reason for expecting the LOF to weaken over time is that the superior firm-specific advantages of MNEs lose some of their superiority via spillovers and imitations or appropriation by local competitors (Zaheer and Mosakowski, 1997). Hymer referred to the diffusion of firms' advantages over time via demonstration effects that induce local firms to follow the example of foreign firms and imitate their operating routines and technologies. Formally:

Hypothesis 2a: Length of operation weakens the LOF by enabling foreign firms easier access to the host country resources.

Hypothesis 2b: Length of operation weakens the LOF via its impact on the dissipation of the firm-specific advantages.

Cultural distance between the host and home countries

The greater the differences in political, legal, socio-cultural, and economic institutions between

[3] It might also be that British-owned firms do not take advantage of their better ability to access the home-based advantages, and hence these do not support their competitive position. Since the focus here is on foreign firms, and British firms are only used for comparison, this cannot be tested.

the home and host countries, the greater the disadvantages that foreign firms are likely to have *vis-à-vis* local ones (Miller, 2001; Miller and Parkhe, 2002). Cultural distance increases both the difficulty of understanding and interpreting local requirements, and the extent of the adjustments required in order to compete successfully in foreign environments (Kostova and Zaheer, 1999).

Such impact is likely to be exercised in two ways—first, by eliminating the ability of an MNE to effectively transfer the firm-specific advantages to the affiliates. Studies have shown that the cultural distance between the home and host countries is negatively related to the transfer of the parent's practices to the affiliates (Rosenzweig and Nohria, 1994) and to the intensity of the linkages between them (Rosenzweig and Singh, 1991).

Second, cultural distance is also likely to reduce the ability of a foreign entrant to access host country resources and to build its advantages based on them. In support of this, Zeile (1998) found that the use of domestic content by foreign affiliates in the United States is related negatively to the cultural and institutional distance between their home countries and the United States. Zeile suggests that cultural distance between the home and the host countries may very well constitute a barrier that makes it more costly for the affiliates to contract with U.S. suppliers for their immediate inputs. Formally:

Hypothesis 3a: The greater the cultural distance between the host and home countries, the stronger the LOF, due to difficulties associated with the transfer of the firm-specific advantages.

Hypothesis 3b: The greater the cultural distance between the host and home countries, the stronger the LOF, due to difficulties associated with access by foreign firms to the host country's resources.

Entry mode

Entry mode, whether via greenfield or M&As, is likely to affect the LOF in two different directions. On the one hand, there is a far weaker basis for expecting MNEs to experience the LOF when they enter foreign markets via the acquisition of a previously independent local firm. Such an entry mode is likely to eliminate the difficulties of accessing host country resources and building competitive advantages based on them. The disadvantages arising from lack of knowledge of the foreign environment are weaker, as MNEs are able to draw upon the knowledge of the acquired firm. Also difficulties associated with discrimination of various kinds are usually weaker, when the acquired firm has previously enjoyed a status of a local firm. An affiliate established via M&A is likely to gain legitimacy and appear less foreign (Kostova and Zaheer, 1999) than one founded *de novo*.

At the same time, however, entry via M&As is likely to impede the transfer of the firm-specific advantages to the foreign affiliates (Rosenzweig and Singh, 1991; Rosenzweig and Nohria, 1994), acting to strengthen the LOF. When affiliates are founded as greenfield investments the MNE usually seeks to replicate key features of the parent company, and shapes the new establishments to reflect its own capabilities. By contrast, affiliates established via acquisition are likely to maintain their identity and norms of operations that they had developed independently before the acquisition. Hence, there are usually more intense linkages and transfers between parent and greenfield establishments than between parents and acquired firms (Rosenzweig and Singh, 1991; Rosenzweig and Nohria, 1994). Formally:

Hypothesis 4a: Entry via M&As weakens the LOF by easing the access of foreign affiliates to the host country resources.

Hypothesis 4b: Entry via M&As strengthens the LOF by impeding the transfer of the firm-specific advantages.

Organizational structure

The organizational structure, notably the level of autonomy of the affiliates and the extent of their integration within the MNE of which they are part, are likely to affect the LOF in two different ways. Greater autonomy of affiliates may act to strengthen the LOF as this is likely to be associated with less transfer of compensating mechanisms between parents–affiliates. It is also likely to weaken the pressure to conform to the parent's organizational practices and its operating norms (Bartlett and Ghoshal, 1989), and facilitate the adaptation of host country practices (Zaheer, 1995; Rosenzweig and Nohria, 1994).

At the same time, however, greater autonomy of affiliates would facilitate their access to the host country assets, enabling them to base their advantages on these assets to a greater degree. Autonomous affiliates are more likely to develop intense local linkages and to rely to a greater degree on local resources (Rosenzweig and Nohria, 1994). Formally:

Hypothesis 5a: Greater autonomy to affiliates strengthens the LOF by eliminating the transfer of the firm-specific advantages.

Hypothesis 5b: Greater autonomy to affiliates weakens the LOF by facilitating access to the host country resources.

Figure 2 summarizes the theoretical framework and presents the expected direction of causality between the various components of competitive advantages, the variables identified to moderate their strength, and the LOF.

Operation of the constructs

The Appendix presents the measures used to operationalize the three types of advantages, the rationale for their choices, and their operation measures. It also presents the operation measures of the moderating variables, and descriptive statistics of the average performance of British and foreign-owned firms on each of these variables. For the most part these data confirm the differences hypothesized. On most variables, there are significant differences between foreign and British firms, and for the most part in the direction hypothesized.

The measures summarized in the Appendix are not likely to represent all possible advantages that a foreign or British-owned firm may possess that are important in explaining the differences between them. By including the major sources of advantages in this sector, however, I believe that this problem is minimized.

The variables summarized in the Appendix combine advantages at the level of the affiliates alone

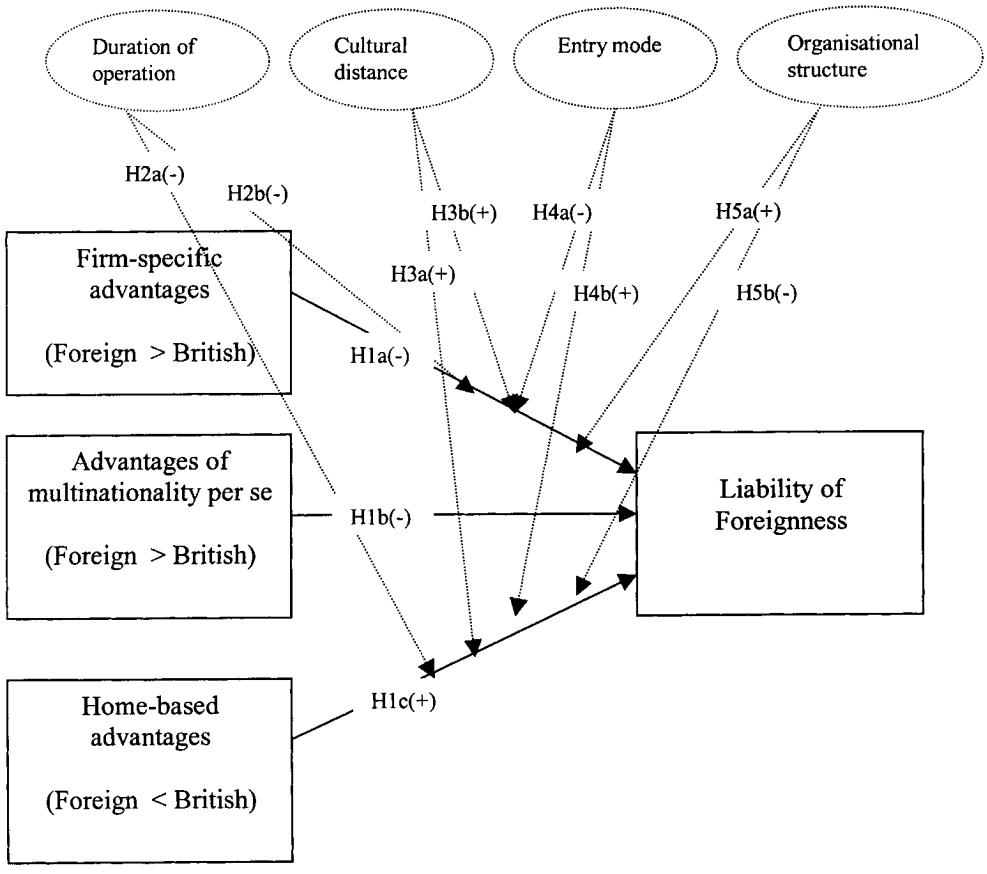

Figure 2. Advantages determining the strength of the LOF and moderating variables

and the MNE as a whole. The firm-specific advantages referred to are advantages of the MNE as a whole, which are transferred to the affiliates, and are shared by the entire MNE. The advantages of multinationality are only meaningful with reference to the MNE as a whole. In contrast, the home-based advantages refer to advantages that affiliates develop locally, on their own. The moderating variables largely belong to this category. These two levels of reference correspond to the LOF experienced by affiliates and the compensating mechanisms transferred to them by their parents.

I create a single measure for each of the three advantages by combining the standardized values (based on the mean and standard deviation of all firms in the sample) of the multiple operations used to measure them.[4] This is a commonly used procedure to operationalize multidimensional constructs, whose dimensions consist of measures of different scales (e.g., Law, Wong, and Mobley, 1998). There are a number of theoretical and technical reasons for favoring the use of such compound measures over the individual dimensions that comprise them. From a theoretical point of view, the hypotheses are formulated at the level of the overall advantages, explicitly referring to the three types of advantages, not to their individual dimensions. Technically, the use of compound variables reduces the number of explanatory variables and eases the interpretation of the findings, notably in the presence of the moderating variables. Furthermore, the individual dimensions are often highly correlated. While this poses a considerable difficulty if analyzed individually, it is not a problem if they are grouped into a single variable.

There are a number of ways to combine different dimensions into a compound variable. The choice between them has critical implications for the findings, as it specifies the relationships between the overall construct and its dimensions (Law *et al.*, 1998). The compound variables here are formed as an algebraic combination of their dimensions. Several other specifications were experimented with but were found less adequate, in the sense that they yielded lower goodness-of-fit in the analysis. Law *et al.* (1998) suggest assuming an identical weight for the different dimensions when the theories concerning the constructs provide no firm basis to assign varying weights. They further suggest assuming that given a lack of theoretical specification regarding the exact algebraic relation between the multidimensional construct and its dimensions, linear relationships should be assumed. Both suggestions are adopted here.

The control variables are hypothesized to affect the LOF via their impact on the three types of advantages, that is, the interest is not in their individual effect but in their moderating effect on the relationships between the advantages and the dependent variable. To test for these effects I create interaction variables, by multiplying the advantages concerned and the relevant control variables hypothesized to affect them. A significant sign of the interaction variables would imply that the link between the dependent variable and the advantage in question varies as a function of the value of the control variables (Schoonhoven, 1981; Aiken and West, 1991).

Table 1 presents descriptive statistics and correlation coefficients of the compound variables of the three advantages and the moderating variables.[5] Most coefficients are low (well under 0.5), enabling one not to be concerned about correlation.

METHODOLOGY

The hypotheses were tested on a sample of financial service firms operating in the City of London. For the purpose of this study the City of London was defined as the geographic area corresponding to the EC postal code area of central London (also known as the 'Square Mile'). This definition enables me to exclude from the research financial service firms whose activity is mostly domestic (notably retail business), who tend to be spread across Greater London. The issues addressed here are of limited interest with reference to retail business. The latter is overwhelmingly dominated by local firms, handling the domestic activity of domestic clients. In this market domestic firms have an unrivalled position, resulting from their well-established branch networks and long relationships with clients. It is very difficult for foreign

[4] I prefer this method over the alternative of factor analysis, whereby the factor scores summarize the information contained in individual variables, because I wish to impose a certain structure on the compound variables. The procedure chosen is more adequate for this purpose.

[5] Descriptive statistics and correlation coefficients of the individual dimensions that constitute the compound variables are available upon request.

Table 1. The independent variables included in the model, their operation measures, descriptive statistics and correlation coefficients

Constructs	Operation measures	Descriptive statistics		Pearson correlation coefficients						
		Mean	S.D.	Firm-specific	Multina.	Home-based	Duration	Cultural distance	Entry mode	Org. structure
Advantages (main effects)										
Firm-specific advantages	Compound variable[a]	2.055	1.7972	1.000	0.014 (0.807)	−0.004 (0.942)	0.031 (0.598)	−0.064 (0.288)	0.043 (0.459)	0.090 (0.210)
Multinationality advantages	Compound variable[a]	2.580	1.2580		1.000	−0.053 (0.500)	0.120 (0.124)	−0.178 (0.026)*	−0.019 (0.812)	−0.063 (0.513)
Home-based advantages	Compound variable[a]	1.230	1.6341			1.000	0.039 (0.506)	0.097 (0.108)	−0.014 (0.815)	0.006 (0.937)
Moderating variables										
Duration	Years since establishment	19.2048	24.6303				1.000	−0.058 (0.342)	−0.541 (0.000)**	0.008 (0.908)
Cultural distance	Index	15.4559	19.3693					1.000	0.034 (0.580)	0.040 (0.591)
Entry mode	Dummy (M&As; greenfield)	0.6881	0.4640						1.000	0.043 (0.547)
Organizational structure	Dummy (reporting)	0.2245	0.2083							1.000

* Correlation is significant at the 0.05 level (2-tailed).
** Correlation is significant at the 0.01 level (2-tailed).
[a] See text for explanation.

banks to penetrate this market, as for the bulk of financial services they have no advantage here (Tschoegl, 1987). The retail market is thus an inadequate context for a comparison between foreign- and domestically-owned firms.

Data for the analysis were drawn from a variety of secondary sources. Financial data were taken from the Fame DVD database, which provides detailed financial and accounting information regarding 1.8 million public and private U.K. firms registered in the United Kingdom, based on information gathered from company houses. Information on entry mode, ownership, and ownership changes was gathered from *The Bankers' Almanac, Major Financial Institutions in the World*, and *Britain's Top Foreign Owned Companies*. Information on the use of local currency was taken from *The Bankers' Almanac World Ranking* and on local linkages from *Crawford's Directory of City Connections*. Data related to the use of expatriates were taken from the ESRC study 'Expatriate staffing in international financial centres.' Additional data were taken from unpublished documents of the Corporation of London.

The Fame DVD database lists 1255 financial service firms as having their operating offices in the City of London, and their main business activities corresponding to the following 1992 U.K. SIC codes: 65 (financial intermediation, except insurance and funding companies); 66 (insurance and pension funding); and 67 (activities auxiliaries to financial intermediation). 487 of these firms are foreign owned;[6] that is, their registered headquarters are located outside Britain. 191 firms were excluded from this list because 30 percent or more of the data needed for the analyses were missing, leaving a sample of 296 firms. *t*-Tests found no significant differences between the excluded firms and those included in the study in terms of number of employees and total assets ($p < 0.01$ and $p < 0.05$ respectively). About 54 percent of the sample firms are classified under SIC 6523 (other financial intermediation n.e.c.) as their main area of activity. Another 18 percent and 15 percent are classified as SIC 6601 (life insurance) and SIC 6603 (non-life insurance) respectively. The remaining firms are distributed quite evenly between the other financial service industries (4-digit SIC). The differences in sample size across the various financial service industries mirror the relative magnitude of activity in the different industries.

In order to test the hypotheses, a model was constructed, using the performance of foreign firms relative to British firms as the dependent variable, and the set of advantages identified above as the independent variables. The model is of the general form:

$$P_f / \left[\sum_b P_b / b \right] = f(Af_f; Am_f; Ac_f; (Af_f \times C_f); (Am_f \times C_f); (Ac_f \times C_f)) + E_f$$

where

P = Performance
Af = Firm-specific advantages
Am = Multinationality advantages
Ac = Home-based advantages
C = Control variables
E = Random error term;
b = British-owned firms ($b = 1, \ldots, m$)
f = Foreign-owned firms ($f = 1, \ldots, n$)

In constructing the dependent variable I follow Zaheer (1995) and take the performance of a foreign firm in relation to the average performance of British-owned firms in its 4-digit industry in the City as an indication of the foreign firm's LOF. Return on capital was selected as a proxy for performance because it is a most commonly used performance indicator in financial service industries (e.g., Barber and Lyon, 1996).

Independent sample *t*-tests on the remaining missing observations suggested that the missing value patterns were not random, and they were estimated based on existing observations. The model resulting from an estimation based on all observations for which the dataset was complete was used to estimate missing values. This analysis was repeated separately for each variable with missing observations.

EMPIRICAL ANALYSIS

Moderated multiple linear regression, a commonly used method to test hypotheses that predict interaction effects between variables (e.g., Schilling and

[6] The database covers only firms registered in Britain as limited companies. It thus underestimates the total number of foreign-owned firms in the City, since foreign affiliates operating in Britain under different arrangements are not included.

Table 2. A model linking competitive advantages, moderating variables and the LOF

Variables	Model 1			Model 2			Model 3		
	β(Unstand.)	t-Values	VIF	β(Unstand.)	t-Values	VIF	β(Unstand.)	t-Values	VIF
Advantages (main effects)									
Firm-specific advantages (FA)	0.221	2.381**	1.019	0.261	2.359**	1.006	0.996	1.608*	9.472
Multinationality advantages (MA)	0.696	3.225***	1.023	0.238	2.983**	1.024	2.098	2.525**	7.354
Home-based advantages (HA)	3.245	0.207	1.004	−8.372	−0.672	1.008	−0.340	−1.127	1.441
Moderating variables									
Duration	—	—	—	8.143	0.861	1.367	6.765	0.733	1.415
Cultural distance	—	—	—	2.478	0.229	1.486	3.857	0.365	1.540
Entry mode	—	—	—	0.516	1.636*	1.540	0.459	1.508†	1.557
Organizational structure	—	—	—	6.443	0.127	1.319	8.045	0.160	1.408
Interaction variables									
FA* Duration activity	—	—	—	—	—	—	2.023	1.296	1.909
FA* Cultural distance	—	—	—	—	—	—	3.895	1.950†	7.916
FA* Entry mode	—	—	—	—	—	—	−0.729	−2.381**	6.556
FA* Organizational structure	—	—	—	—	—	—	0.219	0.358	1.486
HA* Duration activity	—	—	—	—	—	—	2.461	1.329	5.820
HA* Cultural distance	—	—	—	—	—	—	1.220	0.991	8.106
HA* Entry mode	—	—	—	—	—	—	2.886	2.125**	1.515
HA* Organizational structure	—	—	—	—	—	—	−0.274	−0.602	1.635
Adj. R^2	0.375			0.398			0.469		
Sig. F	0.004			0.003			0.001		
N	296								

*** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$; † $p < 0.10$

Steensma, 2002; Hox, 1994) is used for estimating the model (Table 2). As is common in this procedure, the analyses start by estimating the model with the main effects only (Model 1). The moderating variables are then added on their own (Model 2), and at the final stage the interaction variables are included (Model 3). The moderating variables were hypothesized to affect the dependent variable only in interaction; that is, no individual effect was hypothesized, but the interpretation of the interaction effects requires that the corresponding variables are included in the model on their own (Hox, 1994).

Although the correlation coefficients between the explanatory variables were relatively small in most cases (see Table 1), it does not ensure a lack of multicollinearity between the independent variables (Hair *et al.*, 1995). Hence, the variance inflation factor (VIF), which indicates the degree to which each independent variable is explained by the other independent variables, was also calculated. All variables are below the suggested cut-off point of 10 (Studenmund, 1992).

The data presented in Table 2 provide strong support for the need to distinguish between different types of advantages when analyzing the LOF. The different advantages vary considerably in terms of their explanatory power for the relative performance of foreign and British firms. When analyzed in this way it becomes apparent that the lack of the LOF in the City is not a paradox with existing theory, but rather signifies a need to extend and develop more refined tools to deal with it (Poole and Van de Ven, 1989).

Hypotheses 1a and 1b, referring to the firm-specific and multinationality advantages respectively, are strongly supported. Both variables are highly significant and in the direction hypothesized in the three models. Furthermore, the regression coefficients of these variables are stable

between the three models. The inclusion of the interaction variables does not change significantly the sign and significance of these variables. The somewhat weaker explanatory power of the firm-specific advantages and multinationality advantages in Models 2 and 3 is probably due to the addition of the moderating variables.

Of the three types of advantages, the multinationality advantages are the most significant, a finding that seems associated with a number of characteristics of financial services. First, the potential for economic benefits from information generated internally on a global level is particularly large in financial services, and hence the ability to gather information globally is likely to be a critical source of advantage (Zaheer and Mosakowski, 1997). Firms with operations in many countries can arbitrage this information through internal communication channels. The larger the share of a firm's foreign activities and the more diverse its linkages, the lower the cost of acquiring information on currencies and the management of risk. Better too would be its ability to meet the demand for multi-currency, multi-country lines of credits and for management of international funds (Brealey and Kaplanis, 1996). An MNE with an international network is thus able to make a more accurate assessment of the risk involved in lending and doing business. Second, in financial services there is a special advantage in the ability to trade continuously around the clock (Zaheer, 2000). International reach enables firms to cover all time zones (Zaheer, 2000), a condition for such activities.

No support, however, is found for the anticipated impact of the home-based advantages (Hypothesis 1c). This variable is not significant in the three models, implying that the home-based advantages do not provide British-owned firms with a competitive edge over foreign firms. This was the only type of advantages in which British firms were hypothesized to outperform foreign firms, that is, the only source of potential LOF. As these advantages are less important, there is no reason to expect LOF. In support of Hypothesis 1d, the lack of LOF in the City indeed indicates that the home-based advantages are less important in this context. Another possibility to explain the findings, which should not be ruled out, is that there are no differences between foreign and British firms in their use of the location advantages of London, and hence these possess no explanatory power for the differences between them. A formal test of this suggestion requires comparing samples of these two populations, which is not possible in this study design.

Taken together, these findings support the suggestion that globalization is eroding the impact of nationality, rendering differences related to nationality—on which the entire LOF argument lies—less important determinants of competitive position (McKendrick, 2001; Nachum, 1999). The processes of globalization yield considerable value to advantages of multinationality per se, and appear to eliminate the value of the home-based advantages. The latter are location bound, and have limited value when competition is taking place on a global basis (Rugman and Verbeke, 1992).

Only a few of the interaction variables are significant, and their inclusion in the model slightly improves its overall explanatory power. Hypothesis 2 is rejected in all its variations; that is, the interaction variables that involve duration of activity in the City are not significant. However, the interaction variables were constructed based on the assumption that the interactions are linear (Schoonhoven, 1981) but this assumption may not hold with reference to duration of activity. Zaheer and Mosakowski's (1997) analysis of the changing LOF over time provides a basis for assuming nonlinear relationships between duration of activity and the LOF. To test for the possibility of such relationships, I add to the regression squared elements of the interaction variables with duration. Both squared measures are significant ($p < 0.01$ and $p < 0.05$ in the interactions with firm advantages and home advantages respectively) and the overall explanatory power of the model increased (adj. $R^2 = 0.437$, $F = 0.002$).

The history of foreign investment in the City may provide an explanation for this finding. Foreign financial service firms have been operating in the City since the early nineteenth century, initially originating from Commonwealth countries, then from European countries, and towards the end of the nineteenth century and early twentieth century from the United States (King, 1990; Coakley, 1992). However, the overall magnitude of foreign activity in this period was quite limited: by 1914 there were about 30 foreign banks in the City (King, 1990). It was in the decades following the Second World War that foreign activity increased considerably. The number of U.S. banks—the

dominant foreign investors in this period—rose from 7 in 1959 to 68 in 1968 (London Business School, 1995). This dramatic growth by U.S. firms was followed by European firms in the 1970s and Japanese firms in the 1980s. The number of staff employed by foreign banks in the City rose from 38,000 in 1983 to 72,000 in 1987 (King, 1990). After the stock market crash of 1987 there was an equally drastic reduction, and London was hosting declining numbers of foreign financial service firms (London Business School, 1995). Thus, while there is a long history of foreign presence, many of the foreign firms operating in the City today established themselves in the late 1980s and early 1990s. This wide variation in terms of the duration of activity is confirmed by the standard deviation of duration in the sample (Table 1). The significant explanatory power of the squared expression of the interaction variables suggests that only the recently established firms experience the LOF, while older investors have long overcome these difficulties. This is consistent with the findings reported by Zaheer and Mosakowski (1997) in relation to foreign firms in New York and Tokyo.

Cultural distance has a moderate effect on the transferability of the firm advantages and no effect on the ability to access the home-based advantages (Hypotheses 2a and 2b respectively). The limited explanatory power of the interaction variables with cultural distance for variation in the LOF might be attributed to the national origin of the foreign firms operating in the City. The majority of these firms originate from countries similar to Britain in terms of their locational advantages and structure of demand. For example, about three-quarters of the foreign members of the British Fund Managers Association are affiliates of European and U.S.-headquartered corporations (Fund Managers' Association, 2000). Likewise, 85 percent of the assets of foreign banks in the United Kingdom are controlled by American, Japanese, and European banks (British Invisibles, 2000). This eliminates many of the differences associated with the home-based advantages (Miller, 2001) that undermine the notion of cultural distance. This is consistent with the previous findings regarding the limited value of the home-based advantages in competition in the City of London, eliminating the importance of any differences resulting from national origin. Another possible explanation, which is in support of this, might be that the firm-specific strength overcomes the advantages provided by the cultural distance between the home and host countries, making the cultural distance less relevant (Shenkar, 2001).

The most significant interaction variables are those with entry mode, notably the interaction with the home-based advantages. As hypothesized, entry via M&As eases the access of foreign firms to the home base advantages. The negative sign of the interaction with the firm advantages supports the hypothesis that it also eliminates the transfer of the MNE advantages to the affiliates.

The organizational structure by MNEs has no effect on the strength of the LOF, providing no support for Hypothesis 5. This finding might be attributed to the central position held by many London affiliates, who often hold responsibility for the entire global operation of the MNE of which they are part. The position of London as a center of international activity often puts these affiliates in a better position to manage the international operations of their corporations than the headquarters. Many Japanese as well as other Asian firms establish operations in London with the explicit objective of managing their global operations from there (Hawawini and Schill, 1994; Warner, 1991, Newall, 1996). U.S. financial service MNEs often maintain in the U.S. headquarters the responsibility for the domestic U.S. operations, while the London office handles the entire global operations. Other City affiliates act as the regional headquarters for the European operations of the MNEs of which they are part (London Business School, 1995). Under such circumstances, the London office enjoys considerable autonomy and is likely to be well embedded in the host environment, eliminating the importance of organizational structure in explaining variation in the LOF.

Robustness tests

A number of tests were conducted to validate the findings reported in Table 2. The results of these tests are available upon request. First, the return on capital, which was used to measure performance, may suffer some limitations, resulting from profit shifting and transfer pricing by MNEs. Multinational firms tend to 'play around' with their profits, as a way to avoid taxes, and often do not declare their profits in the place where they were actually gained (Demirguc-Kunt and Huizinga, 2001).

They may also use transfer pricing as a mechanism to show higher profits in low-tax locations. To test whether such profit-shifting practices affect the results I estimate the model with alternative dependent variables. These include Tobin's q (defined as: (equity + stock + debt)/assets) and stock exchange performance (return per share). These measures are likely to be free of the profit-shifting problem because income shifting is supposed to be reflected in the market evaluation of firms. The results continue to hold.

Second, I examine the possible impact of the national origin of foreign firms in the City on the findings. It has been convincingly argued that under certain circumstances foreignness may be an advantage, not a disadvantage (Kostova and Zaheer, 1999; Shenkar, 2001). Certain cultures are considered attractive to other cultures, causing individuals and firms to try to imitate rather than reject them. To test for a possible impact of such perceptions on the results, I split the sample into two subsamples, based on the level of economic development of the home country of the firms concerned *vis-à-vis* the UK. The level of development of the home vs. host countries has been suggested as a major determinant of the perception of foreignness (Miller, 2001). The hypotheses are confirmed for the two subsamples, although the level of significance for the sample of countries at a lower level of development than the United Kingdom is slightly lower, but this might be attributed to the smaller degrees of freedom.

Third, I test for the sensitivity of the results to the presence of indigenous firms in the British population. Many of the hypotheses advanced here might be sensitive to the combination of multinational and indigenous firms in the British population, which was used as the dominator for the calculation of the dependent variable. To test for potential bias that might be introduced by this, I exclude all purely indigenous firms, and calculate the dependent variable based on the performance of British MNEs only. The results continue to hold.

Fourth, I test the robustness of the estimation results after eliminating outliers (McClelland, 2000) on the dependent variable. The presence of 'abnormal performance' was recently acknowledged as a potential bias of research that relies on performance measures (Barber and Lyon, 1996). The hypotheses are confirmed at similar significance levels for the reduced sample.

CONCLUDING REMARKS

This research has sought to extend the theory of the LOF by explicitly acknowledging the possibility of its nonexistence. Empirically, it is based on a study of the financial service sector in the City of London, whereby the superior competitive position of foreign firms relative to that of local ones does not conform to the prediction of existing theory. In order to understand this departure from theory, and its implications beyond the specific setting of the City of London, a close look was taken at the causes of the LOF. A theoretical framework was introduced, which distinguishes between different types of advantages that determine the relative performance of MNEs *vis-à-vis* domestic firms and hence the degree of the LOF. Rather than taking the existence of the LOF as given, and searching for the firm and environmental characteristics that affect its strength and persistence (e.g., Miller and Parkhe, 2002; Mezias, 2002), I put the mere existence of the LOF at the center of the analysis. I am thus able to identify the variation that arises from the nature of the advantages and the underlying characteristics determining the LOF itself.

The theoretical framework advanced here enables one to understand what are the sources of the superior competitive position of foreign firms in the City: whether they arise from the superior firm-specific advantages of MNEs, who may compensate for foreign firms' disadvantages; or else that nationality does not affect the ability of firms to access host country resources; that is, the home-based advantages are of limited importance. The findings show that when examined in this way, the nonexistence of the LOF in the City of London is not inconsistent with existing theory, but rather signifies a need to expand its scope (Poole and Van de Ven, 1989), to accommodate cases whereby the LOF does not exist. This is achieved by taking a more refined look at the causes of the LOF and acknowledging systematically the plurality of the components comprising it.

This theoretical framework was also shown to have considerable merit when used to analyze a number of moderating variables, which were proposed in the LOF literature as affecting the strength and persistence of the LOF. It enabled me to examine the multidimensional impact of these variables, and to show their impact on different types of advantages, often in different directions. These moderating variables were shown to influence only

particular aspects of the LOF and have only limited or no impact on others. However, most of the moderating variables tested here were insignificant, excluding most of these explanations for the lack of the LOF in the City of London.

The findings of the study have important implications for managers of MNEs. They imply that the LOF does not apply to all foreign activity a firm may undertake, but rather is likely to vary in line with the type of advantages an MNE possesses and those that are important in competition in different settings. Foreign expansion may thus not always be associated with additional costs to those incurred within the home country. The need for compensating mechanisms to overcome the LOF in order to compete successfully, which has been emphasized in the literature (e.g., Zaheer, 1995; Mezias, 2002), may not be an obstacle to all foreign operations. Rather, there is a need for a careful evaluation of the specific context of foreign expansion, and an assessment of the extent to which the LOF is likely to be experienced there.

Another important lesson to managers is that the LOF is not a unified concept but rather has a number of components, with considerable variation across them in terms of a firm's ability to influence them by way of strategic positioning. The implicit assumption in most discussions of the LOF is that they are determined by forces external to firms, on which firms have no control (see Miller and Parkhe, 2002, for a representative approach). In contrast, underlying the approach taken here is the implicit assumption that firms can partly manipulate the strength and persistence of the LOF. The home-based advantages of local firms are advantages on which firms exercise no individual control, but the firm-specific advantages and the advantages of multinationality are subject to the strategic maneuver of firms, and can be manipulated to lessen the impact of the LOF.

An important task for future research which emerges from this study is to examine the validity of the findings reported here in different contexts. There is a need to establish the extent to which these findings are unique to financial services in the City of London, or else characterize certain specific geographic and/or industrial settings. If the latter, another important task for future research would be to identify these settings.

The most immediate candidates for such generalizations are other global financial centers. The literature on global financial centers introduces a hierarchy of centers whereby London, New York, and Tokyo are recognized to form the top (Roberts, 1994; Sassen, 1991). Their common characteristics, which set them apart from other financial centers, are their centrality and the global reach of their financial ties. Yet, these financial centers differ in a number of important aspects that may impede generalizations even to these seemingly similar contexts. First, the shares of activity controlled by foreign ownership are higher in London than in Tokyo and New York. For example, the number of foreign banks in London is 537 compared with 275 and 93 in New York and Tokyo respectively (Corporation of London, 2000). It is likely that in the presence of other foreign firms the liability of being foreign is weaker (Zaheer and Mosakowski, 1997). Second, and related to the first, London handles more international activity than New York and Tokyo. While London specializes in international activity, New York and Tokyo have built their strength upon their domestic economies (Morgan, 1997), and they are dominated by domestically headquartered firms (Tschoegl, 1988). The third characteristic that appears to distinguish London from Tokyo and New York is the policy attitude towards foreign ownership. British policies have been more liberal than those of American and certainly Japanese governments (Tschoegl, 1988), and for the most part have made no distinctions by nationality in their policies (Morgan, 1997). This has eliminated many of the forces creating the LOF in London.

A second direction, which is closely related to the first, is to test the possible generalization of the findings to global cities in general. Global cities are distinguished from other locations by their high levels of global links, hosting high proportions of foreign firms and individuals. Their dynamics are driven by the global economy rather than by local or national economies, and they tend to be linked with each other more than with the national economies that host them (Pred, 1980; Sassen, 1991, 1999). It might be that this specific context gives rise to somewhat different sources of advantages and affects differently the existence and strength of the LOF. The notions of the home-based advantages and differences associated with nationality—on which the LOF lies—may not hold in this context. Likewise, the additional costs incurred from running global networks may not be a liability because having such networks is a condition of operating in this context and hence

these costs are incurred to all participants (Sassen, 1999).

Finally, there is also a need to examine the possible generalization of the findings reported here to other sectors and industries. Most analyses of the LOF thus far, including the present one, have focused on financial services. These services exhibit a unique configuration of local linkages and nationality influences that may impede generalizations to other sectors and industries. In some respects, notably the ease with which financial information is transferred over distance, they are subject to a greater degree than other sectors to the influences of the forces of globalization, which eliminate differences associated with national origin (O'Brian, 1992; Darlington, 1998). Furthermore, competitive position in many financial services is determined on a global level, reflecting the ability of firms to meet certain conditions of entry and price, which are set on a global scale (Sassen, 1999; Morgan, 1997). At the same time, however, certain advantages and disadvantages of financial service firms seem to be closely associated with national origin, and are difficult, if not at all impossible, to replicate by foreign firms. Studies have repeatedly shown that the growth of financial service firms is closely related to the growth of the economy of their home countries (Benston, 1990; Hawawini and Schill, 1994), and that firms often have an advantage in deals involving their home country currency (Smith, 1992; Brealey and Kaplanis, 1996). Furthermore, financial services are a major target of national government regulations, acting to stress national differences (Steinherr and Huveneers, 1994), making a firm's home-base a vital determinant of its competitive position.

The theoretical framework advanced here, based on the relative importance of the different types of advantages to determine the LOF, is likely to provide a useful framework for testing the validity of the findings to different contexts. For example, when an industry is subject to a considerable amount of international competition, and international competition is taking place on a global (rather than multidomestic) level, the advantages of multinationality are likely to be the most important, and the LOF less significant. Under such circumstances firms derive advantages from the international scope of their activities through learning and access to resources, and this eliminates the value of the home-based advantages. By contrast, in industrial and/or geographic contexts in which the home-based advantages are particularly valuable the LOF is likely to be most significant.

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APPENDIX: OPERATIONS OF THE CONSTRUCTS AND DESCRIPTIVE STATISTICS

Firm-specific advantages

1. *Intangible assets*. The possession of certain intangible assets, such as goodwill, innovative capabilities, trademarks, publication rights, and brand names, is conceptualized in the international business literature as a necessary attribute of MNEs (Caves, 1996; see also Delios and Beamish, 2001). The possession of such assets is operationalized here by the value of a firm's intangible assets (expressed as share of total assets).
2. *Financial strength*. Solid financial base is a critical advantage for firms dealing with the finance of risk, as it provides them with a better ability to meet their financial obligations. It signals financial security and thus makes firms more attractive to clients (Hirtle, 1991). Two indicators of financial strength are used here:

(1) liquidity ratio: the ratio between current assets and current liabilities; and (2) credit rating: this provides an indication of financial stability and capacity of a company, and is often used as the ultimate indication of creditworthiness.

3. *Size*. Large size is an advantage in the gathering and processing of information, as it reduces the unit cost of acquiring information (Brealey and Kaplanis, 1996; Hirtle, 1991). Larger financial service firms can attract large clients and handle the management of large portfolios of financial instruments, and those tend to be more profitable (Steinherr and Huveneers, 1994). The wave of mergers and consolidation that has swept the financial services sector in the last decade, and the sheer volumes involved in these deals (*The Banker*, 1998), suggest that size does convey considerable advantages. Total assets is a most commonly used measure of size in financial services (e.g., Barber and Lyon, 1996) and it is used here.
4. *Managerial skills*. As the services provided by financial service firms are becoming increasingly similar (largely a result of technological advances), the effective management of resources, which allows firms to compete on price, is becoming an important source of differentiation. Furthermore, in the past, firms in many financial service industries were operating in noncompetitive environments, protected by regulation. With increased competition, managerial skills, directed towards the efficient utilization of resources, have become critical. Finally, the increased size and sophistication of the activities of many financial service firms, in terms of both their geographic and product coverage, put high demands on managers and require specific managerial skills. Directors' remuneration (as share of total remuneration) is used to operationalize management skills. Pay levels for directors in the City of London have risen considerably, and although there is a debate as to whether these indeed pay off (*Financial Times*, 2000), the willingness of firms to pay their directors so handsomely suggests that they see a link between these compensations and the performance of managers.

Advantages of multinationality

1. *Intensity of international activity*. The intensity of activity is taken as a proxy for the possession of advantages of multinationality (Dunning, 1993). The number of foreign offices a firm controls is used as an indicator of the intensity of international activity. The more commonly used measure—share of foreign sales (Sullivan, 1994)—is only available for a small number of observations in the sample. However, the correlation coefficient between the two measures for the small number of observations for which both measures are available is very high (0.91, $p < 0.01$), enabling one to accept the number of foreign offices as an adequate measure.
2. *Internal linkages*. The access of affiliates to the stock of information and commercial knowledge possessed by the network of the organization of which they are part provides them with considerable advantage over indigenous firms, who are deprived of such sources of information (Zaheer and Mosakowski, 1997). The extent to which affiliates benefit from advantages of multinationality in the form of access to information of the network depends on the intensity of their linkages with the parent company and the rest of the MNE of which they are part. Share of profits transferred by the affiliates to the parents is taken as a proxy for the intensity of the linkages between them. Internal transactions, measured by financial (Kobrin, 1991; Nohria and Ghoshal, 1997) or information (Mezias, 2002) transfers, are often used as indicators of the strength of the relationships between affiliates and headquarters. This is measured here by a dummy variable that gets four values indicating different levels of profits transfer as shares of total profits earned.

Home-based advantages

1. *Access to local information*. Zaheer and Mosakowski (1997) have convincingly argued that in financial services the main type of advantages that national firms enjoy over foreign firms are those related to the local information flows provided by local customers, other firms in the industry, and national central banks. Foreign firms are likely to be in a considerable disadvantage *vis-à-vis* local ones in this respect, arising from them not being sufficiently embedded in the information networks in the country of location (Shukla and van Inwegen, 1995). The number of local

links a firm establishes with other firms in the City (including insurance, stockbrokers, financial advisers, auditors, solicitors, major shareholders) is taken as an indication of its access to local information.

2. *Preference of local customers.* An important source of the LOF, which was highlighted already by Hymer (1960/1976) and in many discussions since, lies in the preference of local customers for domestic firms, with whom they have long-established relationships and who are usually perceived to have more stable and reliable links to their home country. A direct measure of the preference of local customers is not available and I use the share of activity in British pounds in total activity to capture this potential source of advantage of British firms. Local customers are likely to have greater shares of their transactions undertaken in their home currency than foreign customers, thus providing a reasonable proxy for the share of local customers serviced by firms.
3. *Reliance on local resources.* Local firms are likely to have easier and more favored access to their home country resources, such as local suppliers and labor. Hymer was explicit in suggesting this as a major reason for the LOF (Hymer, 1960/1976). While later discussions have acknowledged that this advantage may not apply in all circumstances, it appears to be an important source of advantage of local firms in the City of London. The characteristic attitude in the City emphasizes the 'old boy network' for purposes of recruitments and external linkages of any kind (McDowell, 1997; Thrift, 1994). This has given British-owned firms a considerable advantage over foreign firms in accessing local resources, notably local labor. London resources are regarded as world class (London Business School, 1995), and favorable access to them can certainly provide a considerable source of advantage. Share of expatriates among total senior managers and professionals is used to measure the reliance of firms on local labor. This is measured by a dummy variable that distinguishes between four levels, based on the proportion of expatriates among the active directors and chief executives (less than 10%, 11–20%, 21–30% 30%+). Reference is made only to senior positions because the dominant tendency among MNEs is to rely on local labor for all their lower skilled employment. Similar measures of other local resources are not available, but with labor being by far the most critical resource of financial service firms, the omission of other resources is unlikely to bias the findings.

Duration of foreign operation

Is operationalized by years since the establishment of the London office.

Cultural distance between the host and home countries

Following Kogut and Singh (1988) I calculate a composite index, based on Hofstede's indices (Hofstede, 2001). The index is based on the deviation along each of the four cultural dimensions (power distance, uncertainty avoidance, masculinity and individualism) of each country from the UK. I correct for differences in the variances of each dimension and then calculate the arithmetic average between the four dimensions.

Entry mode

Dummy variable that gets the value 1 for entry via M&As; 0 for greenfield.

Organizational structure

A number of studies have used the layers of reporting within the organization as an indication of the organizational structure of MNEs (Zaheer and Mosakowski, 1997; Mezias, 2002). I adopt a similar approach and operationalize organizational structure by a dummy variable that gets the value 1 if the affiliate reports directly to the headquarters, 0 otherwise.

Table 3 summarizes the competitive advantages and presents their operation measures, as well as the performance of the foreign and British[7] firms studied.

The data in the table show that, in line with the hypothesized relationships, foreign-owned firms

[7] The British sample was selected for this analysis in the same way as the foreign one (see Methodology section for explanation). All British-owned firms listed in the Fame database, 768 firms—were considered, and excluded were firms for which 30 percent or more of the data were missing. Tests of differences found no significant differences between the latter and the remaining firms at the 0.05 level or higher.

Table 3. Competitive advantages of British- and foreign-owned financial service firms in the City of London

Advantages (constructs)	Operations	Sample means and standard deviations (*t*-test results)	
		British firms	Foreign firms
Firm-specific advantages			
1. Intangible assets	Value of intangible assets (% total assets)	0.491 (0.352)	0.572 (0.338)**
2. Financial strength	Liquidity ratio	5.159 (10.701)	6.346 (11.985)*
	Credit rating	45.728 (37.391)	49.438 (32.976)**
3. Size	Total assets (million pounds)	61.426 (273.438)	34.656 (70.882)
4. Managerial skills	Directors remuneration (% total remuneration)	0.590 (1.818)	0.456 (0.568)*
Advantages of multinationality[a]			
1. Intensity of international activity	Number of foreign offices	6.591 (12.798)	15.381 (35.022)**
2. Internal linkages	Profits transferred to parents (% of total)	N.A.	0.424 (0.985)
Home-based advantages			
1. Access to local information	Number of links in the City	11.789 (3.765)	6.522 (2.638)***
2. Preference of local customers	Activity in British pounds (% of total)	0.632 (0.594)	0.212 (0.148)**
3. Reliance on local resources (labor)	Expatriates (% of active directors and chief executives)	N.A.	0.071 (0.129)
N		428	296

[a] The comparison between foreign- and British-owned firms of the advantages of multinationality by definition refers only to British-owned MNEs, and excludes indigenous firms (see robustness test for a discussion of this issue and some statistical testing).
t-Test (2-tailed) for equality of means significance levels (equal variances assumed, Levene test of homogeneity of variance $F = 1.589$, $p = 0.329$): * $p < 0.1$; ** $p < 0.05$; *** $p < 0.001$

indeed outperform their British cohorts in terms of most of the firm-specific advantages considered and the advantages of multinationality, while these relationships are reversed in relation to the home-based advantages. There are, however, two exceptions to this generalization. In two of the firm-specific advantages British firms perform better than foreign-owned ones—they are larger and pay their top management better. It appears that this departure from what was hypothesized can be attributed to a bias introduced by the comparison between affiliates and headquarters operations, rather than an indication that British firms indeed possess superior advantages. Thus, affiliates are often smaller than the headquarters (and in some cases, the size of the latter reflects the size of the entire corporation). Likewise, headquarters operations are often associated with higher-level managerial tasks than those of affiliates, and these differences correspond to different pay levels.