How to Get the Most Out of Foreign Direct Investment in Commercial Banking*

Cómo sacar el máximo partido de la inversión directa extranjera en la banca comercial

In this paper, I examine the impact of Foreign Direct Investment (FDI) on efficiency of local firms in the commercial banking industry. FDI in banking has accelerated rapidly in the last decade, especially in Latin American and Eastern European countries. Despite this increase in the number of foreign banks, there are still many restrictions on which foreign banks can enter, what they can do and how they can compete. In addition, banking FDI is still contentious since banking systems are so important to the health of the economy. I argue that to get the most out of FDI, policy makers should focus on improving the general institutional environment and reducing the regulatory burden on companies. Regulations that encourage competition and allow free entry will maximize the positive impact of foreign bank investment on local banks’ efficiency.

En este artículo, examinamos el impacto de la inversión directa extranjera (IDE) en la eficiencia de empresas locales en el sector de la banca comercial. La IDE en la banca se ha acelerado rápidamente en la última década, especialmente en América Latina y en los países de Europa del Este. A pesar del aumento del número de bancos extranjeros, siguen siendo muchas las restricciones para poder operar y ser competitivos. Además, la IDE en la banca sigue siendo un tema polémico, ya que los sistemas bancarios son importantes para una economía saludable. En el artículo se defiende que para sacar el máximo partido a la IDE, los gobiernos deben concentrarse en mejorar el entorno institucional general y en reducir la carga normativa de las empresas. Las normas que animan la competitividad y que permiten la entrada libre aumentan al máximo el efecto positivo que la inversión en banca extranjera tiene en la eficiencia de la banca local.

Neste artigo, examinamos o impacto do Investimento Direto Estrangeiro (IDE) na eficiência de empresas locais do ramo da banca comercial. O IDE no sector da banca acelerou rapidamente na última década, principalmente nos países da América Latina e da Europa de Leste. Apesar do aumento do número de bancos estrangeiros, existem ainda muitas restrições quanto à forma como estes poderão entrar nos diversos países, aquilo que podem fazer e a forma como podem competir. Além disso, o IDE em termos de banca é um tema polémico, dado a importância dos sistemas de banca para a saúde da economia. Defendemos que, para se tirar o melhor partido do IDE, os governos deveriam concentrar-se em aperfeiçoar o ambiente institucional geral e a reduzir a carga regulatória sobre as empresas. As regulações que promovem a concorrência e permitem uma entrada livre maximizam o impacto positivo do investimento bancário estrangeiro na eficiência dos bancos locais.

DOI

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1. Introduction

Foreign direct investment (FDI) in the banking industry has reached record levels in the past decade (Litan et al., 2001; Clarke, Cull, Martinez-Peria and Sanchez, 2003). Both liberalization of the financial sector and implementation of international agreements such as the General Agreement on Trade and Services (GATS) have been important driving forces behind this increase. As a result, more and more banks are increasing their presence in foreign countries, especially in developing countries in Eastern Europe and Latin America. For example, whereas foreign banks in Argentina were providing only 18% of total loan volume in 1994, this number had increased to 48% by 1999 (Dages, Goldberg, and Kinney, 2000). Similarly, while foreign banks were virtually absent from Mexico as late as 1995 (less than 1% of loan volume), by 1998 they had grown to 18% of the market, especially following the Peso devaluation crisis in 1994-1995. Following further liberalization at the end of 1998, two of three largest Mexican banks came under foreign control (Dages et al., 2000). In Latin America overall, the share of foreign banks increased from 13.1% to 44.8% between 1994 and 1999 (Martinez Peria and Mody, 2004).

In fact, FDI has become one of the central elements of economic development policies (United Nations, 1999). It is now widely held that foreign direct investment can boost the productivity of local firms through technology transfer, informal and formal exchanges, demonstration effects and most importantly, increased competition. This relationship between FDI and productivity of local firms has been a topic of interest for students of international business for at least 3 decades (e.g.: Caves, 1974). The general conclusion of these studies is that FDI has a positive effect on the productivity of domestic firms (e.g. Lipsey, 2003). These effects are usually termed ‘productivity spillovers’.

The special nature of the banking industry makes the effect of foreign investment all the more important. Banking is special because financial institutions allocate savings to productive investments and therefore have a direct effect on economic growth (see Levine, 1997 for a review). For example, a recent paper by World Bank researchers demonstrates how financial development can help countries meet the Millenium Development Goals set by the United Nations (Claessens and Feijen, 2007). This makes the role of foreign banks more important and also more contentious.

Several arguments have been offered both for and against increased foreign investment in banking. First, just like in other industries, foreign banks can increase the efficiency of domestic banks through increased competition and transfer of best practices. In addition, foreign banks can increase the safety of the system because they help diversification of risks and they can provide more stability during crisis periods (Graham, 2001; Clarke et al., 2003). Furthermore, foreign banks can increase capital and funding available for domestic projects, and provide stability of lending by diversifying the sources of funding available for credit. They can also help improve the quality and transparency of the financial system and aid in development of institutions that help generate information such as rating agencies and credit bureaus (Clarke et al., 2003; Dages, Goldberg and Kinney, 2000). On the other hand, some are concerned that foreign banks can put weak domestic banks out of business and therefore increase the risk of systemic crisis. Concerns about incompatibility between the interests of foreign banks and those of the country in which
they operate also remain. Foreign banks can also dominate the banking industry if domestic banks are weak, and lead to decreased competition and higher prices. Finally, foreign banks can be very difficult to supervise and regulate, since they tend to be larger and multinational.

In this paper, I briefly survey the literature on the impact of foreign bank entry on local bank efficiency and offer some suggestions on how to maximize this impact. The evidence indicates that entry of foreign banks generally improves the efficiency of host country financial system. However, it also shows the importance of having market-friendly institutions and prudent but not burdensome regulations for the efficiency of the banking system (Demirgüç-Kunt, Laeven and Levine, 2004). Furthermore, the institutional and regulatory structure of a country determines the intensity of competition between firms (through regulation of entry for example), a key determinant of how much of an effect foreign entry can have on local firms as mentioned above. Since the institutional and regulatory systems vary widely across countries, the impact of foreign banks is likely to vary from one country to another as well. In other words, it would be a mistake to assume that the benefits of allowing foreign bank entry are automatic.

In particular, existing evidence strongly suggests that the effect of foreign banks on efficiency of local banks will be greatest when institutions and regulations are designed to enhance competitive interactions between local and foreign banks and provide the right incentives – i.e., when they are not burdensome. Therefore, policy makers can enhance the effects of FDI by improving the regulatory framework, which can be changed much more readily than the underlying institutions. Specifically, policy makers should focus on improving the quality of regulations, especially those pertaining to entry of new banks and the scope of activities banks can engage in. In the longer run, governments should strive to improve the quality of property rights protection and reduce corruption in the country. I explain these ideas in more detail below.

2. FDI in Banking and its Impact on Domestic Bank Efficiency

The evidence on foreign bank entry and its effect on domestic banks and the overall banking system clearly show the influence of regulations and institutions on bank efficiency, foreign bank entry, and the impact foreign banks have on local banks. Banking has traditionally been a heavily regulated industry, even in highly developed countries, due to its special role in channeling savings to productive investments and their fundamental role in keeping the economy function smoothly. As the recent credit crisis has shown, banks’ risk taking and appetite can lead to financial crises that can wreak havoc on even the most powerful economy. This indicates the need to have some kind of prudential supervision and regulation. At the same time, restrictive regulations can impede efficiency in the system and slow economic growth. Researchers have argued that burdensome regulations, including limitations on entry, make banks less efficient and do not necessarily protect a country from financial crises (Barth, Caprio and Levine, 2004). These arguments against strict regulations highlight their importance for ensuring competition and efficiency among market participants, as well as the integrity of the overall system.

As part of a broader pattern of financial liberalization, FDI in the banking industry in
many countries has seen a big surge in the last 10 to 15 years (Claessens and Jansen, 2000). This increase has been particularly significant in emerging markets (e.g. Latin America, Central and Eastern Europe) many of which were protected from foreign entry. Furthermore, most of the FDI in banking in emerging countries has taken place in the second half of the 1990s (Litan, Masson, Pomerleau, 2001). For instance, foreign banks composed less than 25% of all banking assets in almost all Eastern and Central European countries by 1994, whereas these figures rose to more than 50% in some countries by 2001 (Martinez Peria and Mody, 2004).

These recent and sizable inflows of FDI, and because it can affect both the efficiency and the stability of the financial system in the host country, FDI in banking is still controversial. Further, banks allocate savings; hence, development of the financial system has important implications for economic growth (Levine, 1997). Supporters of foreign investment in banking argue that entry of foreign banks leads to more efficient local banks due to increased competition and transfer of best practices from foreign banks that have superior skills and technology (Litan et al., 2001). Moreover, foreign banks can increase the stability of a banking system by providing a more stable source of credit and by increasing the diversity of credit sources in times of financial crises. On the other hand, critics of FDI in banking argue that foreign banks can put local banks out of business, become too powerful, and can run away during times of crises, increasing the intensity of the crisis. Further, foreign banks tend to speculate in the currency of the host country, which might increase risk of destabilization. Finally, foreign banks tend to be larger and more multinational, which makes them very difficult to supervise effectively.

This recent surge in FDI in banking, its important implications for economic growth, and the strong arguments both for and against foreign bank entry has led researchers to investigate the effect of foreign bank entry on financial development and domestic banks. Although there are several case studies conducted at the country level (Claessens and Jansen, 2000; Litan et al., 2001), number of cross-country studies is relatively few (e.g. Claessens, Demirguc-Kunt and Huizinga, 2001; Dages, Goldberg and Kinney, 2000; Levine, 2002). These studies generally show that increased foreign bank presence leads to a reduction in the interest margins, which means that the overall banking system has become more efficient, and to a reduction in pre-tax profits and overhead costs of local banks, indicating more competition. However, some other very interesting results also emerge.

First, it is not clear how much foreign bank presence a country needs to have in order to achieve a meaningful effect on banking efficiency. In a study of foreign bank entry on local banks in many countries, Claessens et al. (2001) do not find a significant relationship between the share of foreign-owned assets in the banking industry and the net interest margins of local banks. However, they do find a significant relationship between the number of foreign banks in a country and the interest margins of local banks. This means that the number of foreign banks exerts a bigger effect on margins than the share of assets controlled by them. This in turn suggests that entry of foreign banks is more important than how much of the domestic banking system they control. This is somewhat contradictory to earlier arguments such as given by Bonin and Abel (2000), who speculated (based on their review or some earlier studies) that foreign presence would have to reach a certain level before it exerts a competitive pressure on domestic banks. Unfortunately,
Claessens et al. (2001) do not distinguish among different countries, so we do not know if the effect varies across countries.

With regard to Latin America, Dages, Goldberg, and Kinney (2000) find that foreign banks in Mexico and Argentina have higher and more robust loan growth than local banks, but their margins are not very different from those of local privately-owned banks. Furthermore, it appears that foreign and privately-owned domestic banks compete across the board, in all classes of loans and exhibit similar loan portfolios. It is worth noting that both groups exhibit less lending volatility than government-owned banks. Moreover, they find that foreign banks did not cut and run during crisis periods, but rather contributed to the stability of the system. Similar results are found in Clarke, Cull, D’Amato and Molinari’s (2000) study of foreign entry in Argentina’s banking sector. This latter study also showed that whereas the margins in the corporate banking sector fell, margins remained higher in the consumer-banking segment, which attracted less foreign investment than the corporate banking. This is consistent with the view that foreign bank entry induces competition and increases efficiency of the system.

Second and in contrast with this evidence, other authors have suggested that foreign banks usually do not compete directly with local banks because they focus on the corporate segment, or fee-based services, whereas local banks usually are stronger in the retail segment (Graham, 2001; Masson, 2001). These authors argue that foreign banks would not crowd out domestic banks, because they provide complementary, not substitute, services. However, if this is the case, foreign entry would not necessarily have an impact on efficiency of local banks since the competitive pressures would not necessarily be there. Still, if foreign banks provide complementary services, this could increase the overall size of the market and lead to cost savings from scale economies. Nonetheless, in those segments where there is direct competition, margins fall more than in other segments that do not experience direct competition, which again highlights the importance of direct competition to maximize the benefits of FDI.

Moreover, it is not clear if it is the actual entry or the threat of entry by foreign banks that increases local banks’ efficiency. In an intriguing study, Levine (2002) shows that the share of assets controlled by foreign banks in a country does not have a significant effect on bank interest margins in that country. However, the restrictions on entry of foreign banks do have a significant (statistically and economically) effect on the margins. Therefore, the contestability of the market – the threat of entry – matters more than actual entry by foreign banks. This is puzzling since the literature on effect of FDI suggests that foreign entry is essential for an increase in efficiency of local firms to occur. Levine (2002) and Demirguc-Kunt, Laeven and Levine (2004) also suggest that institutional conditions explain interest margins more than regulations or foreign entry and that institutions can explain why certain countries put high restrictions on foreign bank entry when threat of foreign entry is good for the country. This raises the possibility that the institutional environment impacts both foreign entry and competition among banks, local and foreign.

Levine (2002)’s study also raises two possibilities – (1) that competition (or potential competition) between local and foreign banks is more important than learning or technology transfer as a mechanism for increasing efficiency of local banks, or (2) FDI does not have to take place for local banks to transfer best practices from foreign banks. Both possibilities however, point out to the fact that local firms should
feel obliged to increase their efficiency, and this obligation is a result of institutional and regulatory approaches to competition.

3. Regulations, Institutions, Foreign Bank Entry and Local Bank Efficiency

This brief literature review highlights several points. First, foreign entry or at least the possibility of foreign entry reduces the interest margins and profit rates of local banks, indicating a more efficient banking system. This happens when foreign banks compete with local banks for the business of the same customers. Since foreign banks are in general more efficient than local banks, this competition forces local banks to become more efficient. Second, sometimes competition is limited to certain segments or foreign banks occupy entirely different segments than local banks, in which case the productivity effects are smaller. Third, we understand that institutions and regulations governing banking have an even bigger impact on bank margins than foreign bank entry itself. Finally and related to the previous point, ‘openness’ to foreign competition and the regulatory environment as potential determinants of both foreign bank entry and its effect on local banks. Within the institutional environment, protection of property rights (e.g. contract enforcement) and eliminating corruption are very important. In terms of the regulatory environment, restriction of entry, scope of activities a bank can engage in, and giving broad supervisory powers to the regulators can all have an adverse effect on results of foreign bank entry. Although the institutional environment is no doubt very important, institutions tend to be stable and difficult to change in the short run. Therefore, in this article, I focus on the regulatory environment, which can be changed relatively more easily by governments. Nonetheless, I give an overview of how lack property rights protection and pervasive corruption can limit benefits of FDI in banking in the next few paragraphs. I then explain how burdensome regulations can dampen positive competitive effects of foreign bank entry.

Property rights protection (rule of law) and corruption have a large impact on incentives of foreign firms. Foreign banks can bring proprietary technology and skills that local banks do not have (e.g. risk management skills) and increase competition in the market. However, without adequate protection of private property rights, host countries cannot lure the best foreign firms and their most advanced technology. For example, Lee and Mansfield (1996) find in a survey study of large American firms that poor protection of property rights in an economy reduces both the amount of FDI inflows by these firms, and adversely affect the age and complexity of the technology they transfer overseas. In addition, a poorly
enforced property rights regime limits competition because in such regimes foreign firms will try to minimize their risks as they are not certain that contracts they engage in will be enforced. For example, in many developing countries, banks focus almost exclusively on collateral-based lending due to poor contract enforcement. However, when contract enforcement is poor, even taking possession of the collateral and selling it can be costly and time consuming. Therefore, foreign banks can engage in a practice called ‘cherry picking’ where they focus on customers with the best credit ratings and lowest risk. This pushes local banks to take on more risky customers and lead to a segmentation of the market, limiting the competitive impact of foreign banks. Therefore, overall property rights protection is very important for both transfers of cutting-edge technology and in enabling healthy competition between local and foreign banks.

Similarly, Smarzynska and Wei (2000) and Cuervo-Cazurra (2006) show that corruption decreases the volume of FDI, tilts the preferred mode of entry towards joint ventures, and changes the composition of source countries in favor of those with high levels of corruption, whose firms are less likely to be much more efficient than local banks. Furthermore, arbitrary corruption creates further risk for foreign businesses and discourages them from making a long-term commitment to the market (Cuervo-Cazurra, 2006). Therefore, corruption will have a negative effect on transfer of valuable, cutting-edge knowledge and practices to the host country. Finally, in countries with corrupt governments, regulations create a rent-seeking opportunity for both firms and politicians (Shleifer and Vishny, 1993, 1994). Consistent with this grabbing-hand view of regulation (Shleifer and Vishny, 1998), Djankov and others (2002) find that those countries that have stricter entry regulations also have higher corruption rates. This suggests that in corrupt countries regulation is used by politically connected interest groups to shield themselves from competition in exchange for rents to bureaucrats and politicians. To the extent that domestic banks are more politically connected and have captured regulatory agencies, they will use those regulations to limit competition from foreign banks. This will limit competition between local and foreign banks and as a result, their impact.

Since regulations can have a direct effect on whether and how firms compete, the regulatory environment can also influence the effect of FDI on local bank efficiency. The traditional ‘public-interest’ theory of regulation argued that regulation is necessary to correct market failures, protect against monopoly, reduce destructive competition and improve social outcomes. However, later theoretical and empirical work has cast doubt on this ideal view of regulation. Beginning with the work of George Stigler, economists showed that regulation did not necessarily improve outcomes such as prices. On the contrary, firms seemed to ‘capture’ the regulatory process and demand regulation in order to keep out new entrants, limit competition and seek rents (Stigler, 1971). More recently, Andrei Shleifer and Robert Vishny have coined the ‘grabbing-hand’ view of regulation, which argues that politicians and bureaucrats use regulation to extract rents from firms (Shleifer and Vishny, 1998). In both of these views, the regulatory mechanisms can be used to protect incumbents from new entrants or to limit competition among incumbent firms, such as foreign versus domestic firms.

Although there has been a worldwide trend toward a more open doors policy regarding bank FDI, many countries still place limits on foreign banks (Claessens et al., 2001). Such limitations can take the form of outright restrictions on foreign entry, restrictions on the range of activities banks can engage in, limits on branching, lack of national treatment, restrictions on
repatriation of profit, or absence of an evaluation process applied uniformly to all applicants. The empirical evidence I presented above is more consistent with the ‘grabbing hand’ view and shows that strict regulations limit competition among firms. Evidence also indicates that regulation of entry and restrictions on scope of bank activities are two of the most important dimensions of regulatory structure since these are most likely to restrict competition among market participants. Below, I argue how they are likely to affect the interplay between foreign presence (entry) and efficiency of local banks.

**Regulation of Entry.** In the banking industry, traditionally it has been argued that screening of entrants is necessary to minimize adverse selection and moral hazard problems. However, evidence indicates that regulation of entry has adversely affected competition and efficiency of banks, both in US and in other countries. Jayaratne and Strahan (1998) find that easing of geographic restrictions in the US banking industry led to an increase in the efficiency of banks in states that were closed to out-of-state banks. Demirguc-Kunt et al (2002) show that heavier entry regulations inhibit efficiency of banks. Barth, Caprio and Levine (2004) find that limitations on entry of foreign and domestic banks do not lead to a more efficient banking system, but they are instead associated with more corruption (consistent with the grabbing hand view that regulation creates an opportunity to seek rents). Furthermore, they find that high entry barriers are associated with higher likelihood of financial crises, suggesting that entry regulations do not solve adverse selection and moral hazard problems. Although not specifically in the banking industry, Djankov et al. (2002) find that regulation of entry did not improve the provision of public or private goods, that countries that regulate entry more heavily are also more corrupt, and that democratic and more limited governments regulate less heavily.

These findings suggest that regulations create rent-seeking opportunities and shift the focus from competition towards preventing it. Since entry restrictions reduce competition among banks and since competition is an important mechanism through which foreign banks force local banks to improve, a lower rate of new foreign entrants will limit the impact of foreign presence on domestic bank efficiency. In fact, Levine (2002) shows that restrictions on foreign bank entry (but not domestic entry) are associated with higher interest margins (i.e. lower efficiency) for domestic banks. What is more important, he finds that once restrictions on entry are controlled for, the actual level of foreign presence does not have any effect on bank margins. This indicates that something more than just entry barriers is going on. It is likely that in countries with high foreign entry restrictions, only banks that would not threaten domestic banks are allowed in and the effect of their entry is therefore small. Hence, high restrictions on entry of foreign banks will limit the impact of foreign bank presence on domestic bank efficiency.

**Activity Restrictions.** Limits on scope of bank activities directly limit the scope of competition. To the extent that scope economies allow banks to become more efficient, limits on scope will limit the efficiency of banks. When banks are allowed to do business in multiple market segments such as underwriting and selling securities in addition to traditional lending, foreign banks may get into all of these segments, and more vigorous competition would ensue. Scope economies would allow domestic banks to spread their costs over more products. Moreover, if foreign banks engage in all segments of the market, local banks that were hitherto not engaging in that segment may be forced to enter those businesses as well. Such a strategy of imitation would increase new products offered by local banks, and allow
them to earn more revenue using their existing assets, thereby increasing cost efficiency. Although there is also a chance that competition in multiple markets encourages coordination and tacit collusion, the chances of this happening between foreign and domestic banks is slim, and the positive effects would overpower the negative effects. Therefore, to maximize the benefits of foreign bank entry through enhanced competition, lower costs through scope economies and more product variety, policy makers should refrain from posing limits on activities that banks can perform.

Bank Ownership of Non-Financial Companies. Bank ownership of non-financial companies can be beneficial because this way banks can be privy to information that others are not, which can help them in their evaluation of that firm’s prospects. Since domestic banks have more information, they can make better lending decisions, which would in turn increase bank efficiency and lower costs due to long term relationships and lower loan losses. Barth et al (2004) have found that limitations on bank ownership of non-financial companies do not improve the efficiency of the banking system, but increase its fragility. Consistent with this, I argue that foreign presence would encourage an increase in efficiency if banks are allowed to have ownership stakes in non-financial companies. This would allow local banks to provide a better response to foreign bank entry. It would increase loans to small and medium sized enterprises (SMEs) because banks could own minority stakes and have better access to information that would allow them to make loans to companies that they would otherwise deem poor credit risks. It would also allow banks to lower their costs and therefore make them more efficient. Therefore foreign bank presence will have a bigger effect on domestic bank efficiency in countries with lower limits on scope of bank activities and bank ownership of non-financial companies.

4. Conclusions

FDI in banking has accelerated rapidly in the last decade, especially in Latin American and Eastern European countries. Despite this increase in the number of foreign banks, there are still many restrictions on which foreign banks can enter, what they can do and how they can compete. In addition, banking FDI is still contentious since banking systems are so important to the health of the economy. In this article, I discussed the evidence on foreign bank entry and its effect on local bank efficiency. Several lessons emerge from the existing evidence.

First, allowing foreign banks contribute to a deeper, more developed and more stable financial system, which in turn contributes to economic growth. Moreover, foreign banks do not seem to contribute to financial crises. Restrictions on foreign bank entry, on the other hand, leads to a less efficient banking system and increases price of credit for those who need it. Therefore, policy makers should not only allow foreign bank entry but also move toward lifting most restrictions on foreign bank entry.

A broader lesson is that policy makers can increase the benefits of foreign bank entry by adopting a market-friendly regulatory approach and getting rid of burdensome regulations. In particular, regulations that limit the scope of bank activities such as engaging in securities
and insurance do not seem to increase efficiency or stability and are likely to reduce the impact of foreign banks on local banks by limiting scope economies, financial innovation and by creating a segmented market where domestic and foreign banks occupy different segments. Furthermore, lifting restrictions on banks’ ability to have ownership stakes in non-financial companies could not only increase credit available to financially opaque firms but also create more efficiency enhancing benefits following foreign bank entry. Local banks could then compete actively with foreign banks due to their information advantages and reduce their costs by better evaluating credit risks and lowering bad debts.

In the longer run, governments should strive to provide better contract enforcement and eliminate corruption so that markets can become healthier and more efficient, and banks can compete for the same customers. Better contract enforcement will help foreign banks bring their most proprietary and valuable skills to the host country and enable them to serve more opaque, smaller customers. Eliminating corruption can go hand in hand with simplifying regulations and reducing the regulatory burden, both of which would dramatically decrease opportunities for rent-seeking. Similarly, eliminating corruption would improve the quality of supervision and create a more level playing field for all market participants.

In summary, policy makers can increase the benefit of foreign bank entry by encouraging active competition between local and foreign banks and by reducing barriers to such competition in the form of burdensome and complex regulations.
References


