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NEW HORIZONS AND POLICY CHALLENGES FOR FOREIGN DIRECT INVESTMENT IN THE 21ST CENTURY

Mexico City, 26-27 November 2001

Making FDI and Financial-Sector Policies Mutually Supportive

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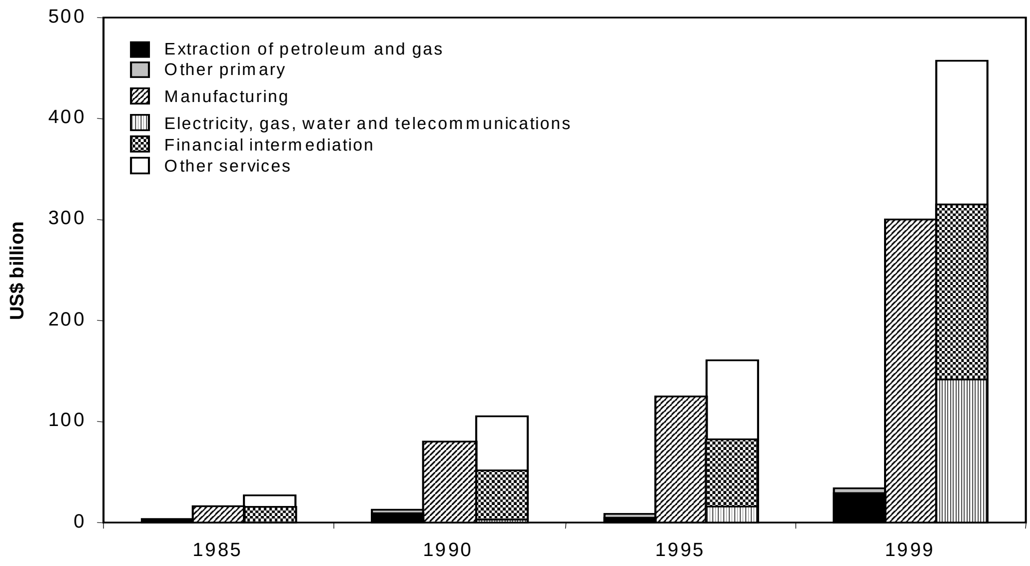
1. The development of a sound and efficient banking and financial sector is widely recognised as an important ingredient of an effective system of resources allocation and robust growth within national economies. It has also proven to be a key condition for ensuring orderly capital account liberalisation. Finally, a solid domestic infrastructure for banking services and capital markets is among the parameters considered by investors as they decide on the location of their investments.

2. This presentation addresses the following question: to what extent can foreign direct investment (FDI) in the banking and financial industry sector support capacity building and more generally enterprise development in this sector?

What are the trends?

3. An important trend in world FDI flows in recent years has been the strong orientation of FDI towards the services sector. More than half of OECD countries' FDI involves the services sector. Banks and other financial institutions accounted for a very high share of these investments. But only a small part of OECD countries' FDI outflows is directed to developing countries – largely concentrated in a few countries in Latin America and Asia. This suggests that a significant under-exploited potential exist for many other countries around the world to catch up.

Total OECD FDI outflows to selected sectors



Source: Compiled from OECD (2000), International Direct Investment Statistics Yearbook.

4. The orientation of FDI towards services has been accompanied in a number of countries by a significant relaxation of the remaining discriminatory barriers to foreign direct investors' participation in the banking and financial sector. Harmonisation and mutual recognition of regulation has also been an important factor in facilitating FDI in this sector.

5. The experience of some of the former transition and emerging market countries that recently joined the OECD illustrates these policy developments:

-- At the time of their accession to the OECD in 1995-96 OECD Members from Eastern and Central Europe exhibited comparatively few restrictions on FDI in banking and finance. However, the Czech Republic required special approval for foreign ownership of domestic banks, and Poland and Hungary did not allow the establishment of branches by non-resident financial institutions. After the introduction of appropriate non-discriminatory prudential arrangements, these restrictions have now been removed. Slovakia acceded to the OECD in 2000 with no restrictions;

-- When Korea acceded to the OECD in 1996, foreign ownership of domestic financial institutions, as well as other parts of the corporate sector, was subject to discriminatory limitations. While the establishment of foreign bank subsidiaries was not legally forbidden, in practice no licences were given. Formal restrictions existed with respect to certain other categories of foreign institutions. As part of OECD accession commitments toward future liberalisation of FDI, and as a response to the 1997 financial crisis, these restrictions were removed in 1998. The government also announced a policy of ending direct interference in bank management. Promotion and transparent implementation of these measures will be key to their success.

-- Upon accession to the OECD in 1994, Mexico undertook to extend most NAFTA provisions to OECD Member countries, including those fully liberalising the direct establishment of, and direct investment in, several categories of non-bank financial institutions. Mexico also agreed to consider extending the remaining market access benefits accruing to NAFTA-based financial institutions, which concerned banks, insurance companies and securities dealers. This extension was decided in 1998 and became fully effective in 2001.

What are the potential benefits of FDI in the banking and financial sector?

a) Broadening of the capital base of the banking and financial sector

6. Recent crises in Asia and other countries have revealed the fragility of many national banking sectors. Governments have often had to recapitalise the sector and resolve non-performing loans problems, since they generally had difficulties in finding a sufficient number of large and healthy domestic banks -- or other investors -- to back the failed institutions. Therefore, encouraging take-overs by foreign investors have been used in banking crisis resolution programmes, for example, in the Nordic countries, Hungary, Korea, Mexico and Slovakia. During periods of retrenchment of domestic banks' balance sheets, the entry of foreign institutions may also be needed if the process of credit intermediation is to be maintained, thus paving the way for a faster recovery.

7. Participation by foreign strategic investors in bank privatisation programmes on the basis of transparent and non-discriminatory rules has also proven instrumental in ensuring a timely and effective implementation of these programmes.

b) Transfer of financial know-how and increased efficiency

8. Foreign participation contributes to increased competition between financial service providers. This competition benefits the economy, by providing incentives for adopting improved corporate management standards, reducing overall intermediation costs, improving the quality of risk management and boosting advisory and other services offered to enterprise and household clients. Foreign institutions also allow instant access to key competitive assets such as advanced financial management systems, marketing expertise in retail banking and presence in global markets.

9. In Korea, for instance, increased foreign participation and the resulting enhanced competition are now seen as key to raising managerial skills in local institutions. Another interesting reported example of this is the case of UK commercial banking. When acquiring Midland Bank, HSBC brought with it from Asia a cash-flow method of assessing lending to SMEs, moving away from a traditional collateral approach. This increased possibilities for smaller companies to gain access to bank lending, aligning practice in the UK with that already in place in Thailand and Korea.

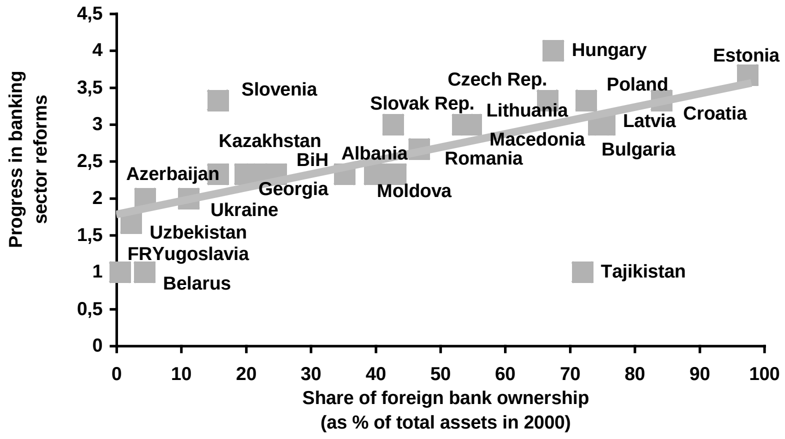
c) Prudential standard upgrading and compliance

10. Local supervisory authorities can enhance prudential standards by opening market access to foreign banks and other financial institutions already subject in their home countries to Basel and to other internationally accepted requirements to capital adequacy, risk management and information disclosure. They are likely to benefit directly from the high standard of prudential surveillance of the entrants, and indirectly to the extent that the entrants promote good standards in the host economy.

11. The presence of foreign financial services competitors, coming from outside established local circles, can also assist the local supervisory authorities as they take steps to limit politically motivated and other connected lending, corruption and other illegal financial activities.

12. In sum, there is broad empirical evidence that foreign involvement helps banking sector development. Using a sample of 21 transition countries, recent findings by EBRD show a clear correlation between the share of foreign bank ownership and a synthetic index of privatisation, interest rate deregulation and other banking sector reform indicators.

Foreign Involvement Helps Banking Sector Reforms



Source: EBRD

Risks of adverse impact

13 The possibility that more efficient foreign financial institutions can crowd out local institutions is real. While the impact in the longer term is beneficial to the industry and the economy as a whole, labour market policies apply to minimise the social costs of adjustment in the short term.

14. Abuse of market position is best combated through appropriate, non-discriminatory competition policy , which, again, is underpinned by a dismantling of entry barriers to the financial services markets. In Hungary, for example, the majority of the banking and financial sector assets are located in institutions originating from other OECD countries. It has been argued that maintaining barriers to cross-border competition in financial services would have amounted to protecting these institutions from overseas competition and depriving the country of the full benefits accruing from the presence of sophisticated foreign-controlled financial institutions

15. It has also been argued that foreign financial institutions are not subject to the same civic spirit and sense of social responsibility as local institutions. In fact, major international banks and other financial institutions are those most often represented in the financial sectors' efforts to develop a reporting framework in support of sustainable development or in the banking sector's initiative for defining good management practice in the fight against money laundering. In addition, while social objectives can be attained by many other means than through the financial sector, nothing should prevent governments from imposing certain non-discriminatory requirements on financial institutions. In the United States, for example, banks are required through the Community Reinvestment Act to recycle a proportion of the deposits they take from poorer regions as loans in those areas.

Policy challenges facing governments

16. Maximising the benefits of FDI for financial sector development creates important challenges for governments.

17. The first policy challenge is to establish a broad enabling environment conductive to attracting high quality investors. Such an environment includes *inter alia* transparent regulatory and

supervisory practices. Moreover, financial institutions cannot perform efficiently if public governance and other parts of the system work poorly.

18. Once FDI has been attracted to the domestic financial sector, more institutions are therefore in operation. Therefore, a second challenge is to upgrade the regulatory framework and the supervisory authorities' monitoring capacity. In particular, this entails the involvement of host country authorities in bilateral information sharing and other co-operative arrangements with their home country counterparts, as well as active interest in the work undertaken in standard-setting international fora, including the OECD.

19. Thirdly, it must be recognised that the opening up of a domestic financial system to foreign participation has wider structural ramifications. As financial practices become increasingly market based, weak debtors can no longer count on forbearance and evergreening of loans, sectors previously considered as "strategic" lose their special status and financial institutions demand influence on the capital structure of their corporate borrowers. Additional policy measures may be needed in order to deal with the changing environment -- *inter alia* in areas such as improved insolvency rules and foreclosure procedures for the corporate sector. Governments should therefore consider taking steps toward greater financial sector openness in unison with, and as a supplement to, their broader policies toward structural reform in the private sector.