FROM MONOBANK TO COMMERCIAL BANKING

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FROM MONOBANK TO COMMERCIAL BANKING

Financial Sector Reforms in Vietnam

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Abbreviations

ADB	Asian Development Bank
AMC	asset management company
ASEAN	Association of South East Asian Nations
BSP	Bank for Social Policies
CAMEL	capital, asset, management, earnings and liquidity of banks
CAR	capital adequacy ratio
CC	credit cooperative
CCF	Central Credit Fund
CIC	Credit Information Centre
CIEM	Central Institute for Economic Management
DAF	Development Assistance Fund
DIA	Deposit Insurance Agency
EAFC	East Asian Financial Crisis, 1997–98
FDI	foreign direct investment
FLC	Financial Lease Company
FRA	Financial Sector Restructuring Authority
GDP	gross domestic product
GDS	gross domestic savings
GNP	gross national product
IAS	international accounting standards

ICB	Incombank
ICVB	Industrial and Commercial Bank of Vietnam
IDCM	inter-bank domestic currency market
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
JSB	joint stock bank
LDC	less-developed country
LEIPC	legislative and executive index of political competitiveness
LCF	Local Credit Fund
LUR	land use rights
MOF	Ministry of Finance
MOJ	Ministry of Justice
MPI	Ministry of Planning and Investment
NIAS	Nordic Institute of Asian Studies
NPL	non-performing loan
PCF	People's Credit Fund
PCPI	prompt corrective power index
PM	Prime Minister's Office
RAB	Radhanasin Bank
RCF	Regional Credit Fund
RCST	Registry Centre for Secured Transactions
Rosca	Rotating Savings and Credit Association
SBV	State Bank of Vietnam
SME	small and medium-scale enterprise
SOB	state-owned bank
SOCB	state-owned commercial bank

SOE	state-owned enterprise
SSC	State Security Commission
T-Bills	treasury bills
TOR	turnover rate (of Central Bank governors)
US	United States
USBTA	US–Vietnam Bilateral Trade Agreement
VAS	Vietnamese accounting standards
VAT	value added tax
VBARD	Vietnam Bank of Agriculture and Rural Development
VBID	Vietnamese Bank for Investment and Development
VBP	Vietnam Bank of the Poor
VCB	Vietcombank
VCP	Vietnamese Communist Party
VLSS	Vietnamese Living Standards Survey
VPSC	Vietnam Postal Service Savings Company
WBG	World Bank Group
WDI	world development indicators
WTO	World Trade Organisation

Preface

In terms of level of economic development, Vietnam has made significant progress over the past decade. Standards of living have improved significantly, and the country's socio-economic achievements are impressive from a human development perspective. One of the main drivers of economic growth and development has been the implementation of various economic reforms, initiating the transformation from a centrally coordinated and planned economy towards a more market-orientated system. Although the uncertainty and lower economic growth following in the wake of the Asian Financial Crisis caused a temporary slowdown of the reform process, the momentum appears to have picked up again in recent years.

The financial sector takes centre stage in the renewed efforts to reform the Vietnamese economy, in part because of the extensive linkages between the predominantly state-owned banking sector and the crisis-stricken state-owned enterprises (SOEs); and in part because the creation of a more market-based financial sector is expected to improve the mobilisation of savings, the diversification of risks, and the allocation of resources in the economy. The current and planned reforms of the financial sector, however, also represent an opportunity to initiate a deeper and more structural break in the way in which the Vietnamese economy is managed.

Only 15 years ago, during the era of central coordination and planning, the financial sector was completely subordinate and instrumental to the achievement of government objectives in the productive, state-owned sectors. Although the Vietnamese government has stopped using the financial sector as a direct instrument for the implementation of productive sector policies, considerable indirect government control of financial sector activities persists. It is in this context that the recently initiated round of reforms potentially holds the promise of lessening the persistent (indirect) government control through the creation of a more market-based, autonomous financial sector.

As indicated by its title, this study will focus on banks: primarily on the state-owned banks. This is not equivalent to saying that other parts of the sector are not important. They are, but regardless of developments in the near future, banks will continue to be the dominant source of outside funding in Vietnam – thus justifying focusing primarily on one type of financial institution.

A first version of this study is available as CIEM discussion paper (CIEM Discussion Paper 0301) published in January 2003. Work on this first version was completed during the autumn of 2002; the last comprehensive study of the financial sector in Vietnam had been made seven earlier (World Bank 1995). As a consequence, the objective of the first version of the study was to remedy the shortage of comprehensive financial sector analyses in Vietnam. It is, however, important to point out that the first version of the study was by no means intended to be a follow-up to the 1995 World Bank report or to substitute for the World Bank Banking Sector Review published towards the end of 2002. While the publication of the latter (World Bank 2002) naturally provided an occasion to review the first version of this study, it by no means rendered it superfluous. One example is the issue of non-performing loans (NPL). Following an initial acknowledgement that the level of NPLs accumulated in the banking system is of concern, the World Bank (2002a) goes on to note that since 'the restructuring and the recapitalization program undergoes frequent joint reviews by the SBV, the IMF and the World Bank Group (WBG), this exercise (i.e. the World Bank Report) will refrain from commenting directly on the plans and the progress, but it will instead take stock independently of the status of the banking reform process.' However, as the above mentioned 'frequent joint reviews' are not made available to the public, the fact that the most recent World Bank report abstains from analysing the NPL problem creates a vacuum. As a consequence, Chapter 6 in this study looks into the central issues surrounding the ongoing process to resolve the NPL problem.

The present study is thus an updated and substantially revised version of the earlier CIEM discussion paper. The objectives are twofold: first, to help establish an open dialogue about the nature and speed of the financial sector reforms in Vietnam based on recurrent independent assessments of banking sector issues and problems; second (and not unrelated to the first objective), to focus on some the issues not dealt with by previous studies of the financial sector in Vietnam.

The above mentioned unavailable 'joint reviews' directs attention to the lack of transparency surrounding issues related to the financial sector in Vietnam. This lack includes both key measures of financial sector performance (such as, for example the ratio of NPL to total loans as measured by international accounting standards) and the government decision-making processes and strategies of relevance to the financial sector (e.g. the extent of continued policy lending through state-owned commercial banks). In both areas outsiders are presented with an information policy that comes close to opaque closure. This is most likely in part attributable to the Vietnamese culture of consensus governance (see Chapter 3). Another possible explanation for the lack of transparency rests on a conjecture that the financial sector (through the above mentioned NPLs and the continued close relationship between state-owned banks and state-owned companies) holds an 'uncollected bill' for failed past policies. To the extent that this conjecture is correct, the high priority assigned to social and political stability by the government in turn implies that the government has little incentive to reveal the true size of this problem. Regardless of the explanations given, the lack of transparency represents a real problem which we seek to overcome by using as many independent sources of information as possible. Any remaining uncertainty will be noted throughout the study as will failure to obtain relevant information.

The noted factual and empirical ambiguity does, however, not disappear when we instead turn to look for an established, commonly agreed upon framework for financial sector analyses.

Establishing a common ground among economists analysing this sector and its role in generating economic growth and stability is at best difficult. Views range from support to Joan Robinson's claim that 'where enterprise leads finance follows' (Robinson 1980), to those like King and Levine (1993) who hold that Schumpeter was right to suggest that financial intermediaries promote and accelerate economic growth through the identification of and subsequent allocation of funds to high-growth investments. This lack of analytical coherence also extends to more specific policy-related decisions such as: (i) whether transitional economies should develop a securities market-based financial system (such as that in place in the United States) or instead opt for a bank-based system (found in Germany), and (ii) whether central bank autonomy should be strengthened through the legislative, political channels or through the establishment of non-governmental interests and powers advocating lower inflation and increased central bank independence. It is thus important to realise that alternative, competing perspectives exist throughout almost all aspects of financial sector analysis. The approach taken in this study is to note and describe competing perspectives and their associated policy recommendations, while at the same time indicating which perspective/approach is likely to be best suited to a Vietnamese context.

In addition to consulting recent research on financial sector regulation in developing countries, particularly in Vietnam and South East Asia, the research group responsible for this study has employed the services of two local Vietnamese consultants, Le Khac Tri and Dang Nghiem Diem, who conducted background studies of the State Bank of Vietnam and the allocation of credit to the different sectors in the economy, respectively. The process of collecting and analysing data and writing the report was based on desk studies in Copenhagen and field trips to Vietnam. The latter has been of vital importance, as the opportunity to present and discuss ideas and perceptions resulted in new and more productive analyses. Preliminary findings and conclusions were presented at a number of meetings and a seminar held at the Central Institute for Economic Management in Hanoi in October 2002.

Numerous intellectual and creative debts are accumulated throughout the process of making a study of this nature. In this respect special thanks go to the president of the Central Institute of Economic Management (CIEM), Dr Dinh Van An, Vice-President Le Xuan Ba, and the director of the Nordic Institute of Asian Studies (NIAS), Dr Jorgen Delman. We are also grateful to World Bank staff, including economist Theo Ib Larsen and other colleagues at CIEM and NIAS. In addition, Dr Adam McCarthy and an anonymous referee have been very helpful in providing comments and suggestions for the revision. All errors and omissions remain, of course, the sole responsibility of the authors.

Introduction

This study is about the difficulties and problems encountered in the process of transforming the Vietnamese financial sector from one subordinate to government objectives and goals to an autonomous sector guided by market forces and competitive pressures.

Chapters 3 and 4 present a descriptive analysis of this process, making it evident that Vietnam has come a long way in changing its financial market from a centrally coordinated sector to a market economy. New markets and new institutions have been established and new legislation is in place. A gradual approach to reforms has abolished the more direct government control of the financial sector and reduced the still persistent indirect control. As a result, total credit intermediation by the banking sector now amounts to more than 40 per cent of GDP, considerably higher than in many other transitional economies.

The reform process has been gradual and has from time to time been set on the backburner for a period. This is not unusual. Evidence from other countries undergoing similar transitions testify that financial liberalisation and deregulation is a lengthy and difficult process occasionally involving setbacks and lack of real progress. A number of factors, however, suggest that the reform process is likely to be even more prolonged in the case of Vietnam. First, the French civil law tradition may slow down reforms. Second, and perhaps more important, the Vietnamese tradition of consensus governance in concert with the ruling elite's preference for social and political stability is also likely to act a brake on reforms. Third, the extensive links between the state-owned productive sector and the financial sector may also cause these reforms to take longer. Finally, the early crises in the process of liberalising the sector (most notably the collapse of the system of credit cooperatives) may also restrict the pace of reform. It may take a long time to rebuild trust in the formal financial market in turn causing newly established markets to take longer to develop. The fact that Vietnam was spared from the direct consequences of the East Asian Financial Crisis (EADC) suggests that the Vietnamese response to the crisis differed considerably from that of the other East Asian countries. While the latter strengthened and broadened reform efforts in response to the crisis, Vietnam imposed a temporary halt to comprehensive reforms – most likely to minimise the risk of social and political instability.

Although Vietnam has come a long way, considerable obstacles to financial sector liberalisation and deregulation remain. The persistence of policy-based lending is one such while the lack of transparency and accountability is another. As for the problem of non-performing loans in the banking sector, it is important to keep in mind that this problem in both the corporate and financial sectors also persists in most of the other East Asian countries affected by the EAFC. These countries have also embarked on a process of institutional reform, new banking and accounting standards, disclosure requirements and rules for corporate governance, but, as in Vietnam, the new rules and legislation that have been passed are not rigorously enforced.

Again, however, a number of factors combine to make it likely that the Vietnamese problems relating to non-performing loans will take even longer to resolve than in neighbouring countries. The first factor is the lack of transparency, as testified by the continued lack of international accounting estimates of the size of the NPL problem. The second factor is the culture of consensus governance blocking most attempts to reform the debt-ridden state-owned enterprises (SOEs). The third factor is that the banks holding the NPLs and the companies to whom these loans were given are both owned and controlled by the government, making it easier for the government to conceal the problem and/or to propose cosmetic solutions to it.

Following a descriptive analysis of the process of liberalising the financial sector, the study moves on to consider the progress already made from a regional perspective. More specifically, the analysis presented in Chapter 5 seeks to answer the question of how financial sector development, and more specifically banking sector supervision and regulation, in Vietnam compares to that found in neighbouring East Asian economies. Recognising that the level and character of supervision and regulation depends upon the level of competition in the sector, the analysis first compares the competitive pressure in the Vietnamese financial sector to that of its neighbours. Here it is found that although Vietnam in recent years has levelled the playing field for new entrants somewhat, there is still much to be done before the Vietnamese banking environment can be characterised as competitive or even partly competitive. Given that bank concentration in Vietnam coincides with state ownership, one option would be to strengthen the efforts to equitise the state-owned commercial banks (SOCBs). This is, however, a lengthy process that is unlikely to proceed unless the problems of non-performing loans and continued policy lending are resolved. Current thinking in Vietnam is that the equitisation of the SOCBs will not be piloted before 2006 at the earliest.

Another approach is to make financial markets more contestable – i.e. increase the competition between the banks already in the sector. Here, the signing of the Bilateral Trade Agreement with the United States stipulating a gradual opening of domestic financial markets to US banks ensures that this process will accelerate in the coming years. In this context, the concerns about the risk of 'unhealthy competition' among the SOCBs should be reconsidered. The Vietnamese banking sector is characterised by so little inter-bank competition that any indirect regulation – with the objective of making SOCBs 'stay within the areas assigned to them during the period of central planning' – is likely to make the eventual entry of foreign banks resemble shock therapy.

Any attempt to introduce new entrants and a higher level of competitiveness in the sector should of course be gradual so that the franchise value of local banks does not erode quickly, causing instability and increased risk of financial crises. As a consequence, any liberalisation of the entry process must be both managed over time and transparent. In addition, the regional comparison presented in Chapter 5 points to those areas where the Vietnamese government is most likely to benefit from strengthening the capacity and autonomy of the regulatory framework prior to opening the sector to foreign banks:

The promptness by which the regulator can or will respond to problems in the financial sector is generally lower in Vietnam than in the other countries in the region. Hence, while Vietnamese legislation is equal to or outperforms that of other countries of the region, the autonomy and power to rapidly implement these laws is lacking in Vietnam compared to those other countries.

Moreover, the Vietnamese banking system appears to be very restricted in respect of the types of activities banks can engage in. Banks in Vietnam are generally prohibited from operating in securities, insurance and real estate markets – activities that are permitted or only somewhat restricted in most other countries in the region. Finally, it was found that compared to the countries in the region Vietnam has very restrictive requirements regarding the amount of capital that a bank must have before being granted a permit to operate.

The institution responsible for the supervision and regulation of the financial sector in Vietnam is the State Bank of Vietnam (SBV). Consequently, Chapter 6 takes a closer look at SBV autonomy, SBV management of key financial markets and the measures taken to resolve the problem of NPLs burdening in particular the state-owned banks. Looking first at SBV autonomy, the overall conclusion is that the SBV cannot effectively develop and execute national monetary policies as long as it remains operationally and politically dependent upon support from other government agencies. The Vietnamese tradition of consensus governance thus appears to be in direct conflict with the conventional emphasis on creating autonomous central banks. This is likely to be the case whether one chooses to follow the direct (legislative) approach or the indirect (lobby-building) approach, although the expected increased presence of foreign banks is likely to increase the indirect pressure in the coming years.

In terms of the SBV role as a facilitator and organiser of financial markets, the current status of the market for government bonds and the inter-bank market for domestic and foreign currency are considered. Both markets appear to lack depth as well as breadth reflecting in part their early stage of development. The government moreover appears to have paid little attention to facilitating the development of a market-based benchmark yield curve, focusing solely on the fact that issuing bonds helps to finance budget deficits. In addition, a lack of coordination between the institutions issuing bonds (the SBV and the Ministry of Finance) in combination with a number of legislative restrictions restrict the growth of the secondary market for treasury bills. Conducting monetary policies through open market operations consequently seems to be too ambitious at the time of writing.

As for the role of the SBV as a supervisor and regulator of the financial markets and institutions, progress can be noted, although it is obvious that there is still a long way to go. This is particularly the case when it comes to adopting the international accounting and auditing practices which are likely to improve the overall transparency of the sector. In this context, the creation of a separate institution that is responsible for supervision and regulation could have the potential for further improvements in this area.

A number of problems related to judiciary, administrative and human capital related constraints are identified in relation to the measures taken to address the problem of NPLs. The limited autonomy and legal power associated with a system of decentralised asset management companies, in combination with the noted persistence of policy lending and a low stock of human capital, consequently make it highly unlikely that the recent progress in resolving NPLs can continue in the future.

Finally, Chapter 7 provides a brief description of how banks operate in the agricultural sector. This includes both the specific problems encountered by the different types of banks and their interrelation in the market. The focus on the agricultural sector in Chapter 7 rests upon the fact that the financial sector is the largest and most important in terms of employment and value of output. Here it is found that the government has in effect has laid down an explicit division of labour between the different financial institutions providing financial services to the rural population. In addition, the local communes, people's committees and mass organisations play a crucial role in the identification, screening and follow-up on clients for each type of institution. The result is that the initiatives to form joint-liability groups and/or contacts with potential lenders come from the institutions themselves. Overall, this reflects a top-down approach, which most likely originates in a desire to divide the market among the institutions in order to extend their outreach.

The competition and segmentation of the rural financial markets is further hampered by the widespread practice of offering subsidised interest rates. While this approach is chosen to improve development opportunities for the rural population, the net effects of this policy are likely to be negative and detrimental to the overall purpose of improving the livelihood of rural populations. In addition to restricting the mobilisation of savings, the practice of subsidising interest rates damages customer perception of credit, lowers the overall quality of financial services and reduces the quality of investment projects financed through the financial sector. All this runs counter to the government desire to develop and create growth opportunities for the agricultural sector.

Addressing these problems will involve profound structural changes in the rural financial sector. Long-term political commitment and allocation of resources is imperative. Failure to address either of these problems is, moreover, likely to affect adversely the efforts of the agricultural sector to remain competitive both nationally and internationally.

Overall, the analysis presented in this study supports the view that ensuring timely, fair and transparent supervision and regulation of the financial sector is of central importance to financial sector development and stability. Liberalising financial markets is thus not solely a question of limiting in many cases and/or restricting government influence. It might in fact involve the opposite since the influence and power of supervisory and regulatory institutions needs to be strengthened. As a consequence, the Vietnamese government will continue to play a central role for the financial sector, albeit it may be hoped through different channels of influence.