BANKING SECTOR REVIEW

VIETNAM

JUNE 2002

THE WORLD BANK
FINANCIAL SECTOR
EAST ASIA AND PACIFIC REGION

Acronyms

ALCO	Asset and Liability management Committee
AMC	Asset Management Company
AML	Anti-Money Laundering
BIDV	Bank for Investment & Development of Vietnam
BIS	Bank for International Settlements
BOD	Board of Directors
BTA	Bilateral Trade Agreement
CEO	Chief Executive Officer
CFT	Combating Financing of Terrorism
DAF	Development Assistance Fund
CIC	Credit Information Center
DIA	Deposit Insurance Agency of Vietnam
ECA	Export Credit Assistance
FATF	Financial Action Task Force on money laundering
FIU	Financial Intelligence Unit
IAS	International Accounting Standards
IBPS	Inter-Bank Payment System
ICB	Industrial and Commercial Bank of Vietnam
IFC	International Finance Corporation
IMF	International Monetary Fund
JSB	Joint Stock Bank
JVB	Joint Venture Bank
MFIs	Microfinance Institutions
MIS	Management Information System
MOF	Ministry of Finance
MOJ	Ministry of Justice
NBFI	Non-Bank Financial Institutions
NPL	Non-Performing Loan
NSCERD	National Steering Committee for Enterprise Reform and Development
PCF	People's Credit Fund
SBV	State Bank of Vietnam
SMEs	Small and Medium Size Enterprises
SOCB	State Owned Commercial Bank
SOE	State Owned Enterprise
USD	US Dollar
VAS	Vietnam Accounting Standards
VBARD	Vietnam Bank for Agriculture and Rural Development
VBP	Vietnam Bank for the Poor
VCB	Vietcombank or Bank for Foreign Trade of Vietnam
VND	Viet Nam Dong
VPSC	Vietnam Postal Savings Company
VPT	Vietnam Post and Telecom
WBG	World Bank Group
WTO	World Trade Organization

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PREFACE

A World Bank mission visited Vietnam during April and June 2002, as part of the Banking Sector Review.[1] The principal objective of the mission was to assist the State Bank of Vietnam in identifying potential vulnerabilities in the Banking Sector. The members of the mission are grateful to the Deputy Governor Tuan for his leadership in this exercise, the staff of the State Bank of Vietnam (SBV) for organizing many of the meetings and assisting with the gathering of information. We also want to thank Government officials from the various Ministries, Agencies and Organizations; as well as the management and staff of the State Owned Commercial Banks, Joint Stock Banks, foreign banks, private sector and market representatives for kindly sharing their time and thoughts with the mission.

Meetings were held with the Governor of SBV and his senior management team (including Deputy Governors and other senior officials from the various Departments of SBV), as well as with officials from the Ministries of Finance and Justice; the State Owned Commercial Banks; the Bank for the Poor; several Joint Stock Banks, foreign banks and insurance companies; the Securities Trading Center; the Development Assistance Fund; The Hanoi Union Associations of Industry and Commerce; the Vietnam Chamber of Commerce and Industry; the Postal Savings Company; the Deposit Insurance Agency; the National Registration Agency; law and local consulting and auditing firms; and, representatives from the International Donor Community.

Both the World Bank and the State Bank of Vietnam extend their most sincere thanks to The Banque de France and the Monetary Authority of Singapore for generously providing staff to assist in the Review.

[1] Primary mission members were: Thomas Rose, Paula Perttunen, Miguel Navarro, Renuka Vongviriyatham, Nagavalli Annamalai, Neesham Carter Kranz (World Bank), Thierry Bayle (Banque de France); Timothy Ng (Monetary Authority of Singapore). Additional contributions were made by Kazi Matin, Michael Markels, Duc Min Pham, Yibin Mu, Bikki Randhawa and Allan Schott, (World Bank) and support provided by several team assistants at the World Bank's Hanoi office.

VIETNAM BANKING SECTOR REVIEW

INTRODUCTION

1. A review of the banking sector of Vietnam was conducted in April and June 2002 by the World Bank with assistance and cooperation of the SBV, commercial banks, insurance companies and the private sector. The intent of the report is to point out areas within the banking system at the time of the assessment which either differed substantially from international banking standards or were seen as potential risks to the system. This report will highlight a number of key issues in a general way. The intent of the SBV and the team was to produce a document which would stimulate discussion on ways to strengthen Vietnam's banking system into the future. This is seen as a living document that will be updated and revised from time to time. It is seen as the first of many steps designed to bring about a strengthening of the banking sector as the SBV reviews and selects specific issues for more in depth study.

BACKGROUND

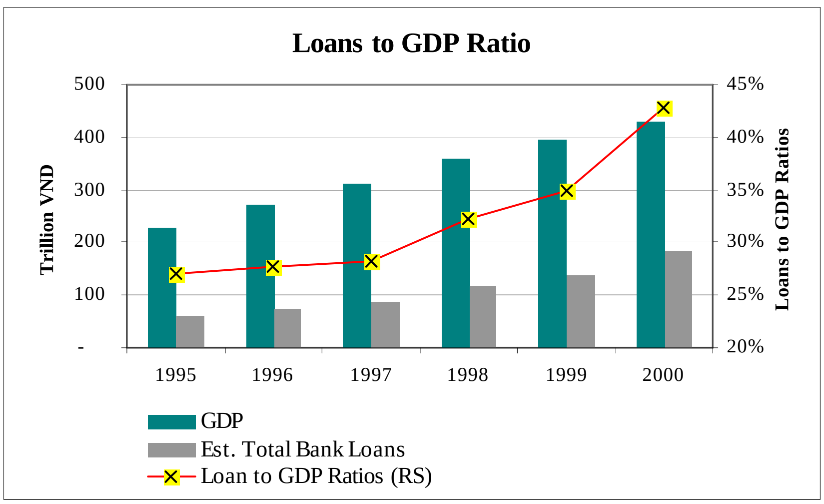
2. Since its beginning in the late 1980's the Vietnamese banking sector reform has come a long way. Important changes have been accomplished both in the structure, the regulation and the operations of the banks thus moving the banking sector towards a modus operandi that closer resembles domestic banking sectors in other emerging markets and newly industrialized economies The system continues to be dominated by the large four State-Owned Commercial Banks (SOCBs) accounting for about 70 per cent of the total assets in the system. The SOCBs are complemented by a number of Joint Stock Banks (JSBs), Joint Venture Banks (JVBs), and branches and representative offices of foreign banks, and to a minimal extent credit cooperatives/credit funds, Microfinance Institutions (MFIs), and financing companies. Given the dominance of the SOCBs in the Vietnamese banking sector, this paper discusses key issues primarily from the perspective of these four institutions and their operations.

3. Over the past decade the four SOCBs have evolved from specialized policy lending vehicles to state-owned banks that are expected to operate in a more commercially sound basis by intermediating domestic savings to various segments of economy and providing other needed banking services both to the Vietnamese people and companies. This transformation has progressed under guidance from the Government and the supervision of the SBV in some areas

at a managed pace, in others with some fits and starts -- which is not unusual for this type of process.

4. Alongside the change in the SOCBs' way of operations, the past decade has witnessed fairly rapid deepening in the level of monetization in the Vietnamese economy with the share of bank credit increasing as a proportion of Gross Domestic Product (GDP) from 13 to 27 and further to 44 percent between 1990, 1995 and 2000, respectively (see Graph 1). While the State-Owned Enterprises' (SOEs) share of that credit has fallen from 90 percent to levels of 50 to 60 percent, this change has not come about without costs. Continued policy lending practices through the 1990s, coupled with the banks limited credit skills in the wake of rapid credit growth and significant change in borrowing clientele, resulted in a level of Non-Performing Loans NPLs accumulated in the banking system that is of concern. Hence, the Government has embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalization program with the support of both the International Monetary Fund (IMF) and the World Bank Group (WBG).

GRAPH 1



Source: The IMF, the International Finance Corporation (IFC), bank's audited reports, and the World Bank's estimates.

5. While the Government is committed to fully commercializing the banking sector, the implementation is still in the early stages. The measures taken to date include deregulation both in the banking sector and the interest rate regime, putting into place restructuring plans for SOCBs, establishing Asset Management Companies (AMC) for NPL resolution, phasing in SOCBs' recapitalization, and phasing out directed policy lending by the state.

6. As the restructuring and the recapitalization program undergoes frequent joint reviews by the SBV, the IMF and the WBG, this exercise 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. It will also seek to put forth complementary observations and suggestions that will be of value to the Government when assessing the banking reform programs going forward.

This assessment will seek to examine the banking reform process beyond the – albeit very important – NPL resolution and SOCB recapitalization programs by viewing the banks and their operations in the broader context of the Government's stated goal for widening and deepening the access to bank finance in Vietnam. It will also discuss the implications to the banking system of the commitments the Government has made or indicated it will make for opening the Vietnamese financial system for international access and competition.

SUMMARY OF KEY OBSERVATIONS

State Bank of Vietnam's Relationship with the SOCBs

7. The apparent assignment of several potentially conflicting objectives to the SBV significantly affects the efficiency of its supervisory function and may prevent the SBV from having a fully independent stance in the supervisory oversight of financial institutions. In this respect, the Government should reassess the SBV's role and relationship with the SOCBs.

Incentive Structure in the SOCBs

8. The compensation of SOCB management and staff is comprised of two separate portions. As special type of SOE, the SOCBs have the annual salary levels tied to: 1) the size and the scope of the enterprise, and 2) the improvement of the profits of the institution. Both compensation schemes reward the beneficiaries for growing the enterprise larger while not penalizing them for undertaking risky business. Both schemes also discourage expenditures and investments. This can lead to behavior that could potentially endanger the bank. Hence, the premises of the reward structures in the SOCBs should be revised to reflect not only the profitability of the bank, but also the risk levels of operations, the need for capacity and skills improvement investments, the build-up of provisioning and the resolution of NPLs.

SOCBs' Profitability

9. Even in the more liberalized rate regime, the banks' interest rate margins remain low. This is somewhat surprising given that the SOCBs are undergoing a needed recapitalization program while, at the same time, needing to increase general provisions for expansion in lending and for NPL resolution. The interest rate spreads and earnings capacity of the institutions are areas the authorities may wish to examine more carefully as they transform the SOCBs into commercially viable institutions.

Credit Skills in SOCBs

10. Given the relatively short history of commercially based lending and the quite substantial recent changes in the regulatory environment with regard to lending, the credit organizations and staff of the SOCBs are naturally still in the very early stages of mastering sound lending policies and good credit practices. With the ongoing rapid credit growth and the expansion of providing credit to various sectors/segment across the economy, the banks' credit organization and staff may presently be stretched beyond their capacity to exercise sound judgment and good credit practices in new lending, and effectively monitoring the capacity of the borrowers of recently granted loans to meet their obligations. As the SOCBs have started to expand their borrower base to new segments of the economy while substantially increasing their lending, there is a

need for improvement in their credit skills – in credit assessment, credit extension and borrower monitoring practices, as well as in credit and risk management.

Bank Supervision

11. Supervision of financial institutions must be significantly enhanced. Vietnam is still at an early stage in this process, but is showing signs of progress and strength. Currently, the task of the inspectors is very much oriented towards checking the financial institutions' compliance with the laws and regulations. The inspectors' task is very much rule-based and does not involve sufficient judgment in the evaluation of a bank's policies and procedures related to the making of loans and investments. The SBV should carefully consider the issues raised by the mission regarding the application of the limited Basle Core Principles.

State Bank of Vietnam Organization

12. The present organizational structure of the SBV, with multiple departments and a considerable number of branches, should be streamlined to improve supervisory effectiveness and efficiency. The reporting lines from the financial institutions to the various departments of the SBV are not completely clear, resulting in inefficiencies and information overlaps. Similarly, the SBV's present multi-office regional structure and the delegation of powers therein appears to limit the SBV's ability to effectively supervise the overall banking sector.

Deposit Mobilization

13. It currently appears that the mobilization of funds and the way they are channeled into the economy by the various segments of the financial system are fragmented. This may not effectively serve the needs of the economy and the Government's competing priorities. The current mobilization of resources by different financial institutions (SOCBs, JSBs, VPSC, etc.) should be examined by the Government to ensure that it is properly serving the purposes of the economy.

Information and Accounting

14. The collection and sharing of accurate and timely information is essential for SBV to properly supervise the banking sector and is critical for the markets. Currently, the accuracy and reliability of the collected and utilized information is questionable. Reports required of the banks are not well defined and are often ad hoc. As Vietnam moves to a more market orientated economy, the availability of high quality, accurate information becomes indispensable. To accomplish this, Vietnamese banks should be required to use International Accounting Standards (IAS) and have their financial statements audited on an annual basis with the reports being made available to the public.

Dollarization

15. At the moment, deposit insurance coverage is limited to local currency Viet Nm Dong (VND) deposits. While this would normally be appropriate when most of the transactions are conducted in the domestic currency and the total value of retail foreign currency deposits is small, the Government may wish to explore whether it is warranted to cover these deposits given

there is such a large volume of foreign currency-denominated deposits in the banking system. The Government should also continue to explore, from the perspective of the entire economy, finding a suitable strategy for the dollarization issue while keeping close watch over its impact on the banking system stability.

STRATEGIC CONSIDERATIONS FOR FINANCIAL SECTOR DEVELOPMENT IN VIETNAM

Role of the Financial Institutions

16. A balanced financial system comprises of various types of financial institutions and markets, that compete with and complement one another while providing a wide range of products and services to all sectors and segments in the economy. These institutions and markets intermediate not only the available financial resources but also the risks taken by their clients and themselves. In this context, the deposit taking institutions – usually limited to banks – have a special standing in the stability of the system, and are therefore under particular oversight by the authorities. This special role also may determine the nature of products and services the banks provide.

17. The banks in Vietnam should make ongoing strategic choices on what banking and other financial services they wish to provide for the economic segments and sectors they have chosen as their focus clientele. The choice of product range may (just to name a few) extend from:

(a) savings products (time and demand deposits, Certificates of Deposits, bonds, life insurance products, etc.); to

(b) credit extension (term and balloon loans, credit lines, credit cards, mortgages, overdrafts, guarantees, etc.); to

(c) non-lending products and services (payments services, ATM's, advisory services, capital market and investment banking products, foreign exchange services, credit card servicing, etc.); to

(d) non-banking services (various insurance products, etc.).

18. The current credit institutions legislation provides a basic framework for what services a bank can provide. A bank expanding its product lines is largely required to obtain a specific license for them from the SBV. Similarly, the banks' decisions on organizational structure and distribution network are subject to approval on a rather detailed level by the SBV, its regional branches and/or the local People's Committees. The present approach may prove impractical in the longer run given the structure of the international treaties and commitments that the Government is making or considering, and the way the foreign competitors are organized and regulated. Hence, the Government may wish to consider moving towards a simpler framework based on a clear and hands-off approach in its regulatory regime for the domestic banks. This would permit the banks to adjust to the internationally applied practices in selection of products and services, as well as to adopt the organizational structures necessary for providing the range of permitted banking and non-banking financial services.

Savings Mobilization

19. The hyperinflation in the late 1980's and quite substantial depreciation of domestic currency more recently[2] resulted in low levels of confidence among the general public in the Vietnam Dong and the banking system. Household savings had largely taken the form of cash in foreign currencies and precious metals kept in safe-boxes at home, making Vietnam largely a cash economy. The Vietnamese Government has been reasonably successful in restoring public confidence in the domestic currency and the banking sector by maintaining prudent macroeconomic policies, controlling inflation, and demonstrating a commitment to structural reform in the banking sector.

20. The quite rapid monetization of the economy implies such a rise in confidence in the banking system by the general public placing their savings in bank deposits. The increase in mobilization of savings appears to be largely concentrated in urban areas, and the rise in dollar denominated deposits has been substantial. The continued increase in household deposits in the banking sector may largely have been stimulated by the recent lifting of regulations that allows the banks to mobilize foreign currency deposits from the general public. This trend is likely to continue with the capital controls and the limited availability of alternative savings instruments. There are, however, some indications of potentially destabilizing factors that the SBV may wish to examine and follow carefully.

21. It currently appears that the mobilization of funds and the way they are channeled into the economy by the various segments of the financial system are fragmented. This may not effectively serve the needs of the economy and the Government's competing priorities. The current mobilization of resources by different financial institutions should be examined by the Government (the State Bank of Vietnam) to ensure that it is properly serving the purposes of the economy.

22. Today, the banks do not adequately provide longer-term savings mobilization products to the general public, however, some new products are being developed. The deposit base of the banking system appears to be quite short term from the general public. Deposits from the enterprise sector are to a large extent limited by various regulations which may prevent enterprises from engaging in effective cash management practices. In contrast, the insurance sector seems to have been remarkably successful in mobilizing longer term funds and – in part, due to the absence of alternative matching investment opportunities – appears to be intermediating those funds to the banking system. There may be a need to examine the causes and the potential impact of this imbalance between the banks' and the insurance companies' success rate in long term savings mobilization. In addition to the traditional mobilization of deposits through banks and the emerging mobilization of funds, the Vietnam Postal Savings Service Company (VPSC) is emerging as an alternative savings channel (see section 9.1.1.).

23. The VPSC appears to mobilize resources indirectly for the government development projects. As the VPSC continues to add additional branches to its network, there is the potential

[2] The official exchange rate for Dong per USD 1 has declined 44% from an average of VND 11,041 / USD 1 in 1995 to an average of VND 15,934 / USD 1 in 2002. Source: FXHistory, Oanda, www.oanda.com.

for increased savings mobilization that will be used to fund these development projects. This increased mobilization by the VPSC is therefore of concern as it may remove from the system funds which otherwise could be mobilized by the banking system for lending to the rapidly growing private sector.

24. Funds raised by the insurance industry appear to be invested in Vietnamese Government paper, deposits at commercial banks, real estate (directly or indirectly), stock market and equity in companies. The continued restriction of investment options should be reviewed to allow more risk diversification and prevent artificial escalation of real estate prices

Non-Bank Financial Institutions (NBFIs)

25. Presently NBFIs, most notably the insurance companies, mobilize a significant amount of long term funds from the general public in direct competition with banks. Further, some non-financial institutions (Vietnam Post and Telecom (VPT) through VPSC – see section 9.1.1. on VPSC) have reportedly indicated interest in mobilizing funds directly from the general public in the form of deposits. In this context, the Government will also need to address how it regulates the savings mobilization and credit provision by enterprises other than banks. At a minimum, the Government should make clear to the general public that the savings placed with insurance companies do not fall under the Deposit Guarantee Scheme. Similarly, there is anecdotal evidence that some SOEs may have been on-lending the credit obtained from SOCBs to private sector Small and Medium Size Enterprises (SMEs) beyond their normal scope of supplier credit/guarantee operations. As the SOEs are unlikely to have credit assessment skills, this may increase the Government's risk as the owner of both the SOEs and the SOCBs and even lead to awkward ambiguity with regard to government's liability in such a situation. Thus, the Government may wish to ensure that the banks enhance their monitoring of on-lending by borrowers.

Capital Markets Development

26. The Government should pursue domestic capital market development, both for debt instruments and for equity, through a concerted effort for the following reasons:

(a) To develop a more balanced financial system;

(b) to enhance the availability of equity and debt capital for the enterprise and the banking sector; and,

(c) to augment the Vietnamese Government's ability to use more effectively the domestic market in its own debt management,.

27. This would be consistent with the Government's stated goal of moving towards a more market-based economy. The appropriate sequencing of the market development efforts and the pertinent decisions related thereto are crucial when developing a capital market. Often this may mean focusing efforts on building a well-functioning government debt market first, and then moving to corporate debt and equity markets that usually take a longer time to develop.

28. The Government of Vietnam has been for some time now issuing government bonds/ notes for the domestic institutional investor market with the large banks and insurance companies as primary buyers. These bonds are being used as collateral by the large banks when utilizing the SBV discount and refinancing windows. During the spring of 2002 Dong-shortage in the banking system left the Government without takers for the 364-day notes auctioned in a number of instances, and the issues affected were duly cancelled. Reportedly, some large SOEs and the Development Assistance Fund (DAF) have also been considering domestic debt issuance (see section 9.1.1.).

29. As a legacy of the past one-tier banking system, the relationship between the Ministry of Finance (MOF) and the SBV does not yet seem to conform with a normal clear-cut division of roles and responsibilities between a ministry of finance and a central bank. The SBV still at times appears to be acting as the Government's banker, and the issuance of their respective debt instruments does not seem well-coordinated. The SBV is presently exploring an overhaul of its structure and use of the monetary policy instruments, and this may have implications to the Government's domestic debt issuance strategies.

30. It is very important that the domestic government debt issuance and the related market development is well coordinated with the structure and the use of the central bank's monetary policy instruments and their market. Experiences from other emerging economies suggest that, unless the MOF and the central bank work together and coordinate their efforts, the result may be confusion and a cause for unnecessary and expensive competition among MOF and SBV in the market which will hinder market development. Hence, the development of well-functioning capital market calls for active and well-functioning cooperation between the ministry of finance and the central bank.

31. For any market development – be it for government or corporate debt, or for equity – one of the most important factors is the transparency and the quality of information available. For government debt market this would require, at minimum:

(a) a clear and well-communicated government debt management strategy;

(b) a transparent issuance schedule with fitting instrument design; and

(c) an appropriate issuance mechanism and good availability of secondary market information.

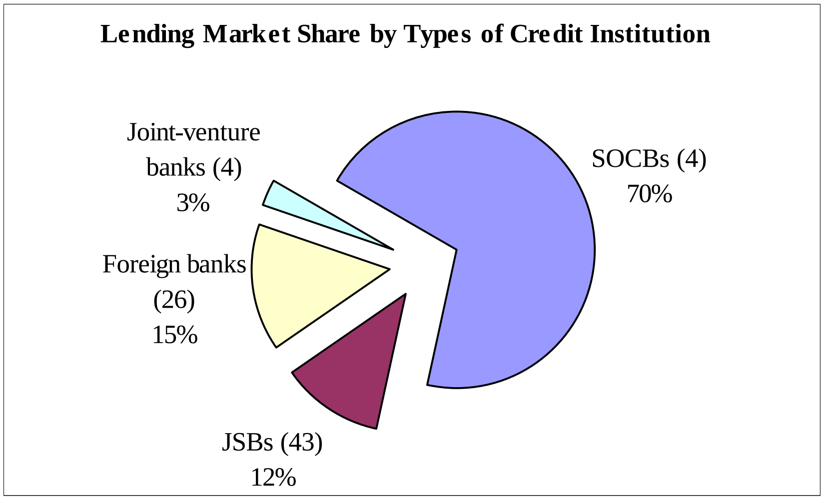
32. It would also require a very clear understanding of how these instruments relate to the central bank's monetary policy instruments and their market, and how these debt instruments can be used as collateral. In the case of corporate issuance of debt and equity, both for the SOEs and the private sector, the transparency and quality of information requirements are particularly pertinent.

Credit Allocation by the Banking Sector

33. Vietnam's banking sector is dominated by four SOCBs, that account for 70% of the domestic lending (see Graph 2). The second largest creditor group are the foreign banks with a

market share of 15%, followed by joint stock banks with 12% market share, and joint venture banks with a market share of 3% [3].

GRAPH 2



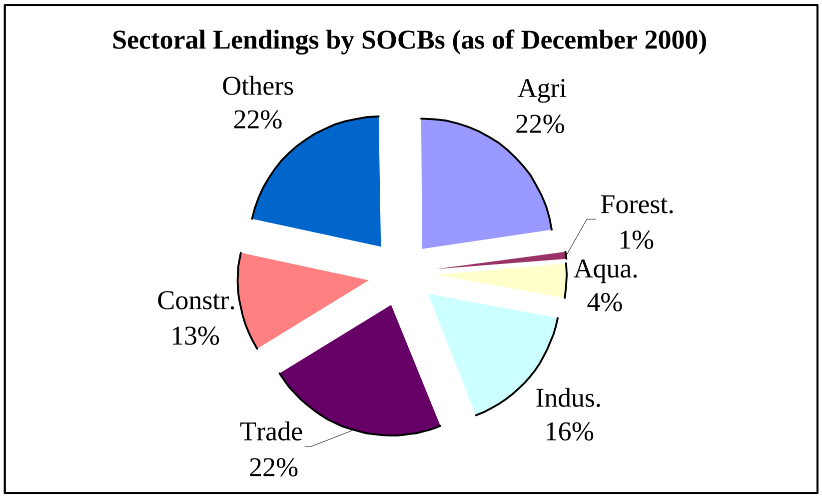
Source: The bank's audited reports (12/00) and the World Bank's estimate

34. While the bulk of the bank credit is still channeled to state-owned enterprises (SOEs), there is a pattern of segmentation in provision of credit by different type of institutions. Presently, more than half (50-60%) of SOCBs' loan portfolio is channeled to SOEs. Foreign banks seem to be mainly engaging in providing financial services to the operations of multi-national corporations in Vietnam rather than getting into competition for services to domestic firms, either SOEs or private companies. Joint stock banks appear to still be the primary source for serving the domestic private sector, which accounts for the bulk of their 12% market share of bank credit. This pattern may reflect to certain extent the historic roles of the different credit institutions, but may also be an indication of their respective competitive positions (or lack thereof) and/or their deliberate choices due to lack of a level playing field or regulatory anomalies.

35. The largest share of SOCBs' loan portfolio is lending to the agri- and aqua-cultural sectors that make up 23-26% of their total loans (see Graph 3). The second largest borrower segment is trade & services sector (16-22% of total loans), followed by lending to the manufacturing sector. Lending for the construction has become the SOCBs' fourth largest borrower group, however there is some lack of clarity as to what is precisely accounted for in this category. More than 60% of SOCBs' loan portfolio in December 2000 were short-term credit facilities reflecting the importance of short-term working capital funding to agricultural and trade & service sectors, with a notable exception of Bank for Investment and Development of Vietnam (BIDV) that continues to focus on medium to long term project finance.

[3] IFC estimates.

GRAPH 3



Source: The bank's audited reports (12/00) and the World Bank's estimate

36. On the aggregate basis, SOCBs had in December 2000 extended about 20% of their credit in foreign currencies, with the exception of Vietcombank (VCB) that had more than 40% of its loan portfolio in foreign currencies. Notably, there may have been even significant shifts both in the term and the currency structures of the new SOCB lending over the past 12 to 18 months with migration to more longer-term currency lending if recent project lending is any indication.

37. While the SOE's proportion of the overall bank credit has been steadily declining since 1998, the credit growth to the state-owned sector has continued to exceed the real growth rate of the economy even while the Government has progressively started reducing the number of SOEs (see Table 1). The private sector , particularly small and medium sized enterprises are commonly believed to be underserved by the banking sector. The regulatory framework and the Government's explicit and implicit backing of SOEs over privately owned enterprises constrains the ability of the private sector, particularly SMEs, to access bank lending. While the Government has removed obstacles for the private sector to operate and have access to bank credit, various forms of regulatory prejudice still remain, particularly in prudential regulation. For example, although banks are now allowed to provide unsecured lending to private enterprises this applies only to firms with two consecutive years of profits, thus precluding start-up enterprises from accessing bank financing. In addition, lending officers of the SOCBs may be reluctant to extend credit to the private sector in fear of possible consequences of potential losses to the bank as a government entity.

Table 1: Credit to the State-owned Enterprises from the Banking System Actual and Projected

	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002
Trillions of VND	31.0	38.1	54.3	69.9	79.7	86.9
Growth Rate of Credit to the SOEs		22.9%	42.5%	28.7%	14.0%	9.0%
Credit to SOEs as a Percentage of Total Credit to the Economy	49.6	52.4	48.2	44.9	41.8	40.3

Source: IMF and WBG staff calculations (Dec. 2002 estimated).
Note: Credit to SOEs from the banking system is defined as the sum of all claims on the SOEs by the banking system; SOEs are defined as wholly state-owned enterprises.

Level playing field

38. As the Government traditionally has viewed the SOEs as key vehicles for economic development in Vietnam, using the SOCBs to channel funds to this segment, the regulatory framework appears to have been designed to favor SOCBs. While the Government has taken measures to start deregulating financial and banking services, the playing field does not yet appear to be consistently level across different types of financial/credit institutions. For example, foreign banks are tightly restricted to mobilize Dong deposits while there is no such restriction applied to foreign insurance companies. Barriers to entry are considerably high given that the State Bank of Vietnam controls quite tightly granting of banking licenses, both for the establishment of new banks as well as the provision of new banking services by established institutions. As Vietnam enters into Bilateral Trade and World Trade Agreements, all regulatory discrimination against foreign institutions will eventually, in due course, have to be abolished.

39. This would also mean that liberalization of the banking sector in terms of foreign ownership will need to be addressed. Given the Bilateral Trade Agreement (BTA) schedules for the opening of the financial system and the Government's announced schedule to join the World Trade Organization (WTO), it is time to develop a clear strategy or road map for gradual liberalization and sequencing of sectors to be liberalized. The liberalization has to be phased in with a strengthened but not tighter regulatory and supervisory regime. The liberalization of the banking sector should be done to ensure that only competent foreign banks can conduct banking business in Vietnam. Therefore, the regulatory framework should provide for transparent, consistent and equitable entry requirements for foreign institutions.

40. Presently, the state dominates the banking sector which, in turn, accounts for the bulk of the Vietnamese financial system. The SOCBs appear to be expanding their scope of services through the establishment of JV and/or Joint Stock banks, plans to establish insurance companies and to enter into capital markets services, and so forth. At the same time, some non-financial SOEs are expanding their operations to banking through JSBs.

41. There appears to be an emergence of financial conglomerates as the SOCBs establish or plan to establish other banks and non-bank financial institutions. It is unclear whether the Government has developed a coherent strategic view on how it wishes banks and other financial institutions to be owned, licensed, organized and operate in the future. The nature of ownership and conglomeration allowed for key financial and, in particular, for deposit taking institutions is an important structural issue that will require explicit Government policy decisions, and may be insufficiently addressed in the present regulations and laws. Therefore, the Vietnamese Government's approach will have strategic implications for all domestic banks though, in particular, for the large SOCBs. These decisions, particularly the nature of conglomeration, would need to be carefully weighed in the context of the introduction of IAS and also consolidated accounting. In cases of conglomerations particular attention should be given to the protection of depositor funds covered by deposit insurance through creation of appropriate 'fire-walls' within the conglomeration structure. The choices on ownership and conglomeration will also be closely linked to decisions on the regulatory regime, the structure and coverage of supervision, the numeration and coverage of deposit insurance, and to the nature and effectiveness of the bankruptcy regime and process for deposit taking institutions.

42. When making these policy decisions protection of depositor funds and the stability of the financial system should be the Government's foremost consideration. In many regimes, owning a qualified minority interest in a deposit taking institution is subject to approval by the Government, thus reflecting the Government wanting to avoid undue influence through imposing a 'fit and proper' test not only for the selection of key bank officials, but also on the approval of shareholders who are in a position to significantly influence decisions of a deposit taking institution. Similarly, various governments have chosen not to allow conglomeration between financial and non-financial institutions in a structure where a deposit taking institution is owned by a non-financial entity. Several countries have chosen to limit conglomeration even within the financial sector to holding company structures only. There are various alternatives for structures and Vietnam should, after careful consideration, adopt the one most appropriate for the prevailing circumstances and the desired outcome. As the financial system develops, the regulatory structures may need to be revised.

43. There may be cause for some concern on the ongoing convergence of the SOCBs' business strategies. The present structure of the banks, their regional coverage, their comparative skills and their operational strengths are reflected in the segmentation and size composition of each SOCB's loan portfolio (and in VCB's case in its asset structure) revealing their different focus and potential competitive advantages and possible weaknesses. To give some examples of the differences to date:

(a) BIDV has been focusing primarily on medium- to longer-term project financing to SOEs;

(b) VCB's core businesses appear to be in money, particularly foreign exchange, markets and trade;

(c) Vietnam Bank for Agriculture and Rural Development (VBARD) portfolio has become heavily weighted on rural/agricultural finance and it presently has the widest distribution network; and

(d) Industrial and Commercial Bank of Vietnam (ICB) has evolved to a very conservative commercial bank.

44. In part due to their past focus, each of the four SOCBs have their particular strengths they need to build on and weaknesses they need to address. Unfortunately, despite their distinctly different characteristics, all four banks appear to have today remarkably converging strategies and views on how their future business focus and competition will evolve. All four banks are very much focusing and actively participating in large syndicated investment loans to SOEs; all four appear to have very similar plans for SME lending programs; all of them are increasing their dollar deposit base and building higher currency/maturity mismatches in their balance sheets; and all four appear to view that they will face with more competition due to the announced opening to foreign entry.

45. With the rapid deepening of the level of monetization in the economy, the present level of economic growth, and the prevailing interest rate and other regulation, it is understandable that the SOCBs do not appear to perceive one another as sources of competition. However, with the interest rate liberalization and with the steep learning curve, the banks, the borrowers and the depositors, the primary and toughest source of competition for both deposit taking and for lending opportunities will come from other SOCBs. Interestingly, some strong competition appears to be arising also from the insurance sector in deposit mobilization. The intensity of competition will be escalated if these large banks – as it now appears – all focus on serving the same segments of the economy with the same business model that they presently seem to be converging to: a universal bank that serves all segments of the economy with no specialized focus. Any economic slowdown may cause such competition to intensify and may potentially lead to cut-throat pricing practices, which will weaken all or some of the banks even prior to the planned opening of banking services to foreign competition.

46. If all SOCBs pursue all segments/sectors in the economy, they will be stretching their human capacity resources extremely thin and vigorous price-based competition will likely reduce the profitability in the most profitable commercial market segments while other segments or sectors go un- or underserved. Thus, there is a potential danger that the four SOCBs may – through uniform strategic choices – end up weakening one another through intense competition if all four become universal banks instead of focusing their efforts on key segments in which they appear to already have competitive advantages. While it is not advisable for the Government to return to directing the banks in their lending practices, the banks can be indirectly encouraged through a right incentive structure and proper corporate governance to provide services in segments of the economy in which they have a competitive advantage until they are fully commercialized.

Widening Access to Finance (Private Sector/SME)

47. The Government of Vietnam has in the past year or two made clear its intention to widen the access to bank finance to the private sector, and to SME's in particular. It has also undertaken various steps to increase the level of trust of the general public in the banking sector, thus enabling a deepening of the monetization of the economy both through savings and borrowings by individuals and businesses. At the same time, the Government is progressing on many different fronts simultaneously in its banking and financial sector reform efforts. It is unclear,

however, whether there is a consistent view within the Government of the desired outcome of this process and a coherent path going forward. It is also not clear what the mechanism is for ensuring that the various decisions get coordinated and properly sequenced. Going forward, it may be useful for the Government, the SBV and MOF in particular, and possibly also the National Steering Committee for Enterprise Reform and Development (NSCERD) – as the owner of the large banks, the supervisor of the entire financial system and the coordinator of enterprise reform – to review such matters in a more systemic and structured fashion. These stakeholders should also consider how the efficiency of the intermediation of capital can be enhanced through improving market-based incentives, instead of direct intervention.

48. Thinking about access to finance and banking services in an evolving economy is an exercise requiring multi-dimensional mapping of both the various segments and sectors of the economy against the different needs for banking and other financial services by the productive sector. Developing a strategic framework for the Government's thinking as the owner of the SOCBs and still a large part of the enterprise sector would help map a safer and more effective path forward both with regard to planned equitization of SOEs and reform of the financial system. As an example of the various dimensions that need to be covered: it appears that going forward over the medium term the Vietnamese economy will have at least the following segments that will all have their own specific needs in terms of bank and other financial services:

(a) Policy lending for strategic investment projects,

(b) SOE commercial lending,

(c) Private sector large and medium-sized companies,

(d) Private sector SME's,

(e) Affluent urban retail customers,

(f) Home enterprises - small/microenterprises,

(g) Rural retail customers (primarily farmers), and

(h) Urban and rural poor retail customers.

49. Similarly, different sectors in the Vietnamese economy that will have considerable financing needs would include at least the following:

(a) Agri- and aquaculture,

(b) Construction,

(c) Manufacturing; both in capital and labor intensive sectors,

(d) Utilities/ petrochemicals / infrastructure,

(e) Foreign trade, and

(f) Domestic trade and services.

50. Ensuring access to bank funding and other banking services by these various segments and sectors throughout the economy will pose a challenge. Many of these sectors and segments have their particular needs both in terms of the nature of interface/relationship with the banks and the type of funding and services they need. Furthermore, their ability to provide the banks with good financial information on their repayment capacity and back their borrowing with collateral varies significantly – thus each requiring specialized structure, approach and skills from the banks that service them. The banks will also need to start differentiating through access, pricing and covenants between good and less attractive borrowers within the various sector and segments. This will require enhancement of skills and capacity - sustainable profitability and growth will only follow from successful application of such resources.

Challenges in Exercising Sound Credit and Risk Management Practices

51. Given the relatively short history of commercially based lending and the quite substantial recent changes in the regulatory environment with regard to lending, the credit organizations and staff of the SOCBs are naturally still in the very early stages of mastering sound lending policies . With the ongoing rapid credit growth and the expansion of credit to various sectors/segment across the economy, the banks' credit organization and staff may presently be stretched even further beyond their capacity to exercise sound judgment and good credit practices in new lending, thus unable to effectively monitor the capacity of the borrowers of recently granted loans to meet their obligations. Reportedly the new lending over the past few years has resulted in a relatively low non-performance ratio, this purported good performance may, in the longer perspective, be substantially overstated given the large annual increase in lending (in the denominator of the NPL ratio) and the impressive recent economic performance of the Vietnamese economy. In an economic downturn, the ability of borrowers to repay their loans will both quickly turn adverse, and the banks may see the level of their non-performing portfolios escalate very rapidly. (see further discussion in the section 5.2.2. 'Potential Stress to the Banking System')

52. As the SOCBs have started to expand their borrower base to new segments of the economy while substantially increasing their lending, there is an urgent need for improvement in their credit management skills – in credit assessment, credit extension and borrower monitoring practices, and credit and risk management. The recent lending presently appears to have reasonably low NPL levels but should not be interpreted as a sign that there is room for complacency in this regard. With the notable exception of VCB, the SOCBs' business is almost solely lending-based with non-lending businesses accounting for a very small proportion of their income and profits. It is therefore vital that the banks improve the capacity of their credit staff, build a core banking sector, and establish and enforce credit policies in line with each bank's strategic positioning to ensure sustainable income streams and prevent future increases in NPL levels.

53. The incentives for SOCBs to lend to the private sector appear still quite weak. SOEs and the Government guaranteed projects, which are still perceived by banks as low risk and were considered the primary engine of development in Vietnam throughout the 90's, are competing with the private sector for credits from SOCBs. It seems that the SOCBs have been, and may

still be, excessively relying either on an implicit or explicit government guarantee, and/or a risk assessment by a centralized state committee in their lending to the state-owned sector. The inherent weaknesses in the banks' ability to assess the risks on commercial basis and, consequently, to price loans according to their risk level is an important impediment to the migration of banks to market based lending, particularly to the private sector. The apparent under-capitalization of SOCBs by IAS standards may constrain them from expanding their private sector lending, but the present prudential regulation invites increased lending to SOEs which will ultimately result in further capital constraints under IAS standards.

54. While the private SME's may have had reasonable access to short-term financing by banks, it is has been more difficult for them to access medium-to long-term loans. The SBV's recent removal of the lending rate ceiling will facilitate improved access by the private SME's to bank credit as the banks now have the ability to price riskier loans at higher interest rates. This of course may greatly depend on the rates established by the SOCBs. Currently, short-term lending to private SME's appears to be collateral-based although enforcement and disposal of such collateral tends to be very time consuming. To finance medium- to longer-term private investments, banks cannot rely on collateral but need to assess the economic viability and risk-level of the project. The banks still lack the capacity for appropriate credit assessment and there is an urgent need to strengthen their skills in this area. Similarly, the ability of the SME's to submit proper business plans and accurate financial accounts needs to be built up.

STATE BANK OF VIETNAM (SBV)

55. The peculiarities of a country in economic transition play a role in the outcome of banking sector development. In particular, the pace and conditions of the transition from a centralized, State-planned system to a system that grants more room for initiative and development of the private sector all have an impact on banking and bank supervision.

56. The SBV's role and organizational structure have historically reflected the evolution of the economic philosophy of the country. The current role and structure were appropriate for the early stages of the transformation from one-tier to two-tier banking. Now that both the Government and the SBV are moving forcefully forward in taking the commercial banking system to the next stage of market-development, the SBV's role and organization will also need to become more conducive to the development of a market-oriented system.

57. Though SBV carries out it supervisory role adequately under the current law and regime, there are shortcomings. The quality of its regulatory and supervisory actions can be improved. With the ongoing transformation of the Vietnamese economy to a market based system, there is a need for supervision to become more proactive, better coordinated and, above all, to move from purely compliance based supervision system to one that is more risk based.

58. The most significant issues that have been identified in relation to bank supervision relate to the lack of clear accountability in the management of the sector , organizational weaknesses within the supervisory structure, inconsistency in application of laws and regulations and a lack of real corporate governance and transparency in the banking sector and the bank supervisory process. All of these fundamental areas impact supervision and the potential health of the banking sector.

59. In addition to the key fundamentals, the supervisory process itself must be carefully examined. To this end, a limited Basle Core Principle Assessment has been conducted covering nine key principles and is incorporated by reference in this report (for more detail, see Attachment I). The report provides a number of valuable insights into the operation of the banking system and points to areas needing to be examined and possibly changed.

Accountability for Bank Supervision

60. Accountability for the management and supervision of the banking sector is confused due to the lack of operational independence of the SBV vis-à-vis other State bodies. Currently, the SBV operates more like a government department than a central bank. The relationship of SBV with the government and other agencies should be reconsidered and the Law on Credit Institutions should be amended to strengthen the supervisory role of SBV. Its level of lending to government entities, acting as the banker for the government, and its role in the implementation of policies intended to give effect to government's developmental goals, should be carefully considered with a view towards substantial reduction in the short term and elimination in the longer term.

61. In addition, according to the law, other bodies in addition to the SBV participate in banking supervision. In practice, these various entities do not seem to play extensive supervisory roles, but it is acknowledged they have significant indirect roles, which are likely to bias the SBV's actual supervisory practice. The licensing and supervisory roles need to be consolidated and centered in the SBV and participation of Peoples Councils and various other regional (urban and rural) committees in bank supervision should be reassessed with a view towards their elimination from any participation in bank supervision.

62. The assignment of several potentially conflicting objectives to the SBV significantly affects the efficiency of its supervisory function and may prevent the SBV from having a fully independent stance in the supervisory oversight of financial institutions. In this respect, the Government will need to seriously reassess the SBV's role and relationship with regards to commercial banks. Presently, the SBV is tasked with acting, on behalf of the government, as the state body managing the banking system. To that end, the SBV has permanent representation on the Supervisory Boards and appears, through various appointment, approval and even licensing processes, to be involved in such activities in SOCBs that are essentially powers to be exercised by the owner. This poses an inherent conflict given its role as a bank supervisor. There is always a tendency towards regulatory forbearance when there is this type of conflict and, hence, this ownership role would need to be relinquished by the SBV in order to enhance a level playing field among the banks and improve bank supervision.

63. Accordingly, the Government ought to take steps towards severing bank supervision from the exercise of the ownership role in the SOCB's. In addition, the Government should consider distancing its ownership role from the day to day operations of the SOCBs, thus providing sufficient autonomy to SOCBs to make their business decisions. In this regard, there are reportedly considerations within the government to move to exercising ownership rights in SOE's – and possibly even SOCB's – through a financial management company structure (a de facto, a holding company) that would be tasked with managing the state's capital investment in enterprises. Such efforts are welcome as they could go a long way in improving the governance

of state assets. While potentially positive, such a control structure can also present a number of risks which should be carefully considered and addressed. More important than the ownership role of the State is the need to permit the SOCBs to freely operate in a markets oriented manner, holding management accountable for the operations and results of the institution and demanding that SBV effectively supervise the system.

The SBV's Organizational Structure

64. The present organizational structure of the SBV should be streamlined to improve its supervisory effectiveness and efficiency. While the various departments appear to perform their designated areas of responsibility under the present regulatory regime, this fragmentation leads to a 'silo' effect where cross-departmental issues requiring fluid exchange of information and active cooperation between departments is not functioning well. The flow of information within the organization is slow, some matters may fall between cracks while in some areas there may be overlaps and duplication. The reporting lines from the financial institutions to the various departments in the SBV are not clear-cut, resulting in inefficiencies and overlap of information. As a result of the dissemination of information between several units, no department of the SBV can purport to have a comprehensive view of a financial institution's performance and situation.

65. The SBV's present regional structure of 61 branch offices and the delegation of powers therein is limiting the SBV's ability to effectively supervise the overall banking sector. It is also disrupting the large banks' ability to function as one, nationwide institution with consistent and coherent policies and business operations. The role of the SBV's branch network and its relationship to local governing bodies must be reassessed. The Independence of the SBV and its supervision of financial institutions is diminished considerably, putting at question the value of supervision. The number of SBV branch offices should be substantially reduced and their direct reporting lines to the SBV must be made clearer. The functions of the branch offices should be seen as an adjunct to and under the direction of the SBV, not independent.

Consistency in the Application of Bank Supervision

66. More consistency is required between the various laws and regulations, so that the requirements and terms are not subject to misinterpretation. The SBV is to be commended for the steps it has been taking to address this matter, but much more is needed. In particular, the ambiguous or varying definitions of key concepts and words such as capital, non-performing loans, overdue loans, secured loans, policy loans, etc. is likely to impact the effectiveness of the implementation of related supervisory policies. The SBV should act on behalf of the system as the sole definer of such terms. The SBV should regularly publish its definitions, interpretations, regulations and directives to eliminate potential ambiguities. Clarifying the objectives, duties and responsibilities of the various bodies involved in bank supervision is essential to adding consistency to the supervisory process.

67. The licensing process set by law leaves room for excessive subjectivity, without any clear and objective criteria. This opens to question the fairness of decisions and invites fraud and corruption in the process. While the SBV is granted a wide and comprehensive range of duties and powers in respect to the licensing process, general exceptions are allowed, without being

defined nor limited in scope. Exceptions should be rare and when permitted, they should be documented and justified.

68. One key aspect of banking supervision is the enforcement of banking rules and ensuring the safety and soundness of the banking system. Capital levels, lending limits and operating guidelines are provided to banks as a means of setting a standard by which they can all be judged. Allowing exceptions or offering forbearance destroys the value of the rules and weakens the system. It leaves those who view themselves as having some influence as feeling that they are above the rule and can act as they choose knowing an exception or forbearance will be granted. This discourages all banks from properly functioning within the set guidelines.

69. Application of rules in a consistent manner is critical to the credibility of the system. The extension of exceptions to certain institutions and in certain instances hurt the credibility of the supervisor and can even hurt the credibility of the institution receiving the waiver. The appointments of the SOCBs' board and senior management is a good example. The rules provide for a certain standard to be met by senior officials and board members of financial institutions. It does not appear however, that the same fit and proper tests as those applied to other financial institutions management are applied to SOCBs. This inconsistent application of the standard reduces its credibility as being important, demonstrates a lack of supervisory independence and to a certain extent suggests (even if not correctly), that those appointed to SOCBs would not pass the tests if properly applied. The emerging Camel-based bank rating system[4] introduced recently to grade the performance of financial institutions is a good step in judging performance of institution a consistent manner. Unfortunately, currently the Camel rating process does not appear to apply to the SOCBs. This inconsistent application of the rules attempts to hide problems, but only further builds upon them.

Transparency in Bank Supervision

70. Increased transparency is equally needed, with a view to promoting better discipline on the part of all the players involved in the banking system and its supervision. This transparency should contribute to the increase in the accountability of these players and help to build credibility and confidence in the system itself.

71. The collection of data from the banking sector could be streamlined and standardized to better service the supervisor and the banks. The data could be more effectively managed and efficiently used. Currently there is no clear information-sharing mechanism between the financial supervisors nor with the home country supervisors of foreign bank branches. It is not even clear that the various departments and branches of the SBV adequately share information. When information is shared it appears to be done on an ad hoc basis with no clear advance identification of the extent or content of information to be shared. The failure to do this and to establish certain confidentiality rules applicable to certain components of the data can result in the financial institutions not providing accurate or timely data.

[4] The "CAMELS" (the acronym stands for: *C*apital adequacy, *A*sset quality, *M*anagement, *E*arnings, *L*iquidity, and *S*ensitivity to market risk) Rating system is a supervisory rating of a bank's overall condition that is assigned at the end of an on-site bank exam and is directly disclosed only to senior bank management and to the appropriate supervisory personnel. Source: http://www.frbsf.org/econrsrch/wklyltr/wklyltr99/el99-19.html#subhead1.

72. When moving to a more market oriented banking sector , the availability of high quality, accurate information is essential. Most financial statements of Vietnamese banks are not prepared in accordance with IAS and some are not required to be audited, raising doubts on their reliability. Vietnamese laws and regulations pose a hindrance to the efforts of promoting true and fair financial statements for commercial banks. Vietnamese Accounting Standards (VAS), and particularly those dealing with loan classification and provisioning, have a decisive impact on the computation of capital adequacy ratios and are thus, very important to assessing the real condition of banks. Therefore, it is crucial that full IAS be implemented as soon as possible, setting out clear accounting principles which in the interim, will assist the SBV in the development of future accounting standards and aid in the harmonization and application of existing accounting regulation. (It should be noted that the SBV has taken steps in this direction.) IAS audits should be required of all banks, but in particular the larger ones. This move would substantially move forward the adoption and understanding of good accounting. It should be noted however, that the adoption of IAS for Vietnamese banks is likely to find some of them insolvent and thus the process by which this is done should be carefully considered. This could involve a clear and transparent picture of the financial position of the banks while providing explicit forbearance to permit the banks to reach the desired capital levels. Consideration should be given to requiring that the VAS and IAS audited financial statements be made available to the public. All of this would contribute to increased transparency in the system.

73. Though the legal framework for banking supervision has been deemed to be broadly suitable for the licensing process, exceptions have been noted, which contradict the principle of the SBV's exclusive competence in this field. Likewise, the SBV is legally empowered to address compliance of the financial institutions with the laws, but is restricted in exercising qualitative judgment in forming its opinion in many areas. The lack of transparency in the application of set standards for the appointment of senior managers and directors of SOCBs as discussed above, diminishes the credibility of the system.

74. The SBV should regularly publish and maintain all of its decisions impacting banking. Decisions on specific issues should also be published and the SBV should become the key source for information concerning all rules and regulations pertaining to banking. The publication of all rules, laws and decisions in one location would greatly benefit all players in the market. It would increase the likelihood of all participants being able to readily access the information and comply with it.

Supervision of Financial Institutions

75. Supervision of banks must be significantly enhanced. The supervisory process is an important element of the banking system and is one of the key components used to ensure its health. The examination function is one of the tools used in the supervisory process that permits the supervisor to review the operations of institutions to ensure they are acting consistently with the rules and regulations for the industry.

76. The examination process in an emerging market is often an evolving process. Vietnam is still at an early stage in this process, but is showing signs of progress and strength. Currently, the task of the inspectors is very much oriented towards checking the financial institutions'

compliance with the laws and regulations. The focus on the report structure, stamps and signatures is an indication of the early stage of the examination process. The inspectors' task is very much rule-based and does not involve much judgment in the evaluation of a bank's policies and procedures related to the making of loans and investments. Their main duty is to inspect whether the laws on monetary and banking operations have been observed by the financial institutions. Consequently, there is no assessment by the inspectors of asset quality or other risks in the banks' operations. In addition it would appear that lending decisions by some banks are still subject to external influences, thus increasing risk and diminishing the value of the examination process.

77. Although SBV's examination force is beginning to conduct compliance examinations, the examination force do not yet perform a forward-looking risk assessment based on the review of the asset portfolio and risk management control and procedures. The examiners also do not require, nor determine, the adequacy of provisions in case of diminution in value of investments. Loans are assessed based on a matrix of overdue periods, as stipulated in Decision n°488, rather than on the analysis of the risk profile of the borrowers. Examiners do not review the adequacy of the banks credit risk management systems, including underwriting standards, delegation of authority, adequacy of collateral and other lending procedures. Nor does the SBV always review the division of responsibilities to ensure there are sufficient checks and balances in a loan transaction. In addition, the SBV does not assess the processes of banks to evaluate the creditworthiness of their counterparts.

78. While the SBV has just been provided with an on-site inspection manual by an international accounting firm, the latter still needs to be implemented across the country. Beyond the procedures outlined in the manual, examiners need training in order to better assess the risk of credit and market exposures. Off-site surveillance does not appear to be based on a forward-looking methodology either. Short of an early warning system, the off-site monitoring does not seem in a position to assess risk-based profiles of the banks .

79. The SBV has recently been provided with a wide range of sanction powers, thus, there is not yet any meaningful track record to confirm the effective use of these powers. The actions can be potentially prompt, since the on-site inspectors themselves are empowered to apply them before reporting to the Governor. The actions can be challenged before a competent State body or a court, but their action cannot delay the corrective measure. It is also not clear yet if these powers will be used in a consistent and transparent manner as many of the same circumstances and issues discussed above potentially will apply.

Other Observations Concerning SBV

80. Going forward, SBV should concentrate more clearly on its core central banking and bank supervisory functions and, to that end, embark on an exercise to evaluate its role, mission and vision in the financial system development. A skills assessment should be conducted to determine the needs of the departments based upon the reforms that have been taken as well as those planned. An extensive training program should be undertaken for examiners and others that addresses the new skills needs and measures the performance of the staff. A review of the current examiner compensation should be undertaken to ensure that good staff can be retained and are not inclined to move to the banks, this could also help to prevent incidences of graft.

The SBV needs to formulate concrete strategies and policy direction for the regulation of the banking and non-banking sector emphasizing the key objective of ensuring the stability of the financial system. Similarly, the role of SBV branches should be reassessed as their functions appear to have been made somewhat redundant by the banking reform process.

81. In line with the vision of a modern dynamic central bank, the SBV law should be amended to grant it more operational and legal autonomy. The powers to decide, implement and enforce bank supervision should be clearly vested in the SBV, but should not prevent consultation with other relevant agencies. The provisions on internal governance and disclosure of financial accounts of SBV also need to be enhanced. In addition, consideration might be given to enhancing the powers of the SBV to decide monetary policy. There is a clear need for a diverse Board of Directors with requisite qualification and proper disclosure and clear rules should be set for declaration of interest and avoidance of conflict of interest by the Board members and the employees of the bank. Consequently, the SBV – as the central bank and bank supervisor – needs to review its organizational structure, policies and work processes, its legal powers and it objectives and role in the context of a dynamic financial sector.

COMMERCIAL BANKING

Operating Environment

Registration of Collateral Interest and Credit Reporting

82. The Government has recently set up under the Ministry of Justice (MOJ) a Registry Center for secured transactions, which should reduce future disputes among creditors on claims on secured transaction with movable assets. The first registered transaction was March 2002, and the Center's scope of operations covers all movable assets with the exception of ships and aircraft. The registration process should increase the transparency of lending transactions and of the ownership of the underlying collateral. Currently, there are two issues with regard to the Center: first, it is still in the early stages of its operations and is used only marginally by the banks; and second, the Center is not sufficiently technologically advanced to permit electronic filings and access to data. All filings for the entire country are done manually in the central office located in Hanoi, and all requests for information on liens rely similarly on a manual process. Reportedly, the MOJ is considering on an experimental basis expanding the operation to include registration of liens on land. To be able to effectively handle such expansion the Registry Center would need to computerize its operations adequately, and have its present operations running smoothly. Another important improvement would be to allow multiple liens properly prioritized to be provided on the same property. To that end, the SBV should consider strongly encouraging the banks to start using the services provided by the Center.

83. The Credit Information Center (CIC) was also established recently to provide credit information of borrowers to creditors. These two newly established agencies are in the early stages of operations but will be crucial tools for banks to reduce risk of their future lending. The CIC needs to be focused and concentrate on becoming a self-sustained and dynamic credit bureau. Its function of collecting all enterprise related information should be handed over to the registrar of enterprises and CIC ought to concentrate on credit information collection and analysis. To that end, the CIC should become as a separate legal entity/enterprise owned by the

credit institutions and/or enterprises with a regular Board of Directors, collection of a fee structure that will make it profitable, and it should provide access to borrowers in addition to the credit institutions. The related rights and duties of the pertinent parties involved should be clearly backed by a legislation with adequate sanctions for breaches.

Legal Issues Impacting the Banking System

84. There is an apparent need to amend the SBV law to provide the SBV with more operational and legal autonomy and to clarify its roles and responsibilities relative to other pertinent ministries and/or agencies. The powers to conduct and to implement and enforce bank supervision should be clearly vested in the SBV, without barring consultation with other relevant agencies. In addition, consideration should be given to giving them the same authority over monetary policy issues. The law should grant the SBV sufficient budget flexibility to enable it to recruit, train and retrain high quality staff. In addition, there is also need for proper disclosure, transparency and consistency in the activities of the central bank. To that end, the law ought to enable the SBV to have its accounts audited by an international audit firm followed by disclosure of the audit. (for further discussion, see section 4. on the SBV).

85. The Credit Institutions Law similarly needs amending to strengthen the supervisory role of SBV, both in terms of capacity and competence. The licensing and supervisory role needs to be consolidated and centered in SBV. The credit institution law needs also to be amended to allow for more effective prompt corrective actions. The provisions on the bank resolution and closure also have to be strengthened.

86. To enable effective and efficient supervision of credit institutions the SBV law should provide the SBV staff with sufficient legal protection from civil law suits potentially arising from their actions as SBV officials so as to encourage them to carry out their responsibilities. Similarly, the State-Owned Enterprise Act would need to be revised so that the SOCB staff and management are not held personally liable for losses created in the normal course of the bank's operations.

87. A new Anti Money laundering law ought to be enacted to ensure that Vietnam does not become a haven for money launderers. The current provisions on secrecy applicable to credit institutions have to be amended appropriately to enable the implementation of the anti money-laundering regime. Apart from that, necessary institutional structures to combat anti money laundering need to be also established. (for more details, see separate section 9.2. on Anti-Money Laundering).

88. The laws on insolvency, debt recovery and realization of collateral ought to be reviewed to provide for clearer, consolidated and comprehensive rules on the recovery process. This will take on a growing importance with the expansion of the private sector. To make the issued decrees effective, the decisions that have not yet been issued but are pertinent for the implementation of the newer decrees ought to be drafted and disseminated. There should also be recognition that despite the influx of circulars and decisions, the core problem concerning disposal of collateral still remains. Ownership documents of landed properties frequently fail to meet statutory requirements thus resulting in unsuccessful disposal of collateral. Apart from this, the procedures are still not clear on the transfer of the collateral to the bank or a third party under

an auction or private sale. Consequently, land titling reform ought to be expedited to enable banks to realize collateral related to land. Formal Alternate Dispute Settlement mechanism might also be considered to expedite debt recovery.

Deposit Insurance and Resolution of Problem Institutions

89. Past failures of financial institutions that resulted in the loss of deposits generated distrust in the banking system. Many citizens still harbor this distrust of the system and instead purchase gold and foreign currency, both of which are often kept outside the formal financial system. Foreign currencies, particularly US Dollars, are held widely and used both as store of value (or asset substitute) and as means of payment (currency substitute). These assets held outside the banking system, while giving comfort to their holder, do not assist in the mobilization of deposits that can potentially then be used by people and businesses throughout the economy in a more productive fashion. In recognition of this weakness in the system, the Government, with the assistance of the Asian Development Bank, drafted what became legislation for the creation of a deposit insurance system. Pursuant to the Law on Organizations of the Government dated September 30, 1992 and the Credit Institutions Law of December 12, 1997 (Law no 02/1997/QH10), the Government issued a Decree on September 1st 1999 (Decree No. 89/1999/ND-CP) establishing the Deposit Insurance Agency of Vietnam (DIA). In accordance with Article 23 of that Decree, the State Bank of Vietnam issued a Circular (No 03/200/TT-NHNN5) on March 16, 2000, which provided guidelines for implementation of the new system.

90. The stated purpose of the Decree was the protection of the lawful rights and interests of depositors. It was also the stated intention of the law, that such a system would contribute to maintaining stability of the credit institutions and help to ensure the safety and health of banking operations. It was hoped that the new deposit insurance system would benefit the smaller financial institutions which were viewed by the citizens to be more risky for deposit placements than the SOCBs. In order to ensure that citizens and depositors are aware of the existence of the protection, participating institutions are required to post notices of the existence of the deposit insurance.

91. The Deposit Insurance Agency officially started operations in July 2000. It is a Government organization, separate from the SBV, although it works closely with it. Irrespective of this separation, the SBV is represented on the Board of Directors along with the Ministry of Finance. DIA's headquarters are in Hanoi and it has 4 branch offices, including one in Hanoi, and it has a total staff of approximately 160. The DIA appears to have been provided independent examination powers for matters related to its function, though it seems to rely heavily on the SBV examination materials and other reports for much of its work.

92. Deposit Insurance coverage is VND 30 Million or approximately USD 2,000,including principle and interest. There is a setoff provision for depositors with outstanding loans. Today the amount covered can be deemed appropriate given the current average earnings of the citizens of Vietnam. The coverage amount can be altered by approval of the Prime Minister after recommendation of the Governor of the SBV and the Minister of Finance. The insurance coverage is for residents of Vietnam with no regard to nationality, but is limited to individuals. The coverage is by institution, thus providing flexibility to depositors to spread their deposits to other institutions to maximize their deposit insurance coverage. There is no clear priority of

distribution of proceeds of assets of failed institutions, although the SBV appears to be providing some guidance in this area. Further clarification in this regard is needed to provide a smoother exit process for failing institutions.

93. As of April 2002, 22 institutions had required the assistance of the DIA. Although the institutions were all small People's Credit Funds (PCFs), this is an impressive start for a new organization. Handling small institutions during this start up phase provides the DIA and its staff an opportunity to gain valuable experience and an opportunity to identify potential problems in the administration of the new system before there is a need to handle a larger institution. It is reported that the citizens of the local communities wherein these small institutions were closed have been pleased with the existence of the deposit insurance. Some saw the payment as a welcome surprise since they thought they had lost their savings with the closing of the institution. The experiences of the staff as well as the depositors will continue to add to the credibility of the system.

94. During the period March 2001 and November 2001, 19 institutions had their registration withdrawn. Data made available from the DIA shows that for these institutions, the total deposits outstanding on the day the registration was withdrawn were VND 4,939,128,000 (USD 329,275). Of that total, VND 4,078,615,000 (USD 271,907) was determined to be insured deposits. On average the insured deposits were paid within 66 days of the date of withdrawal of registration.

95. While there has been very good progress in the deposit insurance regime, there are some issues and concerns that the Government may wish to review. At the moment deposit insurance coverage is limited to local currency (VND) deposits. This would normally be appropriate when most of the transactions are conducted in the domestic currency and the total value of retail foreign currency deposits is small. International experience implies that countries with high degree of dollarization – many Central and South American, Middle Eastern and some key Asian countries – have opted for coverage of the foreign currency deposits. In 1999, of the 67 explicit Deposit Insurance Schemes in the world, only 26 exclude foreign currency deposits either completely (17 schemes) or some of them (9 schemes). Some countries offering coverage have opted for guaranteeing the payment for the covered foreign currency deposits in their own local currency. [5]

96. Accordingly, the Government may wish to explore whether it is warranted to cover foreign currency deposits given there is such a large volume in the system (45% of total customer deposits in the system although the number is distorted by one institution as the remaining institutions' average is closer to 25+%). In the event that an institution having foreign currency deposits were to become troubled, it would be reasonable to expect that depositors in other institutions would immediately seek to withdraw their foreign deposits. This could potentially have very serious implications for institutions with large volumes of foreign deposits as well as the system as a whole. Hence, consideration should be given to covering foreign deposits so long as they play such a major role in the mobilization of deposits in the system. If foreign deposits are not to be covered, then customers should receive clear notice that their foreign currency deposits are not protected by the deposit insurance scheme.

[5] Gillian G.H. Garcia, "Deposit Insurance; Actual and Good Practices" -- IMF publications, 2000

97. When considering the coverage of the deposit insurance, the Government may also wish to explore both clarifying and expanding its reach. Presently, the coverage is limited to individuals. As the private sector starts growing, the exclusion of firms from the deposit insurance coverage could have a potentially adverse impact on small businesses. These firms could lose their payrolls and working capital in an event of a failure of an institution. Consideration might also be given to making certain the current coverage limitations (individual depositors) does not discourage new types of accounts from being added to the banking system (joint accounts, trust accounts, etc.).

98. The over-riding policy consideration for a deposit insurance scheme should always be protection of the depositors' funds through the maintenance of the stability of the banking system, not preventing failures of financial institutions. To that end, the Vietnamese system does not appear to have a sufficiently clear process for the exit of troubled financial institutions. Although there appears to be a commitment to issue guidelines on the exit of troubled financial institutions, they are still pending. These guidelines should be issued as soon as possible so that they can serve to identify troubled institutions in a transparent manner. Early and clear identification of such institutions will help to ensure that the DIA can manage its risk. Moreover, the Circular No.03/2000/TT-NHNN5 contains a provision that addresses systemically important institutions. It provides that when an institution is in danger of insolvency, but not yet under "special control" that a determination can be made that its operation is important for the safety of the entire system as well as for political and socio-economic stability. Following such determination, the DIA can support the institution through various methods. It is unclear whether guidelines have been issued to prevent this provision from being abused and thus further clarification would be valuable.

99. According to the present regulation, the depositors having loans at the same failed institution face setoff of their deposit to the extent of the outstanding loan. This appears to apply without regard to the status of the loan at the time of the determination (performing or not performing). It is further unclear if the setoff against the loan is only to the insured amount or the total of the deposit. This lack of clarity can cause problems in the work of the DIA and could cause delays in distribution. Even more significant is, however, the potential impact on depositors with performing loans who rely on their deposits for day to day expenses. For example, an individual owning a small business who has a loan and a deposit at a failed financial institution may be relying on the funds in the bank for working capital or payroll. To the extent these funds are applied against the entire loan balance, the individual may not have funds to continue the operation of the business.

100. A great deal of attention must be given to resolving problem institutions particularly in winding down the affairs of a closed institution. The process can be hampered by weak supervision, inaccurate and inadequate data and a weak legal environment. The clearing of assets is important to the general creditors and uninsured depositors. It is not clear that the data requirements placed on banks are adequate to quickly identify accounts in a manner consistent with the goal of the DIA. Further, as there is an increase in depositors and types of accounts this will become increasingly more difficult to manage. It is noted that the current legal regime may not provide sufficient strength and consistency to support the needed collection efforts following the failure of a bank. It is not clear how the proceeds of a bank are to be distributed. While the insured portion of a deposit is covered by the DIA, the balance of the deposits is to come from

proceeds of the assets of the institution. In this context there is a need to clarify if the depositors have priority, how the DIA is to recover the deposits it has paid (insurance payments), and what is the claim status of the unpaid workers in relation to other creditors including unpaid taxes. To that end, a clear priority scheme for the distribution of the proceeds of the assets of a failed bank should be established.

101. The DIA has been granted independent examination authority, which can improve its ability to manage the risks, but this may result in potential duplication of functions between the DIA and the SBV. In a system that is currently scarce in experienced and well trained examination staff such practice may or may not be the best use of limited resources. Hence, attention should be given to minimize the potential negative impact of this duplication on the supervision of banks as well as the institutions themselves. This could be resolved through improving the coordination between the primary regulator and the DIA, especially when the examiners note a problem but have not yet completed their examination report. At the moment it appears that notification to the DIA of a problem is delayed until the formal examination report has been completed. Notification to DIA by the examiner of the discovery of a potential problem should be immediate.

Development of a Modern Payment System

102. Vietnam's payment system is a legacy of its centrally-planned past. Until recently, most payments were executed manually through SBV, which maintains 61 municipal and provincial branches through the country. Every branch of a commercial bank had to maintain a clearing and settlement account with its local SBV branch to be able to send and receive payments through the system. While consumer and retail transactions were (and still are) generally cash based, enterprise and government transactions were largely executed through special purpose checks and payment orders and several days to clear. The system did not adequately deal with issues of certainty or speed of payments that are essential for a market based economy.

103. Basic computer-assisted processing procedures were introduced in the early 1990's that helped improve the level of services but much more was needed to improve the design, development and installation of a comprehensive, effective and efficient payment processing arrangement. A comprehensive program to develop a modern banking sector was developed in 1995. The program aimed at improving payment services in the economy in order to reduce float, speed up circulation of funds and increase efficiency of funds transmission while providing convenience, service, and safety to users. The development of the national inter-Bank payment clearing and settlement system to handle inter and intra-provincial inter-bank payments (Inter-Bank Payment System (IBPS)) was a primary focus of this program.

104. With the support of the WBG, the Government is investing substantial resources in a payment system project that aims at increasing confidence in the Vietnamese banking system. This will be accomplished through improving payment services in the economy, and strengthening the institutional capabilities of participating banks (clearing banks, including all four SOCBs). The system will also permit the SBV to have sufficient and valid data available for making informed decisions, improving their internal management, and monitoring performance relative to the risks undertaken. The Government's payment systems project consists of both a national inter-bank payment clearing and settlement system to handle inter-

and intra-provincial payments; clearing bank intra-bank payment systems to handle inter- and intra-provincial intra-bank payments; and clearing bank institutional strengthening through setting modernization priorities, and specifications for key systems such as core banking system, management information and accounting systems, and risk management systems.

105. Experiences in other emerging market economies bring some important lessons to bear which the Vietnamese Government should consider. First, a substantial investment is required to build a function on-line payment, management and supervisory information, accounting, core banking and risk management system environment. The cost of initial investment and the expense of running the system rises disproportionately if the chosen system platforms are not compatible, i.e. cannot communicate with one another and use the same databases. Second, when building the core banking systems for individual banks, it is important that the design of the system takes into account the nature of each bank's core business focus and its needs. For example, a bank focusing on large and complex corporate finance would have different system design from a bank primarily serving a large number of clients nationwide in SME or household lending. As the banks today are embarking on larger scale IT investments to build their core banking, Management Information Systems (MIS) and risk management systems and beginning more extensive training initiatives for capacity building, they have a unique opportunity to tailor those significant investments to match their future chosen strategic focuses.

The Inter-Bank Payment System

106. Installation of the new IBPS was completed in April 2001. The final acceptance test took place in September 2001. With the approval of the IBPS legal and regulatory framework, the system has been operational since May 2002. The system is operating smoothly with approximately 20,000 "live" transactions being processed on a daily basis from the 60 commercial bank branches that are currently authorized to use the system. A further development is the recently issued Decision 44/QD-TTg by the Government, under which electronic signatures are given the same value as handwritten ones in documents. This is a significant step that will further reduce payment times, facilitate currency transfer, and allow for the future development and expansion of the IBPS.

107. While the system will benefit end users considerably (e.g. money transfers among companies via the banking system can be carried out within a few seconds instead of in one day) the IBPS will also greatly benefit the SBV's operations. One of the most important benefits of the IBPS for the SBV is the information it can provide to the different departments. The steering committee will be key in defining the information that will be generated, its frequency and who will have access to and be able to use the information.

The Intra-bank Payment System

108. The development of the intra-bank payment system was an integral part of the 1995 comprehensive plan to develop the banking sector. As originally envisioned the four large SOCBs and selected JSBs were to develop their own Intra-bank payment systems to handle inter and intra-provincial intra-bank payments. The development plan also called for institutional strengthening and the installation of key systems that will enable commercial banks to continue

the modernization of their banking operations through the deployment of modern Information Technology.

109. A proposed payment system steering committee of the SBV will monitor the operation of the system and prepare the regulation that will govern the pattern and content of electronic documents to be used for payment services among banks. The committee should also propose a plan for the future development and expansion of the IBPS that will cover, within a determined period of time, all commercial banks operating in Vietnam.

110. SBV appears to fully recognize the importance of the pending payment system regulation and is making serious efforts to ensure that it covers all relevant matters, including the operation of settlement accounts, and the mechanisms that will be used to provide central bank credit to the commercial banks on both an intra-day and overnight basis. As the system continues to operate, improvements will be required and regulation will need to be reviewed or issued in a progressive manner to ensure the safety and operability of the system in the future.

Regulations Regarding Banking Practice & Procedures Affecting the Payment System

111. The review of regulations covering banking practice and procedures is relatively urgent for the full implementation and development of the Payments System. Such review and the decision over these matters should be the responsibility of the proposed SBV steering committee.

112. Consultation with commercial banks on the payment system would be both reasonable and sensible. Such consultation would seek to find an appropriate balance between the safety of the Vietnam banking sector, and the freedom and ability of banks to promote the economic development of Vietnam through their own commercial activities and development. The proposed steering committee should act as the coordinating agent for suggestions regarding new procedures and for reviewing proposed departures from current regulations.

State-Owned Commercial Banks (SOCBs)

Medium Term Risks for the SOCBs

113. A potentially worrisome phenomena is the converging of the SOCBs' strategies. The SOCBs have recently been uniform in their focus on the large long-term syndicated investment loans to SOEs. The size of government infrastructure projects appears to have become too large to be financed by a single SOCB as it exceeds even the present prudential limit. Consequently, either all SOCBs participate in the syndication of these loans or the government grants exception to lend beyond the existing 15% cap of the legal capital. While all four banks assure that these projects have been priced purely on 'market terms' and that the banks have properly assessed the risk vs. return of these projects, it is not clear to what extent that really is the case. Lack of any foreign bank participation – despite their stated interest to do so – or even any Export Credit Assistance program involvement in any of these syndications begs the question of whether pure market forces were in effect. Further, comparing these rates to the early market indications published on envisioned rates for the planned Vietnamese sovereign international bond raises similar concerns, in that it appears the lending to these SOEs has been at a rate that currently

appears to be more favorable than the rates indicated by the international market for the Government itself.

114. As previously mentioned, the four SOCBs suffer from lack of credit skills and capacities and do not appear to have particularly strong capabilities in assessing complex long term investment projects on a commercial market basis. The reported maturities of these large syndications are very long (12 to 15 years in US dollars) with the premiums over the base rate coming across as surprisingly low judging by prevailing international market standards. This could potentially be an indication of a 'de facto' market oligopoly or even a cartel formed by the four state banks jointly under-pricing the risk to fend off perceived competition from foreign banks. This may have been done for the benefit of borrowers to avoid having to go through the credit assessment procedures or meeting the usual covenants required by foreign banks and Export Credit Assistance (ECA) facilities. Alternatively, the structures of these syndications could even be perceived by outsiders to be a continuation of policy lending. By avoiding internationally recognized credit assessment procedures, Vietnam missed out on an opportunity to establish an external credit record and strengthen its own internal standards. In the future, Vietnam will need to be able to access commercially based credit (internationally and domestically) for such large projects.

115. Irrespective of the origination process of these recent long-term syndicated loans, they may represent a constraint on the participating banks' profitability for years to come. These loans will tie up the banks' capital base for some ten years beyond the planned completion of the recapitalization program. They will preclude the SOCBs' capital base from being used for more profitable purposes, thus putting a long-term constraint on the profitability and, hence, the competitiveness of all four SOCBs. These recently syndicated loans have been largely long-term dollar lending and, as such, represent potential liquidity, foreign exchange and credit risks going forward.

Restructuring of the SOCBs

116. The SBV launched the start-up of the restructuring program for the SOCBs in April 2001. The program heavily emphasizes the need to resolve existing loan portfolio problems in the banks, including establishment of asset management companies to resolve NPLs, a phase-in recapitalization by the state (provided each SOCB can meet its performance targets), and the phasing out policy lending.

117. The SOCB NPL resolution and recapitalization program aims to clean up the banks' balance sheets and bring the four banks to the level of capital adequacy that meets the international Bank for International Settlements (BIS) standards. This is a necessary undertaking to ensure the competitiveness of the SOCBs and ascertain their access to capital and international funding going forward, particularly in light of the gradual opening of the Vietnamese financial system to international competition. There is, however, an additional challenge that the recapitalization program of the SOCBs will need to address. Given the relatively rapid deepening of the monetization in the economy, as reflected in the significant annual growth of total assets in all of the SOCBs and the sizable annual credit expansion, the future capital base will have to provide for not only the past pre-2000 lending but also for building conservative provisions for their recent and future increase in lending through the

restructuring and recapitalization period. While the banks may at least partially be able to build the provisions from their retained earnings, it is advisable to address the potential implications of this rapid credit growth in the context of the further design of the recapitalization program.

118. The official estimate of SOCBs' recapitalization requirement is believed to be about 17 trillion VND (approximately USD 1.1 billion at the current exchange rate). The objective of this exercise is to seek to quantify the total recapitalization costs of SOCBs under a stress scenario rather than to challenge the official estimate. However, the estimate produced is only preliminary. Further review, discussion, and clarification with various agencies in Vietnam would be necessary to finalize the estimate.

119. It is difficult to estimate the size of required provision and recapitalization need for the SOCBs. While banks are required to make loan classification and set aside provisions, the prevailing rules are quite liberal, subject to interpretation, and not uniformly applied nor are they consistent with international practices. As of April 2002, only the overdue installment portion is classified as non-performing loan. Moreover, there appears to be a window for reclassification of NPLs to "current" through various extensions allowed by existing SBV regulations. These weaknesses are clearly demonstrated by the international auditors inability to consistently estimate the size of NPLs while conducting IAS audit of the year 2000 financial statements of the four SOCBs. The authorities are aware of the issues involved and are expected to introduce international standards for loan classification and provisioning.

120. If the SOCBs are required to set aside the estimated loan loss provisions on both commercial and government policy loans, all SOCBs would likely be severely under-capitalized.

121. Irrespective of whether borrowers are state-owned or private enterprises, establishing a modern credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims though efficient mechanisms outside of insolvency, as well as a sound insolvency system. The establishment of the Asset Management Team and Liquidation Team, the procedures involved and the liquidation process does not promote speed and effectiveness in the insolvency proceedings. The procedures and process have to be made more efficient and the possibility for rehabilitation and reorganization of an enterprise that is illiquid but viable in the long run, need to be introduced. There is a clear need to build in more protection for creditors, and clear procedures for effective reorganizations. There is also a need to improve the skills and the capacity of the judiciary to handle insolvency issues.

Foreign Currency Risks to SOCBs

122. Another challenge to Vietnam banking sector is the growing SOCB exposure to foreign currency risk. During 1999-2000, the SOCBs have increased both their foreign currency deposit base and lending quite substantially. The banks have admittedly kept their net open positions (NOP) small, following the SBV prudential regulation limiting net daily foreign currency exposure. As of 2000, the aggregate net short position in foreign currencies by SOCBs stood at 1% of total assets (7% if contingencies in foreign currencies are included).

123. While the SOCBs losses in the portfolio resulting from the Dong depreciation are unlikely to add significantly to the estimated costs of recapitalization (due to SOCBs' small net

exposure in foreign currencies), some hidden risks remain. The liquidity risks in the short term and credit risks in the medium to long term – potentially exasperated due to maturity mismatches – cannot be identified by simply monitoring the bank's net open position in foreign currencies. The banks are building into their balance sheets even substantial maturity mismatches through lending very-long term dollars from a short-term uninsured deposit base. The banks appear to be managing their currency largely by matching their overall foreign currency exposures (aggregate deposits with matching size lending), and thus are passing much of the currency risk to their borrowers but may unexpectedly building credit risk. These increased liquidity and credit risk components of the currency risk warrant intensified attention by the supervisory authority, the SBV.

124. Passing on the currency risk to the borrowers, many of whom do not have a natural hedge in form of future foreign currency revenue or cannot hedge through the market, could expose SOCBs to potentially significant credit risks. In at least one of the SOCBs' credit portfolios, the denomination of borrowing did not match with borrowers' revenue stream. It is unclear how some of the recent hard currency-denominated lending conforms with the existing SBV regulation restricting banks from lending in foreign currencies for purposes other than financing imported goods or financing of projects which production is export-oriented. The risks involved are clearly demonstrated through the higher level of non-performing loans and the required provisioning on loans with currency mismatch, the bulk of which were extended prior 1997 to liquidated SOEs or to private entities. The SBV supervisors should take heed from past experiences and pay increased attention to the potential risks involved.

Exercise of Ownership Rights in SOCBs

125. The Government will need to seriously reassess the SBV's role in the running of SOCBs as discussed in SBV section 4.1. Presently, the SBV is unofficially tasked with acting, on behalf of the government, as the state body managing the banking system and yet it also serves as the body responsible for ensuring the strength of the system. This inherent conflict potentially diminishes its value in both roles.

126. The Government should take steps towards severing bank supervision from the exercise ownership role in the SOCBs. Further, the Government should look at how its ownership interests might be best managed. This should include increasing the capacity and the autonomy of the SOCBs to operate as market-oriented commercial banks, as well as holding management accountable for the profits and losses of the institutions.

Issues Concerning Joint Stock Banks

127. The consolidation of the non-state JSBs is underway. Licenses of 12 non-state JSBs were revoked as of September 30, 2002 bringing the total number of JSBs currently in operation to 36. Our of the 36 existing JSB, 34 meet the existing capital requirements and, the remaining two are under SBV special control

128. Despite the achievements of the JSB restructuring process, many JSBs could face capitalization problems if IAS loan classification and provisioning requirements were applied. Rapid loan growth and weak capacity to assess credit risk could result in an NPL problem and

JSBs may not have adequate access to external sources of recapitalization. The capital market in Vietnam is small and none of the JSBs are currently listed. Decision 1122 issued on 4 September 2001 puts a ceiling limit of state holding (directly and indirectly) in JSBs. Prior to that many JSBs were majority owned by SOEs and SOCBs. Therefore, the main recapitalization source for JSBs has been only from private equity, which may be scarce in the Vietnamese context.

129. The Government has moved towards regulating ownership of JSBs by limiting the percentage of capital that can be controlled by enterprises (both SOEs and non-government owned), individuals and families[6]. While these restrictions are below 50%, they still allow for 'de facto' controlling interests through large holdings by real sector and private individuals. SOCBs presently, by definition, fall outside any ownership or control restrictions.

130. It is not clear that there is a coherent strategy for the consolidation of the JSB sector. The SBV is implementing a restructuring program by raising the minimum capital level. As of May 31, 2002, the minimum required legal capital is 5 billion VND for rural JSBs and 50 billion VND for urban JSBs. JSBs that cannot meet the minimum required capital will be forced to merge with other financially healthy JSBs. However, since most JSBs appear undercapitalized by international standards, forced mergers could further weaken relatively stronger JSBs. In other words, consideration should be given to assure that the SBV plan to manage consolidation does not damage the JSBs that are in relatively financially strong positions. So far, the SBV has not forced these private sector banks to take over other, weaker private sector banks.

131. Some regulatory discrimination between JSBs and SOCBs remain. Unlike SOCBs, JSBs are not permitted to open an extensive branch network. This could constrain their operations given that most JSBs focus on lending to the private sector, particularly individual consumers and SMEs, which require larger branch networks as distribution channels.

DOLLARIZATION - IMPLICATIONS FOR THE BANKING SYSTEM

132. There is serious debate among Vietnamese policy makers on the impact of dollarization on the economy and what the appropriate Government policies should be towards dollarization. This debate is disadvantaged by the lack of reliable information on the extent of dollarization outside the banking system, and presently the SBV is developing estimates. The policy options with regard to dollarization should be weighed very carefully, as the phenomena has significant implications to the economy as a whole, but also in particular to the SBV's ability to conduct monetary policy and potentially to the stability of the Vietnamese banking system. This section focuses its discussion merely on the potential impact of dollarization on the financial system.

133. The ratio of foreign currency loans to total loans has been on the rise and this trend appears to be primarily driven by a substantial increase in foreign currency deposits. As of 2000, the average loan to deposit ratio of the four SOCBs was less than 100% (and significantly less in VCB[7]), indicating excess liquidity in the banking system. While the SOCB liabilities appear to be disproportionately dominated by deposits with no other significant funding sources available,

[6] Decision 1122 of September, 2001.

[7] VCB, the largest SOCB by size, which is active in interbank & money market lending and places more than 60% of its assets with foreign banks, therefore, has an atypically low loan to deposit ratio (36%).

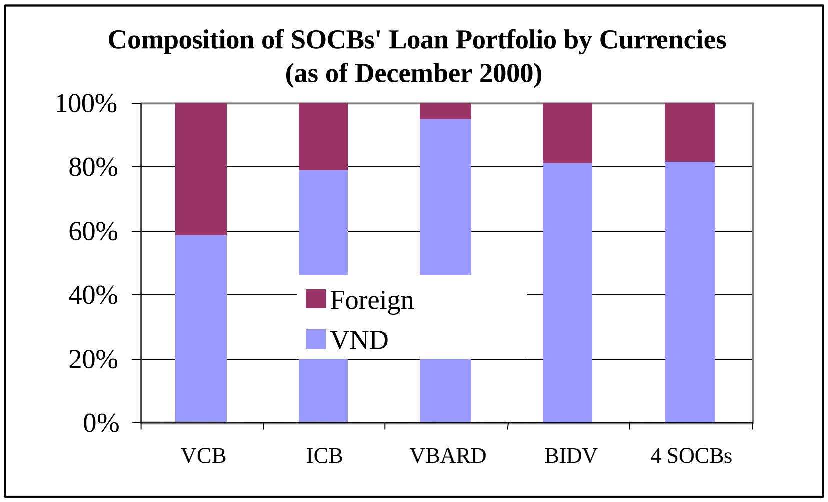
the low loan to deposit ratio may reflect, in part, the difficulties in finding viable borrowers. In the past six years (from 1995-2001), the average annual growth rate of loans by the SOCBs has exceeded 20% while the loan composition has changed only slightly. The SOCBs have gradually begun to increase their credit extension to the private sector[8], following the Government's announced policy to encourage bank lending to this segment of the Vietnamese economy. Similarly, the loan portfolios have also shifted from provision of short-term working capital to funding medium-to long-term investment projects.

134. The recent deposit growth in the SOCBs has been to a large extent in the dollar-denominated deposits. According to the banks, the primary source of the dollar deposits is the general public. While this mobilization of dollar-denominated deposits has been very successful in the past couple of years, these deposit funds are very short-term compared to the maturities lent out and the stability of this dollar funding base has not been tested. Assuming that the recent large long-term syndicated lending has not been directed, the uniformly enthusiastic participation by all four SOCBs in these large syndicated loans on the terms applied raises questions about the governance of the banks, the underlying incentives, and the implications on the banks' risk-taking (as discussed further in section on Corporate Governance / Incentives).

135. While the banks are restricted from extensive maturity transformation from short to medium and long term, the ability of the enterprise sector to consistently repay their dollar-denominated borrowing may be less certain general assumptions. The recent increase in long-term dollar lending (see Graph 4) – though admittedly still clearly below the limits – may be cause for concern. With the exception of VCB (that has significant short-term dollar-denominated placements abroad), it is unclear what the secondary source for dollars is given that no liquid and deep interbank market exists. While naturally the SBV can ultimately provide the dollars to the SOCBs, the confidence for the banking system could be further eroded if it became obvious that the banks are so dependent on the central bank window. The growth trend in dollar deposits reportedly has been somewhat tapering off in the past months. The substantial increase in the dollarization of the deposit base and the resulting maturity mismatches in the banks' balance sheets, coupled with the limitation of the deposit insurance scheme to only Dong-denominated deposits, are areas that should be closely monitored by the SBV.

[8] Growth rate of loans to private sector slowed down slightly during the recent Asian crisis but has since picked up.

GRAPH 4



Source: the banks' audited reports (12/00) and the World Bank's estimates

136. Given the significant proportion of dollar deposits in the system that are not protected under the deposit guarantee, the Government and the SBV should be careful when making policy or enforcement decisions that may affect the stability of these deposits. It appears that the Government, for many possible reasons, has not been particularly stringent in enforcing the prevailing capital controls regulation, especially with regard to use of dollars for domestic transactions within the Vietnamese economy. Recently there has been a mix of measures to tighten as well as to ease enforcement of various capital controls. Very careful prior vetting should be given to what effect such measures can have on the banks' deposit base. Any more substantial policy measures in the currency regime should be carefully weighed. The SBV may also wish to have a contingency plan in place for dollar-deposit flight from any of the banks, although the probability of such an occurrence seems presently quite remote. The Government may also wish to explore whether inclusion of foreign currency deposits under the deposit guarantee scheme is warranted (see section 5.1.3).

137. As in other emerging economies, the ability of banks to hedge through the external placement of funds is limited in Vietnam (with the exception of VCB) and other types of hedging are typically unavailable. Because of risk aversion (and regulation), financial institutions in emerging economies typically have responded to asset substitution by matching the currency composition of deposits with loans and other assets. Matching the currency composition of deposits and loans limits exchange risk but likely increases credit risk as borrowers, other than exporters, may not have assured sources of foreign exchange earnings.[9] It should be noted that merely matching the balance currency composition leaves the bank exposed, not only to such increased credit risks, but also to maturity mismatch and liquidity risks.

138. While the SOCBs appear to have very low net open positions in their balance sheet, they appear to be quite rapidly increasing their currency maturity mismatches through the very long-term (even 12 to 15 year) dollar-denominated lending, increasing the risks of passing on a

[9] Hanson and Honohan, final draft 2002 for 'Dollarization Private and Official – Issues, Benefits and Costs'

currency risk to a borrower that has no natural hedge through currency-denominated income stream to cover the foreign exchange risk. Given the gradual depreciation of the Vietnamese Dong (VND) over the past years and the uncertainty on its future direction, the authorities should monitor carefully the trends and the term structures of the possible dollar mismatches in the banks' balance sheets.

INTEREST RATE LIBERALIZATION

139. The Government has gradually liberalized interest rates since 1996. This process started with the Dong deposit rates, then to expanding the full negotiability to foreign exchange savings mobilizations in 1999, and to foreign exchange lending rates in 2001. Recently, it was expanded to include Dong lending rates. While the interest rate regulatory regime has been eased with these steps, there is little experience on what the true impact of the rate liberalization will have on bank behavior in setting the rates and thus their future profitability. The deposit rates appear to fluctuate relatively little, and it is not entirely obvious why. Rapid growth in monetization, reluctance to compete on rates by banks, and occasional SBV intervention may all be contributing factors.

140. The Dong-shortage during the spring of 2002, while putting some pressure on the over-night Dong-rates, caused only little movement in the rates paid on deposits and generally did not change bank lending rates. However, some rate movement was detected, primarily in the rural areas. The deposit rates were raised just slightly by some banks, primarily by some JSBs and most notably by VBARD, which is understandable as this large SOCB has proportionately the highest need for Dong-based lending. The SBV intervened early in the rate movement, though it is somewhat unclear whether the intervention was driven by a desire to keep interest rates stable, to ease a serious liquidity squeeze somewhere in the system, or to respond to public criticism over tight Dong liquidity.

141. The liquidity pressures eased with the SBV action to increase its open-market operations and to ease the required amount (to 30% of total hard-currency earnings from the previous 40%) of foreign currency that companies must convert to Dong from their foreign exchange earnings.

142. The SBV recognizes that, as a consequence of the rate liberalization, it is facing a sizable agenda of reviewing and reconsidering its monetary instruments and policies. The present policies may be having a distortionary impact, particularly between the SOCBs and the JSBs. The exceptionally low effective rates in the discount window and the refinancing facility, while in theory available to all banks, may be favoring the SOCBs disproportionately. In the planned reform of the monetary instruments, the SBV should – among other goals – aim to reduce the presently apparent 'tiering' in the money market.

143. According to the SBV, the pricing of the foreign exchange swap window reflects interest rate differential between the international dollar market and the on-shore Dong market. This high pricing appears to have been designed to steer the banks to use the interbank market. This may potentially put at least some of the JSBs at disadvantage, depending on the willingness of the SOCBs to deal with non-government banks. While building the money market is a very commendable goal, the high conversion rate at the swap window may also be indirectly leading to an adverse impact on the bank's credit risk through encouraging increases in dollar-

denominated lending – even to enterprises with no obvious natural hedge – when banks try to match their increased foreign exchange liabilities with assets.

144. Despite there having been some room for raising lending rates under the past interest rate cap regime, the Dong rates appear to have stayed quite inelastic and unresponsive to increased demand. At the same time, the dollar rates remained below comparable international market rates. The large SOCBs are clearly the rate-setters with 70% of the banking assets. These SOCBs explain this inelasticity as a fear of competition and a perceived duty to advance their clients' business prospects through providing good rates. This could imply quite an unusual type of pricing by the large SOCBs maintaining the lending rates at concessional levels despite their own interest margins possibly being insufficient to cover both their cost, credit risk and asset growth. In the short term, this inelasticity may appear to be beneficial to the SOCBs and borrowers, in the medium- to longer-term this could hurt the viability of the JSBs and potentially harm the development of a market-oriented and competitive financial sector. It is conceivable that the banks may today be pricing only to cover the direct cost of operations, with no allowance for true cost of capital, provisioning for credit risk or for building capital base for future growth. Since the rate liberalization is a very recent phenomena it is understandable that the banks are wary of taking aggressive steps towards a more market-driven competitive approach.

145. Even in the more liberalized rate regime, interest rate margins remain very low. This is somewhat surprising given that the SOCBs are undergoing a needed recapitalization program and are increasing general provisions for expansion in lending and for NPL resolution. The interest rate margins normally are an important focus area for the banks and the authorities as a proxy for the bank's earnings capacity. The margins should be sufficient to cover the operating cost, the provisioning for extended credit and contribute to the increase of capital base for further growth while providing return on the investments. The interest rate spreads and earnings capacity of the institutions are areas the authorities may wish to examine more carefully as they transform the SOCBs into commercially viable institutions.

146. The impact of rate liberalization may also be somewhat unclear as the banks have no uniform way of reporting their pricing structure in a transparent fashion. As a result it is difficult to determine the degree at which loans are given below prime to the Non- SOE sector. The banks should therefore be required to disclose to the borrower both the actual interest rate, all applicable fees and commissions, and the effective rate upon signing a loan agreement. This will increase the credibility and transparency of transactions and help prevent unauthorized charges from being added to the transactions. As the SBV moves to using more market mechanisms in its monetary operations – such as the envisioned move from prime rate to market-based reference rate – it should also be very clear which rates are being referred to when collecting and disseminating various interest rate information. In this context, it may be beneficial to define the various interest rates precisely and to educate the banks, the enterprises and the general public as to what the rates are, what they are used for, and how the various rates relate to one another.

Corporate Governance – Background

147. In the recent years, Vietnam has embarked on a banking sector reform agenda, both in legal, financial and operational frameworks applicable to its main actors, including the SBV, the SOCBs and the JSBs. The agenda focuses largely on resolving NPLs and recapitalizing the banks to improving their financial status. The implementation of best international practices and regulations on bank corporate governance obviously is encompassed by such a reform agenda. The recent initiatives from the SBV – namely, Decisions 1087 on organization and operation of the Board of Directors, the Supervisory Board and the Chief executive Officer; Decision 1122 on shareholders, shares, share certificates and charter capital of JSBs; and the new Draft Model Charter for JSBs – constitute important improvements of the Vietnamese regulations on Bank Corporate Governance.

148. The government may wish to consider leveling the playing field for SOCBs and JSBs by applying a similar governance structure. The recently issued JSB model charter for governance structure goes a long way in that direction. Given that the SOCBs are behind in this process, a more gradual step-by-step approach could be developed for them for such realignment. The important principles for such reform should be, to put in place proper checks and balances expediently, and to set a schedule for reaching a level playing field by applying uniform governance structures compatible with international standards throughout the banking system.

149. Presently, the conflict of interest regulation applied to SOCBs is stipulated only in the Law of Credit Institutions and, consequently, for these banks and their officials this pertinent area may not be covered in sufficient detail and clarity. Hence, the government should ensure that a similar scope of conflict of interest regulation and "Code of Ethics" applied to JSBs also is applied to the SOCBs and their officials and staff.

Composition and Organization of the Governance Bodies in Banks

Board of Directors

150. Current legal regulations[10] do not provide any distinction between executive and non-executive board members. The best international practice in corporate governance requires between one-third to a majority of Board members be non-executive. Often it may be advantageous for a Board to have a small number of senior management executive members in order for the Board to be better informed on the operations of the company. To accomplish an appropriate balance within the board, the regulations should require that at least the majority of the board members be professional, independent and non-executive. Independence here should be understood as members having no material interest (including shareholding in the JSBs) in the bank, so they can bring truly objective and impartial judgment to Board decisions. Such amendment would contrast with current regulations[11], which provides that members of the Board of Directors in JSBs must be shareholders.

[10] Both Decree 49 and the Decisions.
[11] Article 10 of Decision 1087.

151. The current SOCB governance structure and the assigned roles and responsibilities of various governance bodies involved lacks appropriate checks and balances and proper independence. While the Supervisory Board is affiliated with the Board of Directors, it is somewhat unclear whether it's primary function is to represent the owner's interest in the SOCB (in absence of an annual shareholders meeting) or to support the oversight function of the Board of Directors. The Supervisory Board does not presently seem to have real power or tools to accomplish either of such expected tasks. Further, if its role is limited to supporting the Board of Directors in the oversight, there would be no transparent channel for the exercise of ownership rights in the SOCBs. Meanwhile, the combined internal control and audit apparatus that presently report to the general director is vulnerable to conflict of interest, and make both internal control and internal audit functions directly dependent on the management. As such, the structure is exposed to dual and conflicting functions and can not be independent and objective in assessing activities or business processes. Similarly, the Supervisory Board can not perform its check and balance tasks as expected using the support of present internal control and audit structure for the performance of its assigned tasks.

Supervisory Board and Internal Audit/Controls

152. The Supervisory Board appears to be viewed by the banks to represent the owner's interest in the governance structure, particularly in the SOCBs which do not hold annual shareholders meetings. In place of other owner's representation, among its various tasks, the Supervisory Board seems to exercise on a continuous basis the type of oversight with regard to the owners' interests in the bank which in internationally applied standards is performed by the shareholder's meeting. Curiously, though, the Supervisory Board does not appear to have independent decision-making authority, but rather makes recommendations (for example, on the approval of annual accounts) to the Board for resolution. Hence, while there is a manifestation of the owner's influence through the Supervisory Board, it is weak.

153. International standards separate the internal control and internal audit functions. The internal control is management's tool for ensuring compliance with policies and procedures, preventing abuses and malpractices and promoting good internal risk management and governance within the organization. The internal audit function provides for reports to the Audit Committee of the Board of Directors, as well as periodic and ad hoc investigations to ensure the quality of the annual financial statements. Similarly, the branch level internal control and audit offices should be reorganized and their reporting relationships realigned. Independent mechanisms for risk management, internal financial controls and reporting systems help ensure adherence to procedures to prevent abuses and malpractices. This is an important device for the Board's control and oversight of the bank's management and operations.

154. The Supervisory Board of the SOCBs comprises representation from the MOF, the SBV and the bank's own staff. This is a possible conflict with SBV's apparent responsibility to manage the Government's ownership interest in the SOCBs as discussed in section 4..

The Role of Executive Management

155. A key principle in good corporate governance is the separation of executive (operational management) and the oversight functions to ensure checks and balances. Accordingly, the

Chairman of the Board of the Directors should not be in charge of or involved in the day-to-day operations of the bank. This executive role should be left entirely to the Chief Executive Officer (CEO) and other bank staff. It appears that in some banks the Chairman of the Board of Directors may be involved in the day-to-day management tasks, notably in the loan approval process. The Government may therefore, in accordance with these principles, wish to state in the regulations explicitly that the Chairman of the Board shall not take part in the day-to-day operation of the bank, including the approval of loans.

156. From this principle it is clear that the Chairman of the Board of Directors may not concurrently hold the position of the CEO within a bank. Such provision already exists in the Article 37 of the Law on Credit Institutions, and Article 10 of the Decision 1087. However, Decree 49 provides to the contrary in its Article 46, paragraph 5. It would therefore be advisable to amend Article 46 of Decree 49 to provide, in compliance with the Law on Credit Institutions and Decision 1087, that the Chairman of the Board of Directors may not concurrently hold the position of the CEO .

157. In a bank's credit activities there should be a clear separation between the roles and responsibilities of the Board of Directors and the bank management. The Board should be responsible for approving the overall credit policies of the bank, including setting the requirements for the credit procedures to be applied and the desired credit risk profile of the bank's lending operations. To that end, the Board should then oversee the compliance of the bank's operations against these set policies and procedures, that would be explicitly spelled out in the bank's Credit Manual. The Board may wish to establish a Credit Policy Committee to undertake these functions, recognizing that the operational day-to-day credit activities be under the domain of a Credit Committee that reports to the management of the bank. These roles – the policy and operations – should be clearly separated to provide for effective oversight with proper checks and balances.

Risk Management

158. To ensure effective credit operations, it is crucial that banks have a powerful and reliable Credit Committee established under the authority of the CEO. The Committee should be responsible for routine credit approval, make recommendations to the CEO as outlined in credit policies and provide feedback and information to the Board on implementation of credit policies and developments in credit risk. The Credit Committee's membership should at minimum comprise of the Chief Credit Officer, the Chief Risk Management Officer and other relevant key members of the bank's management. The CEO may also be a member of the Credit Committee and the minutes of the Committee meeting should be available to the Board of Directors, and /or its Credit Policy Committee. To ensure competency and efficiency, the Credit Committee members should have appropriate qualifications and ideally, commercial banking experience.

159. Similarly, the Asset and Liability Management Committee (ALCO) should be established under the authority of the CEO to support the bank management in managing the bank's interest rate, foreign exchange and liquidity risk. This committee typically reviews interest rate exposures and approves management strategies for investment, market, deposit and lending activities. It also evaluates the bank's liquidity position.

Incentive Structure

160. One very powerful incentive for the SOCBs management is the regulation linking their compensation to the performance of the bank. While this approach is universally agreed to be an effective way of motivating the management, the ultimate outcome from this linkage will be greatly affected by the details of how the performance is measured. The compensation of SOCB management and staff is comprised of two separate portions: their salary and the annual bonus. As SOCBs are a special type of SOEs their salary levels are determined by the regulations applied to SOEs which tie the salary level, among other things, to the size and scope of the enterprise through a salary category system. The management and the staff of the larger enterprises fall into the higher salary categories. It appears that presently the performance portion of SOCB management and staff [12] is linked to the improvement of the annual audited VAS-based profits of the institution. As a measure of profitability, the 'bottom-line' – or even its movement from one year to another – completely fails to capture either the efficiency of the utilization of the bank's resources, the long-term sustainability of the bank's profitability, or the risk-level of the bank's operations.

161. Both compensation schemes used for SOCB management and staff (the basic salary category directly and the performance pay scheme indirectly) reward the beneficiaries for growing the enterprise larger while not penalizing them for undertaking risky business. Both schemes may discourage management from expenditure and investment. Hence, this approach may entice the management to engage in risky or under priced lending practices or even to avoid important investments that may be needed for the modernization of the banks. This may be done to maintain the perception of continually rising profits and, consequently, results in higher compensation.

162. There is evidence of the SOCBs expanding their operations rapidly while the necessary investments and NPL resolution appear to be lagging behind. The risks may be exacerbated in the present environment where the SOCBs are slated to undergo a fundamental restructuring and recapitalization program, while the details of those programs are not yet spelled out in sufficient detail. This leads to added concern in relation to the afore-mentioned management and staff compensation schemes. There is a risk of a moral hazard situation where bank management has a limited sense of real capital constraints beyond the present lending limit regulation. More specifically, there may be an inadequate understanding of the opportunity costs involved, for example, in tying up the limited bank capital – present or the one to be received in the recapitalization program – to low-margin long-term loans that may carry credit, currency and/or liquidity risk. Consequently, the premises of the management and staff reward structures in the SOCBs should be expediently reconsidered and revised to reflect appropriately not only the profitability of the bank, but also the risk levels of operations, the need for capacity and skills improvement investments, the build-up of provisioning and the NPL resolution.

Exercise of Ownership Rights

163. Some of the key decisions that, by international standards, would be either shareholder, Board of Directors or purely management decisions are presently made by various SBV

[12] MOF Decision 166, Article 22.

departments on a regular or ad hoc basis. There does not seem to be an explicit procedure or criteria for the appointment of members to the SOCBs' board of directors or top management. Appointments are made by the SBV Governor. Interestingly, many banks seem to have their own staff as members of the key governance bodies implies that many of the key governance related oversight functions are *de facto* performed either by the bank management / staff and /or by various departments of the SBV.

164. One key decision the government needs to consider is which agency or ministry should exercise the shareholder rights in the SOCBs going forward. Presently, it appears that – while the MOF is the official representative of the owner of the banks, the SBV, and occasionally even some other parts of the government, exercise many of the ownership rights. The government is reportedly contemplating setting up a financial management company (similar to a government holding company structure used in some countries) to manage the state ownership interest in SOEs, including the SOCBs. Given the prevailing ambiguity about the exercise of the ownership rights in the SOCBs, the Vietnamese government should not only consider how and through which entity it wishes to exercise these rights, but it should also formulate a clear and consistent framework and policy for this function. Such reforms would need to be coordinated closely with the development and monitoring of the restructuring and the planned recapitalization program. In the process, the respective roles and responsibilities of the shareholder and the supervisor would need to be carefully balanced, separated and clearly spelled out.

165. SOCBs are presently special state-owned enterprises that are governed directly by three laws: the Law on State-owned Enterprises, the Law on Credit Institutions and the State Bank Law. Therefore, implications of SOE reform are directly valid for the SOCBs as institutions. Reportedly, the Vietnamese policymakers have been discussing a model under which SOEs could be converted into a single-owner limited liability company, but still remain wholly state owned. This would represent a way to phase-in the creation of a more level playing field for all enterprises, possibly resulting in SOEs operating more like private companies.

166. Although most banks agree that the SBV currently intervenes less in the day-to-day operations of banks than in the past, the SBV also agrees that the remaining scope of intervention is still too wide. Many of the SBV or SBV branch approvals required today seem to be unnecessary as they slow down the management process without providing the banks any obvious value. The government may wish to move from the explicit SBV appointment, removal or dismissal of the CEO to a less coercive procedure, such as is widely used under internationally applied standards. It is customary for the supervisor to leave such appointment decisions to the Board of Directors, subject to the candidate meeting standard 'fit and proper qualifications' set by the regulator. Such process could easily be put in place for JSBs and a similar 'fit and proper' test could eventually be applied to the appointment processes in the SOCBs.

167. The present ambiguity about the exercise of the state's ownership rights in the SOCBs is not conducive for banks to operate on truly commercial basis, nor does it empower the SBV to function as independent and efficient regulator and supervisor. Therefore, in the context of reassessing the exercise of state's ownership rights in SOCBs, the government should consider moving towards a practice of holding a formal Annual Shareholder's Meeting for each of the SOCBs. The Government should make clear which agency will represent its ownership interests and make public the key decisions made at the meetings. This would constitute an important

step towards improved, more internationally compatible corporate governance structure in the SOCBs.

Transparency – Annual Accounts and Audits

168. An important governance issue is the availability of good quality information for the supervisor, the shareholders and other stakeholders. The quality and usefulness of the data available for the bank management, auditors, the supervisor and other stakeholders is largely dependent on the relevance, consistency and quality of the information content of that data. The regulatory environment defining the key concepts in banking information is the foremost driver of ensuring high quality and relevance of the information available for informed decision-making and oversight. Presently, the data available based on prevailing regulations and VAS accounting standards does not provide relevant and consistent enough information for the various stake-holders to be able to make informed judgments on the true status of and risks being taken by the banks. This creates a weakness in the supervisor's ability to make timely and sound decisions and for taking potentially needed corrective actions.

169. The approach taken by MOF and the SBV in establishing the accounting practices and policies appears to have been rather ad-hoc, resulting in gaps in some areas. While detailed rules have been established, there is no framework setting out the concepts underpinning the preparation and presentation of financial statements for external users. VAS (as of April 2002) differs from IAS in many respects. The major differences include loan classification, loan loss provisioning and accrual versus cash accounting of interest income and expenses. The supervisors do not appear to have made any efforts to promote public disclosure of the banks' financial statements.

170. With paper based reporting still largely in use today for all banks, the quality and timeliness of data available for the supervisor – not to mention other important stakeholders – is seriously lagging. Through the new interbank payment system, and planned build-up of intrabank payment and core banking systems in the large banks, the SBV has a unique opportunity to jump-start the flow of good quality and useful information to important stakeholders. The key stakeholders within the SBV include not only the supervisors, but also the monetary, foreign exchange and statistics functions. These systems and clear information requirements would allow the banks' management to manage operations more effectively. It would also substantially enhance the quality of banks' financial accounts and annual audits, and enable increased transparency to depositors and various other market participants. These suggested changes would require careful planning and coordination of the information content of the various reports to different stakeholders, ranging from consistent and accurate definitions of concepts all the way to the frequency and data contents of the regular and ad hoc reporting.

171. In light of the government's decision to open the financial system to international competition – albeit the most significant opening of the system taking place still some years from today – the future stability of the entire banking system in Vietnam would be well served by the SBV beginning to move carefully, but decisively towards using internationally compatible accounting standards and definitions (particularly for prudential regulation). With the recent regulations issued by the SBV, such as the Decree 1627 on provisioning, some good progress is being accomplished but further steps will need to be taken. By the time Vietnam's

liberalization obligations become effective under the BTA with the United States (and further liberalization requirements under Vietnam's planned accession to the WTO in 2005), the Vietnamese accounting standards will need to better conform with IAS so as to ensure true and accurate information on the financial conditions of banks. Specifically, loan classifications and loan/loss provisioning should reflect the credit risk of loans. Early action by the government will be essential to give the banks sufficient time to prepare and adjust to the requirements they will eventually face when seeking external funding, competing against foreign banks or establishing more extensive international banking relationships and networks.

172. The annual reports of the SOCBs should provide accurate information on the bank's operational results to key stakeholders. To ensure the quality of the annual financial statements of the banks, it is recommended that the SBV issue guidelines on internal and external audit standards for banks. Such guidelines should help management in conducting banks operations and the SBV in supervising banks. As the audit results become more reliable, consideration should be given to requiring banks to publish their annual audited financial statements.

173. The SBV may also wish to consider putting in place a pre-approval process for qualified external auditors for banks and begin publishing such list. This would not only increase the credibility of the audit function but also facilitate the selection of external auditors without the need to request separate SBV approval. This would replicate the practice established by many bank regulators and would be consistent with the State Securities Commission's system. The banks should still have the right to select, at their discretion, external auditors not included in the list subject to explicit approval by the SBV. The application of such an auditor pre-approval process could be gradually expanded to apply to the SOCBs post-implementation of the recapitalization program, subject to strengthened governance structure of the banks.

Fiduciary Duties and Conflict of Interest

174. Insider activities and conflicts of interest by management and directors can lead to reputation, liquidity, compliance, and credit risks. If a manager or a director does not comply with stringent insider policies, the bank's reputation and that of its directors may be tarnished. In the worst case, such crisis of trust could lead to liquidity problems through loss of confidence. A bank may also be exposed to credit risk when insiders use their positions to obtain loans for which they might not otherwise qualify.

175. As already discussed in section 8.1, the conflict of interest regulation and "Code of Ethics" should be equally applied to SOCBs and JSBs.

GOVERNMENT ISSUES

Policy Lending

176. The Vietnamese government has announced its intention to establish policy banks to take over the policy lending from the SOCBs. The government has undertaken measures to that end through the establishment of the DAF, announcing the transformation of the recently established Export-Import Assistance Fund to an Export-Import Bank (though no firm schedule has been set for that transformation), forming a Credit Guarantee Fund for SME finance, and the separation of

the Bank for the Poor from VBARD (for a more extensive discussion on Bank for the Poor, see section 9.1.2).

177. The Development Assistance Fund appears to have picked up some of this policy lending in the past year or two, although at least some of the SOCBs still appear to be extending new policy like loans and all of them carry some old ones on their balance sheets. It is not apparent that the Government has yet determined a timetable to transfer policy lending solely to the established specialized policy lending banks/lending institutions. Hence, as many of these measures are still largely in the planning mode or early stages of implementation, the current portfolios of SOCBs do not reflect the announced intention to transform them into purely commercially based lending institutions. Presently, SOCBs report the majority of their lending to the SOEs as being commercially based, although it also appears that approximately 50% has been extended to either loss making or marginally profitable SOEs.

178. While there appears to be some migration of SOE policy lending to the DAF instead of the commercial banks, two of the four SOCBs still have quite significant policy loans in their portfolios. Some of these credits are backed by designated funding, some with either explicit or implicit government guarantees as they have been viewed as being an integral part of the government's policy lending programs. Typically such loans would have lower margins than the purely commercially based lending and therefore, such loans can tend to repress the banks' profitability ratios. Even when backed with dedicated funding, these loans would represent a constraint to the availability of capital for other more profitable lending – a situation that will arise when the SOCBs will be exposed to normal capital constraints (beyond the present single borrower 15% cap of statutory capital) following the upcoming recapitalization. Therefore, in the context of the recapitalization program, the government will need to make strategic choices on how the existing stock and future policy lending will be handled going forward.

179. It is not directly obvious that all parties concerned have a uniform understanding of what constitutes policy lending. While there are projects that clearly fall under the definition of government policy lending, it appears somewhat unclear whether all credit with explicit government guarantee would fall into this category. There is an even wider confusion with regard to the standing of SOE credit where the government guarantee is only implied, though still apparently perceived by the banks to be fully backed. Even the auditors do not seem to be entirely certain how these various degrees of government involvement should be interpreted when assessing the loan portfolios. Going forward, in the context of the planned recapitalization program, it will be pertinent to clarify these matters for provisioning and capital requirements purposes.

180. The nature of government guarantees becomes even more pertinent given the Government's announced ambitious plans for equitization of SOEs. There is need to seriously consider the possible implications of this program for the banking system as such a process would put the newly privatized companies on a level playing field with the private enterprises. Presently, the loans to SOEs that are perceived to have government backing do not represent a real capital constraint for the SOCBs although those in default certainly impact the bank. It is unclear, however, how the existing stock of credit to the to-be-equitized SOEs would be handled and how their future funding needs would be ensured. More specifically,

(a) the government will need to decide how it will permit the write off of debts and whether it will stand behind the existing explicit guarantees to such companies and, if so, how it will ensure that those guarantees are not rolled over to any new credit extension;

(b) upon equitization the standing of the implicit guarantees is uncertain and the credit with such assumed backing may suddenly represent a significant capital constraint for the banks. The banks may consequently require that the equitized SOEs cover this existing credit with collateral to replace the implicit guarantee, thus constraining the companies' collateral base that they may need for future borrowing; and

(c) to continue to operate profitably and to grow, the equitized SOEs will need to have excess collateral capacity to cover their working capital and future investment needs.

181. While such leveling of the playing field with the private enterprises is naturally welcome, this will require the government and the banks carefully consider the implications to the profitability and the creditworthiness of the SOEs to be equitized. It is not obvious that the banks currently have adequate skilled credit staff to handle this potentially substantial upsurge in 'private' credit.

Development Assistance Fund and Vietnam Postal Savings Service Company

182. The Vietnam Postal Savings Service Company (VPSC) was established in 1999 (making it one of the youngest postal savings schemes in the world) and operates under the authority of VPT. It's main functions are to provide a savings product for the underserved (rural, women, and poor) populations of Vietnam and to mobilize savings for government development investments. The VPSC currently has 539 branches and plans to expand to 600 branches in 2002 and potentially many more in the future. Of those, 93 are currently computerized, and there are plans to computerize 100 more in 2002. VPSC offers a time savings and a collection savings (demand deposits) and a limited money transfer system for clients. Time savings make up the vast majority (some 95%) of the deposits officially, although approximately 30% these accounts are withdrawn early, subjecting them to a lower interest rate paid and effectively making collection deposits 35% of the total deposits.

183. With the program starting in 1999, there are presently nearly 500,000 deposit accounts with the VPSC. VPSC has to date collected about cumulatively VND 7 trillion in deposits, with current outstanding deposits at VND 3.8 trillion and the outstanding amount of VND 2.8 trillion transferred to the government to be on-lent to the DAF. Some VND 986 billion are currently held as a reserve fund in VBARD. All the deposits collected are placed in a bank account with VBARD until they are transferred to MOF or remain in the reserve account. DAF is the vehicle under the MOF through which the government allocates development investment credit. DAF pays MOF interest on these funds that mature at intervals of 1,2, 3, and 5 years which MOF passes as payments to VSPC. The interest rate paid by MOF to VPSC is determined by the Ministry of Finance based on the interest rate of the state budget bond with the same term, currently the annual rate is about 7.1%. It is unclear whether the interest payment by DAF to

MOF fully covers this government interest expenditure. There is a proposal to the government that would allow more flexibility in this rate to allow for VPSC's to be more competitive with the rates the State Owned Commercial Banks pay depositors. It is unclear whether the liabilities arising from the mobilization of these deposits is captured in the state budget liabilities.

184. Current rates for both time and collection deposits range from 0.45 - 0.6% per month depending on the term. It is uncertain how the interest rate liberalization will impact the deposit rates offered by VPSC. The operating cost of VSPC is de facto subsidized by the VPT through the use of its staff, as the VSPC itself has only 100 staff on board. The VPSC sees computerization as its biggest obstacle and opportunity. Moving from paper-based to computerized operations would be an expensive endeavor and such undertaking cannot be completed all at once. This has, however, been identified as a priority to increase the valued added of existing services (all computerized postal savings offices can be linked instantly) and would facilitate the expansion of services to include money transfers between accounts, payment of utilities, etc. The money transfer service between savings accounts within the VSPC has been launched in Hanoi and rolled out in northern provinces, recently starting expansion to Ho Chi Minh City, and it plans to be extended nationwide by year-end.

185. The VPSC serves the traditional roles of a postal savings system providing a savings product to the underserved and mobilizing funds that are then administered by the government for development investment in Vietnam. There is increasing demand for basic financial services, in particular savings, in Vietnam. In a country where 80% of the population lives in rural areas, even the 2000 branches of VBARD cannot reach wide, nor deep enough to the population at large. The postal savings system offers the use of a structure that is obligated to have equal geographic distribution, not access driven by profitability. The postal savings system appears to be preferred by rural customers who have no previous exposure to financial services, especially since it appears to offer an implicit government guarantee.

186. While the VPSC currently plays an important role providing a savings vehicle to the underserved, it should be examined whether it is the appropriate mechanism in the long term. This should preferably be done in the context of a wider assessment of government's policy towards provision of microfinance services (an undertaking that is proposed below in section 9.1.2.on 'Bank for the Poor and Provision of Microfinance'). Many countries, particularly in Eastern Europe, are in the process of privatizing many of their postal savings systems. Many of these systems have been in existence for over a hundred years and the demand for, and provision of, their services has evolved past the traditional structure of a postal savings bank.

187. As an Example, Japan's postal saving scheme is seen as one that has served an important and rather unique role in both the provision of financial services to the underserved, as well as the provision of funds to achieve much needed and many successful infrastructure projects and programs. Today, however, it is seen as a competitor among commercial banks This claim come about as Japan has less need for infrastructure funds. . As a result, Japan was left with more resources than viable development infrastructure projects. Care should be given when Postal Savings funds are used for development projects. While they can be positive results from their use at the early stages of economic development in a Country, if the program is not closely monitored it runs the risk of out-living its usefulness.

188. Postal savings systems and government run funds they support are not necessarily well-designed and those running them often lack the required banking skills needed to administer and adequately protect the funds. To that end, there is some concern that with the VSPC mobilizing more savings, the VPT may desire to use the excess funds for its own investment purposes or providing excess funding to the DAF. This is something Vietnam and other countries with relatively young postal savings schemes may be wise to note when planning these schemes and consider building into the programs mandatory independent reviews of the quality of their investments as well as to confirm their continued need.

The Vietnam Bank for the Poor and Provision of Microfinance

189. The Vietnam Bank for the Poor was established in 1995 by a decision of the Prime Minister and began operations in 1996. The Vietnam Bank for the Poor (VBP) was designed to address what the government saw as a major issue in combating poverty- lack of capital, or lack of access to capital for production by rural and urban poor households. The Bank's mandate is thus to extend small loans to the poor for production purposes, such as farming, animal husbandry or handicraft. The loans are extended to individuals only, not to enterprises, and the bank does not presently lend for mortgages, or education or consumption purposes. The VBP operates in both rural and urban areas, though its primary target clientele for the most part appears to have been rural households. It has to date reached some 2.8 million clients.

190. The bank receives its funding from a variety of sources. It does not mobilize savings from its clients. Its total funds amount approximately to VND 6,000 billion of which the bank's equity is about 16.2% or VND 1,015 billion placed into the bank by the government. VBP has further received approximately VND 412 billion (or 6.6% of total funds) from local governments as trust funds, VND 940 billion from SBV, and some VND 200 billion of foreign trust funds (IFID) and on-lending (OPEC) funds. For the funds received from government or its agencies VBP does not pay interest. Finally, the bank has borrowed approximately VND 3,700 billion from the commercial banks – primarily from VCB and VBARD – under the auspices of government guarantee. VBP pays market rate for these borrowed funds but receives a government interest rate subsidy for the gap between its lending rate and the borrowing rate.

191. VBP does not have its own network, and it relies on VBARD's branch network as a disbursement, collection and accounting agent for its funds according to policies set by the VBP. Thus, it does not offer funds transfer or other banking services either. The bank has a formal board structure comprising vice-ministerial level officials from the various relevant cabinet offices (including the Prime Minister's office), as well as general directors from the SOCBs, the Farmer's Association, the Women's Union, etc. The Vice Governor of SBV acts as the Chairman of the Board. The Board meets to discuss operations and the mobilization of funds for VBP from the various government sources they represent. On the provincial level, there is a board structure that is very similar to the bank's Board of Directors (BOD) and that is chaired the Vice Chairman of the People's Committee and engages in the supervision of the VBP activities in the province. Similarly, the local Farmer's, and Women's Unions partake into supervision of the VBP 'Loan and Savings Groups' on local level.

192. The VBP extends its loans on pre-qualification basis, whereby the eligibility to borrow is based on a list of poor households provided to the bank by communal level People's Committee.

The loans are extended based on a production plan submitted by the borrowing household. The bank extends loans in two maturity groups: short-term loans of 12 months or less and medium-term loans of one year to five years. The maximum loan size is about VND 3 million (USD 196) and the average loan size about VND 2 million (USD 130). The loans are administered in a group lending situation and clients are required to meet with the local VBP "Loan and Savings Group" each month to both pay their interest and a small mandatory savings contribution (VND 5,000 to 10,000) that are placed in VBARD or used for payment of interest or principle. The Groups also encourage voluntary additional savings by their members who can place funds through the group structure or directly with VBARD. The Groups place all funds with VBARD and the funds are individually accounted for (rather than being kept as a group account). There are 250,000 such groups with leaders trained by VBP. The World Bank has previously provided funds for the purposes of training these leaders.

193. VBP reports a 94% on-time repayment rate although it is somewhat unclear what the exact definitions used by the bank in the context are. The overdue rate is reported to be 6.6%, though net of natural disasters of only 2.2%, with the government covering the natural disaster effect. VBP also estimates that some 30,000-40,000 households have graduated to VBARD loans and thus "out of poverty". VBP has expressed interest in increasing the average loan size to VND 5-10 million (approx. USD 326-653) as well as expanding its services to offer loans for consumption as well as production. VBP recognizes that this would require increased sources of funding, and it is somewhat unclear what the strategy for increasing the sustainability of VBP's operations will be. Similarly, it is unclear what the impact of such an increase in loan size would be on the bank's continued service of its current clientele needing smaller loans, and how the bank would ensure that an increase in loan size did not extend the present subsidies beyond the households identified to be below the poverty level.

194. Despite the various government – including VBP – and non-governmental schemes in microfinance, the outstanding issue is that a large portion of the population does not have readily available access to financial services. About 60% of low-income households' do not have access to formal credit (the remaining 40% is from three sources, i.e. Vietnam Bank for Agric. and Rural Development; Vietnam Bank for the Poor and People's Credit Fund). Thus, the vast majority rely on informal sources such as moneylenders, relatives and rotating savings and credit associations and, overall, it appears that the demand for financial services is quite high.

195. VBP along with other government programs reaches only a subset of the poorer population in Vietnam. The SOCBs and government programs appear to reach and service the upper segment of the poor households, with VBARD serving segments with annual average household incomes of VND 1.8 million; VBP of VND 600,000 and People's Credit Funds of VND 300,000. Altogether, close to 6 million low income households were borrowing through these vehicles in 1999[13]. The influence of the informal financial sector – comprising of money-lenders, relatives and rotating savings and credit associations and other individuals – appears to continue to be very significant constituting about half of lending to rural poor households. For the future development of the microfinance sector, the pilots that the various international NGOs are undertaking may provide useful lessons. These initiatives are small and fragmented but

[13] Dao Van Hung, 1999

appear to be doing some good work by providing credit to those segments not targeted by the government banks and official programs.

196. It is unclear, what the implications of the announced lending rate liberalization will be in the provision of microfinance and the balance between the formal and the informal lending segments. The potential impact of this, together with VBARD embarking on a significant restructuring and recapitalization program, the government's announced capitalization of VBP as an independent entity, and the growth of the private sector, may be unanticipated and even sizable. Hence, the government may wish to examine these issues, and consider developing a coherent strategic policy framework for the provision of microfinance services in Vietnam to ensure continued stability and credibility and improved sustainability of this important part of the financial sector (as an indicator of loans and average loan size by source see Table 2).

Table 2: Farm households' loans and average loan sized by sources

	Loans		**Average loan size**
	(% of total)	(% of segment)	(1,000 Dong)
Informal financial sector	51	100	1,752.1
Money lenders	9.8	19	2,141.3
Relatives	24.2	48	1,860.9
ROSCA and other individuals	16.8	33	1,365.7
Formal and semi-formal sector	49	100	3,208.5
Private banks and cooperatives	2.2	4.4	2,230.1
Government banks	40	82.2	3,512.3
Government programs and others	0.7	13.4	1,547.4
Total	**100**		

Source: Vietnam Living Standard Survey, 1997-1998 according to "Microfinance in Vietnam" by DFID in August 2001.

197. The VBP operations are entirely dependent on government funds, guarantees and interest rate subsidies. The bank lends to its clients presently below market rates, pays no interest for a large part of its funds, and receives an explicit government guarantee and interest rate subsidy for the bulk of its funding. While VBP has built a very impressive structure and processes, its operations are not financially nor institutionally sustainable without these support mechanisms. While VBP has certainly been successful in improving access to bank funding, it should be noted that international best practice has shown that, over the longer run, consistent sustainable access to financial services that are provided reliably is more important than low interest rates loans provided by unsustainable institutions.

198. The Government may wish to examine how it can improve the sustainability of VBP and thus, better utilize its built up institutional structure. In light of the ongoing interest rate liberalization process there is a unique window of opportunity to examine the possibility of VBP mobilizing funds through savings products or other means to start moving towards financial sustainability. The extensive number and breadth of the VBP groups could provide a very useful infrastructure upon which to build a more self-sustaining small scale lending operation. The subsidy oriented and government loan funded nature of the current program does not create any market incentives or discipline for client graduation out of subsidized small scale borrowing. The present structure of the program may in some ways indirectly be tying its clientele to dependency

on government subsidies instead of encouraging fully independent enterprising. While admittedly lending to the poor can not always be a market driven enterprise, some middle ground is desirable, and it is a very positive sign that VBP is aware of and tracks the graduation of clients to VBARD loans. This type of success by VBP should be more closely examined to better understand the situations under which households are able to move from subsidized loans under VBP to commercial loans from VBARD.

199. Overall, it appears that there are various providers of microfinance services within and outside government, however, it is not obvious there is a clear vision/strategy on how to sustainably develop microfinance in the long-term. To increase the sustainability of these schemes, the focus should be on institution building rather than targeting the poor with subsidized interest rates – as is the case of the government programs and may become the continued focus of the Bank for the Poor if the new plan to restructure it into a government agency providing loans for development projects is put in place. There is presently a disproportionate emphasis on the credit side of services and a lack of savings products. To develop a balanced microfinance industry that provides wide access to a range of needed financial products throughout the country, the foundations for the microfinance industry – such as the legal and regulatory framework and the consistency of the interest rate regime – would need to be carefully examined and developed. In addition, the issue of which institutions can mobilize savings from the public may need to be considered in this context.

Anti-Money Laundering

200. Vietnam still has a relatively underdeveloped banking sector that is dominated by SOCBs. The organization and operation of the sector is still tightly controlled although liberalization is in process. The high profile terrorist attacks in 2001 and beyond fundamentally changed sentiments on financial disclosure and illicit money flows in the international arena. As a consequence, many countries have recently enacted Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) legislation. As more countries pass such legislation and start actively enforcing it, money launderers will look for 'safe havens' where serious efforts have not been made in these regards. Countries with weak financial sector infrastructures are likely to be targets.

201. It is internationally recognized that AML/CFT laws are important elements of safeguarding financial stability and therefore sustainable economic growth and poverty reduction. Money laundering essentially involves criminals disguising the proceeds of criminal activities so they can avoid detection and the risk of prosecution when they use the funds. AML laws are intended to prevent or at least limit the ability of the criminals to use the proceeds of their illegal activities and to protect the financial system from the potential adverse impact these funds or loss of credibility and public trust could have. CFT is concerned also with the use of funds and the use of financial sector to facilitate terrorism through hiding the identity of those engaged financing terrorism.

202. Under today's international standards, AML and CFT are usually addressed together in a comprehensive statutory framework. Thus far Vietnam has not been listed by Financial Action Task Force (FATF) as a non-cooperative country with regards to fighting money laundering. As

Vietnam seeks greater international acceptance and enters into international agreements, AML/CFT will inevitably take on a growing importance..

203. For some time it was felt that Vietnam did not need to be concerned over money laundering as it had a fairly tightly controlled financial sector and economy. Over the past few years the Government of Vietnam has taken a number of steps to modernize and strengthen the financial sector. Despite these steps to modernize the financial sector, people in Vietnam still use cash for significant amount of transactions. Credit cards, debit cards or even checks are not used in the most common transactions. Some citizens appear to save precious metals as an alternative to depositing cash in the banking system or to supplement and hedge their savings. In addition, many people save foreign currency (primarily US dollars), only some of which they actually deposit in the banking system.

204. In addition to the formal financial system, there exists an informal or underground banking system. There is lending among friends and family which has supported new private sector businesses. Remittances from relatives abroad are often transferred via various informal channels rather than through the formal banking system. Some bring these funds into the country in cash. This informal system represents the primary basis of the financial system in many rural areas of Vietnam and will be much more difficult to monitor. While the amounts involved in the informal remittances appear to be relatively small by size, that does not mean, however, that this area can be ignored as it is open to being utilized by criminals as an avenue for laundering proceeds of criminal activities.

205. The level of government control over the financial sector has been reduced and will decrease into the future, which presents new opportunities for money launderers to abuse the system. Vietnam's largely cash based financial system, coupled with the hording of gold and foreign currency, may even act to support or encourage money laundering activities.

206. Vietnam does not currently have in place an institutional framework to enforce AML/CFT, even though Article 19 of the Credit Institutions Act of 1997 states that:

(a) The Credit institutions and other organizations conducting banking operations shall not conceal or provide any services in respect of sums of money the origins of which, have been proved to be illegal, and

(b) In cases where sums of money with illegal origins are identified, credit institutions or organizations conducting banking operations shall promptly notify the competent State body.

207. In addition, Article 251 of the Penal Code appears to generally criminalize AML, but not explicitly. While these provisions suggest the initial steps of an anti money laundering regime, there are no clear procedures or established structures in place. Nor are there even basic requirements for "know your customer" rules or "reporting of suspicious" transactions to the police or other appropriate authority. Although some laws purport to touch upon AML it appears that the courts have limited their interpretation to matters of corruption and not money laundering. Small deposits as well as the opening of deposit accounts can be done with no identification. Although allegedly deposits of large amounts require identification, there does

not appear to be a set amount. There appears to be no requirement to report domestic transactions of any size to any of the authorities.

208. As the primary banking regulator the SBV has recently begun to take action on behalf of the Government to address the AML issue. The Governor of SBV has assigned SBV staff with a responsibility of preparing draft legislation and regulations for combating money laundering. A timetable has been established that will require a formal presentation be made addressing the issues associated with AML. This will be used in the attempt to gain approval of the National Assembly for placing an Anti-Money Laundering Bill on the Legislative Agenda for next year. The Government has requested that the AML legislation be placed on the National Assembly's legislative agenda. Work on the draft legislation, in parallel with the legislative procedural agenda, has started in the SBV.

209. In drafting it's Anti-Money Laundering Law, the authorities should note that an effective Anti-Money Laundering Law requires an adequate legal and institutional framework to ensure practical compliance. Regulations should comprise adequate and timely sanctions for non-observance and provide for administrative arrangements, including the following elements:

(a) The predicate crimes that serve to trigger the provisions of AML/CFT law should be clearly stated and defined. The list of proposed crimes should be reviewed in the context of Vietnam and its ability to enforce the laws, even if later additional crimes are added to the list.

(b) Criminalization of money laundering and terrorism financing should be clearly established as a part of the law;

(c) The list of all of the types of institutions that must comply with the requirements of the law should be included, recognizing the types of institutions in Vietnam, including insurance, money remitters and others;

(d) A new or existing government authority must be assigned responsibility for the enforcement of the law;

(e) Power to investigate suspected activities and the power to confiscate related assets needs to be included;

(f) The establishment of a central Financial Intelligence Unit (FIU) and the processes for collection, analysis, and dissemination of financial intelligence information within the country should be addressed; and

(g) An established process for international cooperation on matters concerning suspected money laundering and terrorist financing should be included.

210. Vietnam's current lack of an effective AML/CFT regime potentially puts all of its financial institutions at risk of not being able to participate to the fullest extent in world financial markets. This problem can be even greater for a particular institution if that institution demonstrates an inability to satisfy AML/CFT compliance requirements that are otherwise applicable to and enforced in other financial institutions. In addition to the requirements listed

above, the authorities should also review the following issues in the context of establishing an AML/CFT regime:

(a) The issue of the existence of a number of people in the country who still deal exclusively in cash. Although this may be changing, it is still a way of life and must be considered and recognized.

(b) Currently there is no formal suspicious activity reporting process for deposits, or a series of deposit transactions suspected as possibly derivatives of an illegal activity.

(c) In addition, there is no clear policy, procedure or criteria on the identification of persons making deposits, although it was suggested that if a large deposit were made that the person might be asked for identification. Identification of depositors, especially large customers, is essential. Also in this context, the principle of safe and sound banking, "know your customer" rules are essential.

(d) Further, consideration should be given to establishing deposit and cash transaction thresholds that trigger reporting to those assigned responsibility for monitoring money laundering activity and enforcing the law. The threshold amounts for reporting should be set in the context of earnings in Vietnam and should permit a degree of flexibility for future changes in a growing economy.

(e) The continuing distrust of the banking system, as evidenced by the saving in gold and cash by some citizens, should not be discounted. It will need to be factored into any regime, even if there is a phase-in period for change.

211. Each of the FATF on money laundering 40 principles for AML and the recently added eight principles for CTF should be addressed in the proposed law.[14] This may require additional prudential and supervisory regulations for the financial system.

[14] FATF is an inter-governmental body, based in the Organization for Economic Cooperation and Development (OECD) offices in Paris, whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering. For more see: http://www.fatf-gafi.org/index.htm.