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VIETNAM'S BANKING SECTOR DEVELOPMENT OVER THREE DECADES OF ECONOMIC RENOVATION: ACHIEVEMENTS, CHALLENGES, AND POLICY SOLUTIONS

Over the three decades of economic renovation, Vietnam banking sector has been reformed in market-oriented directions and in compliance with international financial standards. The context of deeper financial integration requires a more efficient, resilient and competitive banking sector in the country. For this purposes, in the years to come, the following regulatory measures should be taken into consideration: (1) strengthening the autonomy and capability for the SBV; (2) continuing process of financial restructuring and liberalization to further improve the competitive market behavior; (3) promoting prudent risk management and supervision; (4) cooperating proactively, actively with other countries to cope with common financial risks at regional level; and (5) building a more concrete framework and appropriate roadmap to improve the convertibility of the national currency (Vietnam Dong).
JEL: E52; E58; F36; F38

Introduction

Over the past three decades of economic renovation (*Doi Moi*), the Vietnamese government has implemented many banking reforms to enhance efficiency and competitiveness of the country's banking system. The banking sector has grown substantially from a mono-banking system to a network of credit institutions of all ownership, especially via the equitization (i.e. *per se* privatization) of its state-owned commercial banks (SOCBs). The subsequent reforms have, *inter alia,* focused on restructuring of banks' capital, reconsolidating, improving of banks' governance, merger & acquisition (M&A), equitization and implementation of initial public offering (IPO).

In line with domestic economic reforms, Vietnam has also been active and proactive in international economic integration. The first effort to integrate into the regional economy began in 1995 when Vietnam became a member of Association of South East Asian Nations (ASEAN), and was followed by Asia Pacific Economic Cooperation (APEC) in 1998 and Vietnam – US bilateral free trade agreement in 2001. Vietnam then participated in various ASEAN-plus free trade agreements (FTAs) such as those with China and Korea. Thanks to bold and comprehensive reforms and liberalization efforts, Vietnam became

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member of the World Trade Organization (WTO) in 2007. Even after the WTO accession, the country went on to negotiate and/or implement other ambitious FTAs such as ASEAN-Japan Comprehensive Economic Partnership, ASEAN-Australia-New Zealand FTA, ASEAN-India FTA, ASEAN economic community (AEC), Vietnam-EU FTA, Vietnam-Korea FTA, Trans Pacific Partnership Trade Agreement (TPP), Regional Comprehensive Economic Partnership (RCEP).

Thanks to the efforts of the government, Vietnam banking sector has developed significantly in terms of intermediation, financial/credit depth and governance, and overcome unprecedented financial instabilities taken place since 2011 to present. Despite the fact that the financial system has recovered from turbulence; however, it still contains a myriad of risks, ignorance of that can lead to a catastrophic consequences for itself and the national economy as a whole.

In the context of ongoing restructuring of the economy and financial markets and upcoming implementation of the new generation FTAs, there are urgent needs for further regulatory reform to nurture a sound, efficient and competitive banking system in the country.

Except Introduction, the paper is structured into three sections. The first section provides a comprehensive picture of the banking sector's reforms over three decades of economic renovation. The next section analyzes weaknesses of and challenges for Vietnam banking sector system in comparison with its Asian peers and international financial standards in the context of deeper financial integration and liberalization. The last section offers major policy solutions to resolve the current weaknesses/drawbacks of the Vietnamese banking system and to build up/nurture a sound and efficient banking system in the years to come.

1. Vietnam's banking sector reforms and developments

1.1. Key banking sector's reforms

Vietnam began early reform in its banking sector as a part of the broader set of market-oriented reforms in the mid-1980s, focusing largely on decentralizing financial services. Prior to 1990, the State Bank of Vietnam (SBV) operated as both central bank and commercial bank. It subsequently separated its four main departments to form four newly SOCBs in 1990, each targeted to a different sector of economy. The SBV's role and functions were narrowed to that of a central bank which includes the formulation of monetary policies, management of foreign exchange reserves, and licensing and supervision of credit institutions; while financial intermediation functions, which include funds mobilization and allocation were shifted to commercial banks.

Bearing in mind that many of the banking reforms have been largely motivated by the country's entry into international trade and investment agreements, such as Vietnam – the United States (US) Bilateral Trade Agreement (VN-US BTA) in 2001 and its official accession to the World Trade Organisation (WTO) in 2007. The country has gradually deregulated to allow easier entry of foreign banks in terms of scope/domains of activities and of shareholding.

Over the three decades, the Government has put remarkable efforts in regulatory reforms in order to allow more types of financial institutions to engage in wider equity participation and wider range of banking activities. In opening up the banking sector, a number of policies measures have been promulgated, comprising of two new versions of Law on Credit Institutions in 2010 and Law on SBV in 2010, and many other under-law guiding documents.

The country has lately implemented relevant regulatory reforms in a wide range of banking activities. According to WTO commitments, the array of banking activities offered to foreign credit institutions is practically the same (11 activities) as the group of activity open to their domestic competitors, except for market limitations on accepting deposits 2013 in VND in the initial 5 years of the business opening.

As for acceptance of deposits and other repayable funds from the public, shortly after WTO accession, the SBV promulgated Official Letter No 1210/NHNN-CNH 2007 to gradual easing limitations on foreign bank's branches in accepting VND deposits over a 5-year phase ending in 2011 when national treatment to foreign competitors are granted. In 2010, the amended and supplemented Law on Credit Institutions 2010 provides detailed regulations allowing commercial banks, financial companies and financial leasing companies to provide all types of deposits and repayable funds from the public for full national treatment (NT) in 2011.

Similarly, for lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction, the Decision No. 1096/2004/QD-NHNN were amended and supplemented by Decision No. 30/2008/QD-NHNN, stipulating that credit institutions eligible for factoring services include domestic commercial banks, joint venture banks, 100% foreign owned banks, finance companies, financial leasing companies and foreign branches. Law on Credit Institutions 2010 further allow commercial banks, finance companies and financial leasing companies to provide all types of credit (Articles 98, 108, 112).

The detailed process of banking sector liberalization in Vietnam is also evident as the followings:

<u>Regulatory reforms in licensing conditions and legal form of credit institutions</u>

According to Vietnam's WTO accession commitments, foreign-invested credit institutions are entitled to conduct banking business in Vietnam in the form of bank branch, joint venture bank and 100% foreign-owned bank. Before WTO accession, in 2006, the ratification of Decree No.26/2006/ND-CP officially specifies concrete conditions for establishment of foreign-invested credit entities in domestic banking sector. For example, Article 8, specifies the licensing criteria and procedures including the paid-capital requirement for parent bank in establishing branches (USD 20 billion) and in establishing joint venture and commercial entities with 100% foreign capital contribution (USD 10 billion), which practically fits the WTO commitments. The Law on Credit Institutions also provided the conditions regarding activities for Credit Institutions to be licensed. Recently, Circular No.40/2011/TT-NH specifies the participation of foreign capital contribution (less than 50% of foreign capital contribution in case of Joint venture and more than 50% in case of 100% foreign-owned bank).

Regulatory reform in foreign equity participation in domestic banks

Foreign equity participation in domestic banks has been expanded in recent years. Decree No. 69/2007/ND-CP on 20/4/2007 on foreign investors' purchase of shares of Vietnamese commercial banks provides principles on foreign equity participation, specifically:

1. The maximum shareholding percentage for foreign investors (including existing foreign shareholders) and their affiliated persons is 30% of the charter capital of a Vietnamese bank.
2. The maximum shareholding percentage for a foreign investor other than foreign credit institution or his/her/its affiliated person is 5% of the charter capital of a Vietnamese bank.
3. The maximum shareholding percentage for a foreign credit institution and its affiliated person is 10% of the charter capital of a Vietnamese bank.
4. The maximum shareholding percentage for a foreign strategic investor and his/her/its affiliated person is 15% of the charter capital of a Vietnamese bank.

In special cases, the Prime Minister may, at the proposal of the State Bank of Vietnam, decide to allow a foreign strategic investor or his/her/its affiliated person to hold shares exceeding 15% but not exceeding 20% of the charter capital of a Vietnamese bank.

Recently, the Government issued Decree No. 01/2014/ND-CP dated on January 3, 2014 on purchase of shares of Vietnamese credit institutions by foreign investors provides further participation for foreign investors.

Banking sector's supervisions and prudential measures and restructuring programme

Key aspects of the SBV in regulatory reform's on the supervision of the banking sector include: (1) resolving NPLs in banking sector; (2) gradual standardization of NPLs classification based on international standards and best practices; (3) shifting key standards application from Basel I to Basel 2 (which is scheduled to be completed by 2018); and (4) strengthening on-site inspection and compliance supervision, meanwhile laying initial ground for risk-based supervision. These efforts can be seen in legal documents. For instance, in order to strengthen regulatory and supervising measures, the Decision 83/2009/QĐ-TTg provides detailed provisions on rights and obligations of bank regulatory commission at SBV. Besides, the SBV has issued legal documents specifying prudential ratios to manage credit risk (Decision 18/2007/QD-NHNN), liquidity risk, operation risk, interest rate risk – (Decision 437/2006/QD-NHNN) – for the sake of safety operation of the credit institutions. Circular No. 36/2014/TT-NHNN replaces Circular 13/2010/TT-NHNN to improve capital adequacy and liquidity requirements for credit institutions.

To tackle the problem of bad debts in the banking system, the government has paid enormous efforts to mitigate the problems in the banking industry, especially since the recent undertaken programme of restructuring of commercial banks. In July 2013, the government had established Vietnam Asset Management Company (VAMC), to take bad loans off banks' balance sheets through issuing of bonds to local lenders. In October 2013, VAMC first purchased VND 40 trillion of bad debts; and by the end of Dec 2014: to VND 81.6 trillion.

Liberalization of banking interest rates

In order to strengthen the role of monetary policy, the Law on SBV was amended on 19 June 2010. The amended and adjusted contents include regulations on liberalizing the basic interest rate and managing interest rates in line with market mechanism. The Law on SBV stipulates more clearly missions and responsibilities of the National Assembly, the Government and the SBV in implementing monetary policy. The National Assembly decides the tentative inflation target for each period. The Government identifies inflation target and orientations for conducting monetary policy each year. The SBV prepares the scenarios of inflation targets for each period, on the basis of which the Government will submit to the National Assembly for determination of targets and related monetary policy measures each year.

2.2. Banking sector's development

Since its initial reforms in 1989, Vietnamese banking sector has rapidly developed in market scale, number and type of institutions. Vietnam has swiftly shifted its banking system from mono-banking model to two-tier banking model. In early 1990s, there were only 4 state-owned commercial banks (SOCBs). Owing to the improved legal framework on banking activities, over the three decades, the number and type of credit institutions have experienced a rapid growth with all form of ownership. As of 2015, the number of joint-stock commercial banks (JSCBs) accounts for 33, after recent bold steps of the State Bank of Vietnam (SBV) in restructuring (largely vis-à-vis M&A). Among 4 SOCBs, only Vietnam Bank for Rural and Agriculture Development (VBARD) is pure SOCB. The number of Foreign-invested credit entities (including 100% foreign capital banks, joint – venture banks, foreign bank branches) is totally accounted for as much as 100 (Table 1). In addition, as of June 2013, there were also 18 financial companies, 12 financial leasing companies and 968 people credit funds that provide specific type of credit to the country's economy.

Table 1

Development of Vietnam's financial institutions, 2010-2015

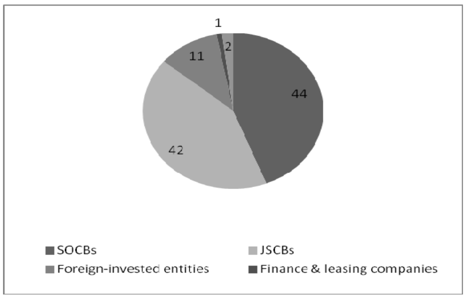
Type of credit institution	2010	2011	2012	2013	2015
SOCBs	5	5	5	5	4
Social policy banks	1	1	1	1	1
JSCBs	37	37	34	33	33
Foreign bank branches	48	53	49	53	53
Joint – venture banks	5	5	5	5	6
100-% foreign capital banks	5	5	5	5	6

Source: SBV statistics and the author's compilation.

It is noteworthy that among credit institutions, the SOCBs have the highest amount of average chartered capital; meanwhile, the credit co-operatives have the smallest. As of Sep. 2014, SOCBs occupied a lion share of 44% of the country's total banking sector assets shrinking substantially from a dominant proportion of about 90% in early 1990s.

Figure 1

Structure of banking sector assets by type of ownership, 30 September 2014

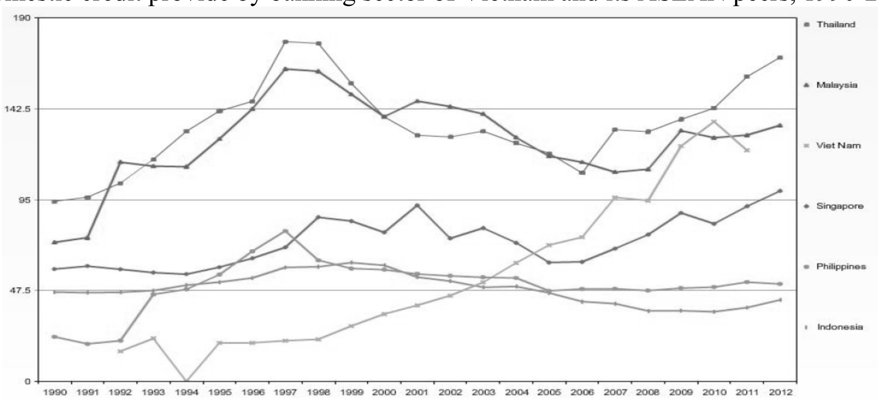


Source: State Bank of Vietnam.

Since the first years of reform, Vietnamese banking intermediation has experienced substantial growth. In 1992, domestic credit provided by banking sector accounted for only 15.7% of GDP, from this time onward, this ratio increased dramatically, peaking at 135.8% of GDP in 2010. Bearing in mind that the country's banking intermediation ratios have been much more higher than those of other economies in transitions in Eastern Europe (about 40-50%), but much lower than some other ASEAN members (for instance, Thailand and Malaysia, see Figure 2). As to its structure, Vietnam's financial market is regarded as a bank-based one, i.e. the banking sector is still dominant in terms of capital intermediation for the economy. Despite its less important role in capital mobilization in comparison to a number of ASEAN peers, Vietnam's banking sector contains a variety of risks that threaten the country's financial stability.

Figure 2

Domestic credit provide by banking sector of Vietnam and its ASEAN peers, 1990-2012

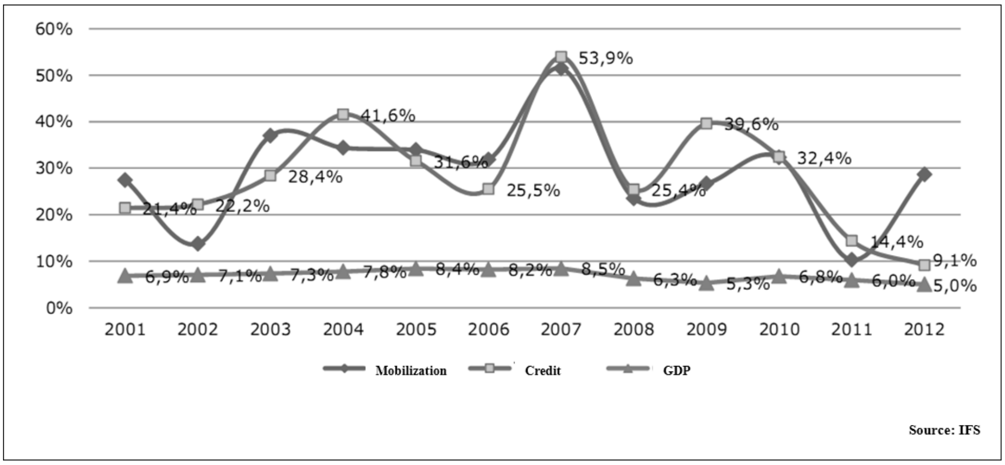


Source: World Bank Database, compiled by Le Trung Hai (2014).

It is noteworthy that the high level of banking intermediation has long been attributed with high growth rates of lending and borrowing (Figure 3) that led to high inflation (CPI) in the economy (particularly in 2008, 2011).

Figure 1

GDP and y-o-y lending and borrowing growth rates, %, 2001-2012

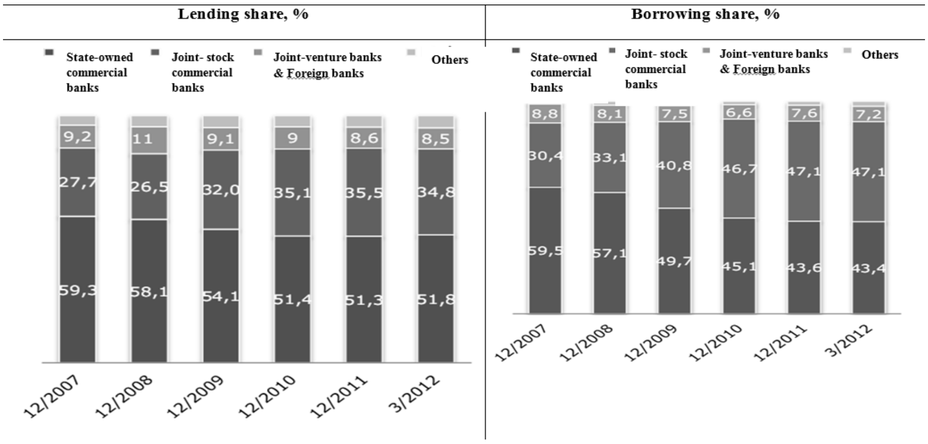


Source: SBV and GSO.

As per banking market structure, with a declining tendency, the SOCBs has long occupied a lion share of credit market, accounting for 78.4%, 59.3% and 51.8% in 2000, 2007 and the first three months of 2012, respectively. Similarly, in deposit structure, the SOCBs share is decreasing from 72.0%, 59.5% to 43.4% in the corresponding years, "devoting" the leading position to the JSCBs since 2009 (Figure).

Figure 4

Structure of lending and borrowing markets by bank ownership, 2007-3/2013, %



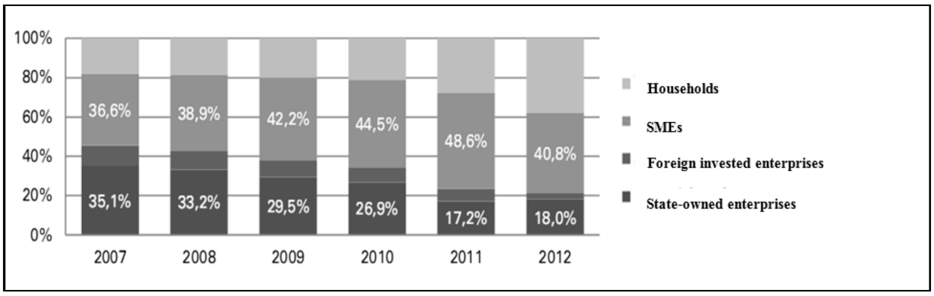
Source: SBV.

Notably, despite the fact that Vietnam has implemented significant liberalization in banking sector since 2007, the proportions of foreign-invested credit entities remain limited and experienced a moderate and declining market position (Figure), especially that of lending albeit the sector saw an increase in absolute term. Key factors behind the market structure, *inter alia,* have been the fact that: (i) Domestic banks, particularly SOCBs have had traditional bank customers, well-established system of branches/offices and profound knowledge about domestic customers' habits and orientations; and (ii) foreign-owned credit institutions' intention to serve largely foreign customers due to well-established relationships and their concern about poor quality of book-keeping and governance of domestic companies, especially SMEs.

Regarding lending structure by bank customers, it is noteworthy that, over time, household business units and SMEs have been devoted to get more loans. Meanwhile, credit to SOEs has experienced a decreasing trend. Foreign-invested companies occupy a smallest and shrinking proportion. Again, the reason behind this tendency has been the fragmentation in Vietnamese lending market.

Figure 5

Credit structure by customer/ownership, 2007-12, %



Source: SBV.

2. Key weaknesses and challenges

2.1. Weaknesses

Despite the weakening monopolistic position, Vietnamese banking sector is still denominated by four SOCBs both in term of deposit and loan markets (see Table 2 for Concentration Ratios (CR) for 4/6 largest banks and Herfindahl-Hirschman Index – HHI).

Table 3

Vietnamese bank concentration ratios, 2007, 2009, 2012

	2007			2009			2012		
	Assets	*Deposit*	*Loan*	*Assets*	*Deposit*	*Loan*	*Assets*	*Deposit*	*Loan*
CR4	66.70%	73.07%	71.70%	53.84%	58.21%	62.84%	49.53%	52.6%	59.91%
CR6	77.95%	81.41%	83.04%	65.36%	68.55%	71.53%	58.26%	61.9%	68.33%
HHI	0.130	0.149	0.166	0.093	0.107	0.124	0.077	0.087	0.106

Source: Le Trung Hai (2014)'s calculation.

It is noteworthy that the decreasing trend in the concentration of Vietnamese banking sector has been largely a result of financial liberalization, deregulation and loosening entry to foreign banks.

Another weakness of domestic credit institutions can be pointed out in their poor competitiveness stemmed partially from over-granting of the business licenses and a lack of levelling of the playing field. *First,* the domestic banks' capacity in governance, technology renovation and application is still poor. *Second,* income of Vietnamese banks from non-credit interest has long been low and unsustainable accounting for 14% in 2013. This figure is much lower than the corresponding ones in other Asian peers, namely 21% in China, 36% in Thailand, 33% in Australia and 40% in Singapore, respectively (VPBS 2014). These factors put the domestic banks in a disadvantageous position over foreign competitors in the context of further financial liberalization and integration.

Poor micro-prudential sustainability has long been persistent among the commercial banks. Most banks in Vietnam records to achieve a minimum Capital Adequacy Ratio (CAR) of 9%, which is rather low compared to the average CAR of APEC at 13.1% or Asian emerging countries at 12.3%. Furthermore, the delayed application of Basel II is not a sole fault of the banks. Despite the significant reduction recently, NPLs are now not risk-free amounting for 2.9% by Vietnamese accounting standards and about 2 times higher by international standards rating by agencies such as Moody's and Fitch. The risks of recurrence of new bad debts can be significant as domestic lending has been swiftly accelerated in 2014, 2015 accounting for approximately 12%, 18%, respectively.

Another persistent weakness of the Vietnamese credit institutions is maturity mismatch, i.e. long-term lending is financed with short-term deposit. However, the problem of maturity mismatch can be mitigated as a short maturity of part of deposits is usually extended (VPBS 2013).

Despite their tendency of reduction, the NPLs in the banking industry have long been a concern. In addition, the lack of transparency in the sector and cross-holdings of banks lead to greater difficulty for measurement of bad debts in Vietnam.

The problem due to cross-ownership among banks is a prevalent issue in Vietnam as pointed out by Tran Bao Tran *et al* (2014). First of all, cross-ownership increases the difficulty for the measurement of bad debt as loan classification and provisioning can be falsified by cross-ownership. In addition, the systemic risk in the sector will increase as the sector becomes concentrated due to ownership of dominating banks in many smaller banks. Finally, the rise in cross-ownership also reduces competition of banks. There was a dramatic increase in the cross-ownership of banks due to increased number of banks and amount of capital in the banking system, especially during 2006-2011.

In addition, the following weaknesses should also be taken into account:

- Small banks have an overwhelming exposure to real estate and individual loans, resulting in highly skewed and risky loan portfolios;
- Accounting standards lag behind international standards and the lack of transparency entails significant risks for foreign investors;
- Domestic banks continue to lag behind their foreign rivals in terms of financial strength and the technological curve.

The above-mentioned weaknesses have been, to significant extent, rooted from the legal financial – banking framework. Some laws and documents were featured by varying and modest quality. Many documents were incomplete, inconsistent with other related ones, ambiguous and inefficient in addressing the targeted issues. Some legal documents had to be amended and adjusted many times, thereby undermining actual enforcement and public trust. As one of the main reasons, many officials had limited skills in drafting legal documents, analysing and formulating policies. This reason is added by the lack of wide consultation on legal documents' contents right after the idea is formulated.

2.2. Challenges

Key challenges for domestic banks in the new context are:

- The foreign–invested banking sector can fight successfully for a larger share of credit market cakes over the medium and long term. Advantages in capital, technology, risk management skills, and so on add more impetus/synergy for foreign banks to crowd out the domestic banks in the domestic markets especially after the AEC commitments implementations in 2015.
- Delays in the carrying out the banking sector reforms could lead to prolonged bad debt problem and eventually bankruptcy for a number of weak banks, undermining confidence in the sector as a whole; and
- Financial liberalization and integration will likely foster capital transactions, but risk management is yet to be accomplished: particularly, inspection procedures, supervision mechanisms, prudential requirements and mechanisms of collaboration among ministries and state regulators should be put in place and or ameliorated consistently.

3. Key policy recommendations

Over the three decades of economic renovation, Vietnam banking sector has been reformed in the market-oriented directions and for the sake of compliance with international standards. The context of deeper economic integration requires a more efficient, sound and competitive banking sector in Vietnam. For this purposes, the following regulatory measures should be taken into consideration.

Firstly, it is crucial to strengthen the capability and autonomy for the SBV. The process of deeper financial integration and liberalization implies a more volatile in volume, direction, magnitude of capital, trade and investments inflows and outflows and creates an enhanced interaction among the flow and uncertainties in the world markets. The new, more complicated environment requires more professional, sophisticated policy making, particularly for monetary policies. As such, the autonomy of the SBV should be consolidated to effectively design, justify and implement the monetary policy aiming to ensure macroeconomic stability, build up a safety, efficient and resilient banking sector and reallocate capital efficiently.

Secondly, the banking sector regulators should continue recent financial liberalization in financial and banking services markets to further improve the competitive market behavior among commercial banks. Deeper international economic integration requires Vietnam to liberalize its capital account, especially the management of portfolio investment. However, given the current development level of its financial system, Vietnam should set this as the objective for the long run. A proper sequence of external liberalization roadmap and good preparedness of domestic stakeholder deserve a serious consideration. Liberalizing the capital account should proceed gradually in the most prudent manner to prevent unfavourable impacts on its financial and macroeconomic stability. This also requires long-term reforms of banking system and financial market.

Thirdly, the deeper financial liberalization and integration will put Vietnamese financial institutions under greater financial exposure. Given the weaknesses of the institutions, particularly JSCBs, it is important to help them improve soundness and efficiency through accelerating the process of recapitalization, restructuring (i.e. M&A), resolving NPLs and applying good/appropriate international standards and practices. Financial policies should be designed to promote prudent risk management, supported by a strong capital base, strict disclosure requirements, and well-designed liquidity management. In addition, it is crucial to crack down on illegal and unregulated practices such as shadow banking practice of financial firms and commercial banks.

Fourthly, Vietnam should proactively, actively cooperate with other countries to cope with common financial and monetary risks at regional level. In this process, Vietnam should learn experiences from other countries in the region for more active prevention of financial and monetary risks.

Last but not least, Vietnam needs a more concrete framework and roadmap to improve the convertibility of the national currency (Vietnam Dong). At the domestic level, this requires bolder, prolonged efforts and higher priority to address dollarization. Controlling and ensuring sustainability of current account deficit and foreign borrowing should also be emphasized.

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