THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

POLICY BRIEF #25

VIETNAM: FINANCIAL SECTOR REFORM POLICY BRIEF

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January 2005

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Introduction

Since the first concerted steps in economic reform and business liberalization were made by Vietnam's policy-makers in the latter part of the 1980s, the country has seen considerable development within its financial sector. Starting from a basic mono-banking system, Vietnam now has a relatively diverse array of state-owned, domestic private, foreign joint venture banks, and foreign bank branches. A handful of leasing companies also operate, along with a similar number of local and foreign insurance firms. Since the tentative opening of a securities market (for both fixed income and equity paper) in mid-2000, Vietnam has seen the arrival of local securities companies and the first local fund managers and investment funds. Foreign fund managers have been present in Vietnam since the early 1990s, mostly operating relatively small private equity funds. The State Bank of Vietnam serves as the banking sector regulator, and the Ministry of Finance (which now includes the State Securities Commission) broadly oversees the non-bank financial sector.

Not only have the financial sector institutions become more diverse, so has the range of financial products and services available to institutions and individuals. More people -- and local firms -- are opening bank accounts, taking out life insurance policies, or opening trading accounts with stockbrokers. Similarly, more companies are able to access bank loans, other forms of credit and debt paper, and even the first derivative instruments (such as gold and interest rate options) have been offered. New financial services, such as factoring, are also being unveiled for the first time. While 'plain vanilla' lending remains the dominant banking activity by far, Vietnam is seeing a far greater variety of financial products and services become available.

It is no exaggeration to say that the reform of the financial sector has been a critical element in, and a key pillar of, the wider economic reform and development process that has been underway in Vietnam for almost twenty years. Foreign commercial banks and other overseas firms within the financial sector have played an important role in pushing forward, and partly underpinning, the overall skill level and capacity of Vietnam's fledgling financial industry. The international donor community has also been an active and important generator of sustainable change in the burgeoning financial sector, across a range of initiatives.

Financial sector fragilities

The above notwithstanding, Vietnam's financial sector remains at a relatively early stage of development, and continues to display a number of weaknesses. For example, the large state-owned commercial banks (SOCBs) that still dominate the banking sector, in terms of total assets, are being gradually restructured and put on a more stable financial footing, but remain currently burdened with non-performing loans (NPLs) that are largely -- but not wholly -- a legacy of policy-lending. The thirty or so private banks (commonly referred to as joint stock banks, or JSBs) remain relatively small, and will need to tap considerable resources to burgeon into more robust and competitive banking institutions. Greater consolidation in the JSB community seems inevitable. Local leasing companies have also failed to achieve critical mass, thus far, largely due to various regulatory and long-term funding limitations. Foreign bank branches are quite tightly constrained in the range and scale of services and products they can offer to local clients, although these bonds are being very gradually loosened, with one eye on Vietnam's impending accession to the WTO.

With less than 30 firms listed on the formal stock market, and an aggregate market capitalization below US$300m at the time of writing, the equity market is very much in its infancy. It largely remains the preserve of individual 'punters' and a small group of boutique investors. The bond market (almost entirely consisting of government bills) is much bigger, in terms of capitalization, but is highly illiquid. Policy lending of a kind also persists, through various state-owned non-bank financial institutions, such as the national Development Assistance Fund (Vietnam's largest single financial institution, in terms of chartered capital), and a number of provincial and municipal equivalents. The list of fragilities goes on.

But none of the limitations and challenges cited above are insurmountable, and they can all be effectively addressed in the next decade or so. Rather, the decisions that confront Vietnam's policy-makers largely pertain to such over-lapping issues as: i) the speed and depth at which financial sector reform and restructuring should be conducted, without taking excessive systemic risks; ii) the extent to which JSBs and private firms in the financial sector will be permitted to compete on a level footing with the SOCBs and state agencies; iii) the extent to which the financial sector will be opened up to foreign banks and financial institutions, as part of a general liberalization process; and iv) the speed with which regulators permit the introduction of new financial institutions, instruments and services. With greatest emphasis placed on ensuring stability, and the avoidance of financial scandals or other incidents that might potentially trigger a systemic crisis, Vietnam's policy-makers and regulators alike will tend to err on the side of caution.

Forces and paces of change

Two forces are likely to dictate the pace of future financial sector reform. On the one hand, large parts of the financial sector reform 'road map' -- including some time-bound milestones -- have already been determined, through agreements made with international donors and bilateral governmental agreements. Vietnam's impending accession to the WTO will likely 'lock in', and possibly accelerate some elements of, this 'road map' further. Policy-makers too are cognizant of the need to develop a larger, more efficient and competitive financial sector, if only to support the development of the burgeoning corporate sector. Vietnam's long-term targets for creating a strong industrial sector will only be attainable if there are adequate sources of (long term) funds to make the fixed capital investments required, and the pools of funds needed to lubricate its day-to-day working capital needs. Foreign investment inflows and development assistance alone will not be sufficient, and Vietnam will need to better attract, harness and leverage its various flows (including substantial inflows of money, remitted back by overseas Vietnamese) of money if it is to meet its economic growth and industrial development targets. In this regard, the perspectives of policy-makers and international donors alike, as well as financial sector participants themselves, are quite well aligned.

But on the other hand, it should be borne in mind that the creation of a robust, competitive and sustainable financial sector is contingent in part on other elements of the wider economic reform agenda. For example, success in restructuring state-owned enterprise (SOE) sector as a whole is the ‘flip side’ of -- and a critical determinant in -- resolving the NPL issue in SOCBs. Creating a larger and more liquid securities market is dependent in large part, not only in developing a financial sector hinterland of institutional investors, but also in improving general standards of corporate governance, financial transparency, and auditing standards. With many companies seeking to reduce significantly their tax exposure through creative accounting methods, it will be an uphill struggle to encourage firms to willingly expose themselves to the greater transparency requirements demanded of listed companies. And individual and institutional investors alike will be wary of investing pools of money in a corporate sector where ‘cooking the books’ is fairly common. Thus, for example, creating a stronger securities market or a viable credit information system are as dependent on tax reform as they are on other issues more closely associated with the finance sector itself.

Growing confidence

Another factor that might have been expected to constrain the burgeoning of the financial sector is the limited domestic demand for banking and financial sector products and services. Vietnam still remains a heavily cash-oriented and partially dollarised economy. Not so long ago, individuals were generally reluctant to place their savings in bank accounts, for fear of bank collapses, negative real interest rates, or even a sudden drop in the value of the local currency itself. Rather, people tended to convert their local currency into US dollars or gold, and squirrel it away somewhere outside of the formal banking sector. While some of these concerns persist, as a legacy of popular experience in the 1970s and 1980s, they are eroding with commendable speed. The speed with which a partial bank run at a leading private bank was nipped in the bud in 2003, and did not become systemic, is testimony to the strides forward that have been made. Further, the rapid rate at which individuals have taken out life insurance policies (which closely resemble savings policies), particularly with foreign insurers, in recent years clearly demonstrates that there is considerable appetite for financial products, if sufficiently well structured, marketed and secured.

The scale of this activity has also served to underline how much money is circulating within the Vietnamese economy, both within the formal financial sector and outside it. Vietnam has seen considerable inflows of funds over the last two decades, from: international donors (around US$2.8bn in 2004), foreign investors (over US$4bn in FDI inflows in 2004), rising external trade (exports valued at over US$26bn in 2004) and other foreign exchange revenue sources; and overseas Vietnamese remitting money back to families. The latter is estimated to have exceeded US$3.8bn in just 2004 alone. These are large sums, and while much of it has served to inflate the price of property and other popular (but largely unproductive) asset classes, it cumulatively serves as a large pool of money on which to build a robust and vibrant banking and financial sector. Such a financial industry can then better intermediate these funds into more productive assets.

Bulk-up or die

Such issues probably help to explain, at least in part, why efforts to reform and develop the banking sector have enjoyed greater traction than those pertaining to the non-bank financial sector. The JSBs in particular have been witnessing substantial growth in recent years, in terms of their aggregate loan portfolios, branch networks and their underlying capital base. Almost every week, it sometimes seems, newspapers report new branch office openings and rights issues by local private banks. Indeed, the pace of loan growth -- around 30% in recent years, and reportedly 25% in 2004 -- has been a source of some concern for the State Bank and others, for fear that loan quality is being sacrificed on the altar of maximum loan growth. One JSB saw its deposit base grow by 72% in 2004, and its loan portfolio grow by 77%, having seen its capital base increase five-fold over eight years.

This dash for growth is driven by several factors, but in particular by a realization in the local banking community that the financial sector is almost certainly going to be radically different in the next five years or so, thanks in large part to WTO accession conditions. For the JSBs, having neither the economies of scale (and remaining privileges) enjoyed by the big SOCBs, nor the technical and financial muscle of foreign banks, their already limited room to manouevre is likely to get even smaller. They are already seeing the SOCBs moving into a field in which the JSBs had previously dominated – lending to small and medium sized private enterprises. Their long term survival is therefore largely dependent on building up greater branch networks and loan books in the window of opportunity still left to them, and by providing a diverse range of attractive products and services. With merger and acquisition activity still quite rare in Vietnam, such 'bulking up' of operations usually must come from organic growth. As a consequence, substantial rights issues by some JSBs are becoming almost an annual event, buoyed by fairly strong investor appetite in what is commonly believed to be a relatively profitable line of business that pays high dividends.

Joining the dots together

An important factor in the financial sector reform process, going forward, will be about knitting together a coherent and conducive environment in which the whole financial sector can burgeon organically. To date, much of the financial reform process has entailed quite tightly focused assistance in specific areas, to address and overcome specific weaknesses that have been identified. Introducing new processes and increasing the capacities of various state and market institutions, for example, so as to permit a more effective financial sector to develop. As with the initial period of any reform effort, it is perhaps easier to identify and address some of these major hurdles and weaknesses. But as the reform process matures, there is less 'low-hanging fruit' of this kind, and a more holistic approach becomes warranted.

Improved coordination between government agencies and other stakeholders (including within the donor community itself) is therefore necessary to tackle some of the less obvious, but often more complex and entrenched, constraints on financial sector growth. The challenge becomes one of weaving together a coherent set of financial sector reform efforts that have the most impact in allowing the financial market itself to widen and deepen, and by its own volition. A government-donor working group focusing on coordination of banking sector reform, established in 1999, has subsequently and sensibly been extended to cover all of the financial sector, including the capital market. It also entails linking financial sector reform with other elements of the wider economic reform and business liberalization process in Vietnam, including private sector development and state sector restructuring.

'Industrialising' the financial sector

Some of the ongoing inefficiencies in the banking sector stem from unnecessary duplication of effort across individual banks, and therefore any attempt to create the kind of infrastructure that could bundle and share certain operations would be likely to reap rewards. Turning the banking sector from a rather 'flat' cottage industry into a more vertically integrated one, with financial products regarded more like commodity units, would allow banks to generate greater economies and synergies of scale. Those synergies would extend beyond just the banking sector, to non-bank financial institutions as well. For example, the bundling, securitizing and selling of multiple debt instruments to institutional investors would help JSBs in particular to leverage their assets further, and help mitigate the challenges they face in accessing long-term funding and issues relating to maturity mismatches. Such securitization would depend on a more uniform and integrated credit risk assessment procedures, which could come from the implementation of a commercially viable, credible and trusted credit scoring service, and/or the pooling of various 'back office' activities by different banks.

Looking forward

So what reforms and developments can we expect to see in the coming five years ? The financial sector will undoubtedly undergo significant change. There will be a widening in the range of financial products and services offered to both corporate and retail clients of banks, with the pace largely dictated by the degree to which the State Bank of Vietnam, as regulator, is willing to see banks and other financial institutions move into new areas of risk. This diversification of products will also serve to increase demand for financial services, with a greater range of companies and individuals using the industry to meet their needs. Some of the large SOCBs will undergo partial divestment, and the aggregate number of JSBs will lessen through industry consolidation. The presence of foreign banks will become more apparent, as WTO accession and other commitments oblige Vietnam to liberalise its financial sector.

The capital market will also expand and deepen, although much depends on policy-makers' ability to attract and encourage financial institutions and institutional investors that are necessary for equity and bond markets to really develop. We should see more companies publicly issuing shares, and greater trading activity in both equity securities and a more diverse range of fixed income paper. All of this will be underpinned by advances in the technical and human capacities of most financial sector stakeholders, through a combination of on-going and considerable external assistance and growing financial sector maturity. The prognosis is a broadly positive one.

About the Author

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