BANKING ISSUES

Presented by
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Introduction

This update from the Bank Working Group is given against a more positive macro economic backdrop than the last one. It is a credit to the policies of the Government and the State Bank that most macro economic indicators have improved markedly since then: inflation is close to single digits; the currency has been remarkable for its stability; the trade balance is almost exactly in balance.

Through a very difficult time, confidence in the Banking System has been maintained, first through skilful management of overall liquidity, and second through a ranking of banks by strength that has been helpful to customers, investors, counterparties and the SBV itself. This has been a particular success for Governor Nguyen Van Binh and his team at the SBV.

The Bank Restructuring Plan, signed by the Prime Minister, represents both recognition of the structural issues in the Banking System, and a relevant agenda for its reform. The long term growth of the economy depends on its thorough implementation. If benefits from recent macro economic policy success are not to be lost, then structural reforms of the economy must progress alongside its day-to-day management. The Bank Working Group supports the strategy set out in the Restructuring Plan and we look forward to seeing its swift and sure implementation.

The period since the last VBF has been one of enormous activity on the part of the Government and the State Bank. Circular 01 promised that there would be 92 new regulations and decisions from the SBV this year, and the flow of documents released has so far lived up to that promise. While the drive, industry and intention of the authorities is not in any doubt, we are concerned at the speed and nature of some of the new regulation that has emerged. Our concerns relate to three themes that are evident throughout this paper:

1. Regulations drafted and implemented quickly are not always the best regulations, and can have unintended and unforseen consequences.

2. Several regulations introduced recently represent new administrative restrictions in areas that should be market based. Fortunately, the SBV has given reassurance directly to the Bank Working Group that these administrative measures will be temporary, and will be removed as soon as the SBV deems this possible.

3. While several of the recent measures have been intended to curtail the activities of the identified "weak" banks, we believe they are having a strongly adverse impact on the business of the identified "strong" banks, making them less able to help the economy in a difficult time. Again, the SBV directly acknowledged this to be the case in relation to some measures, and has suggested some greater flexibility in the near future. It is to be hoped that these measures truly are temporary.

It is a pleasure to report that the working activities of the SBV and the BWG have been intensified this half year. This has largely resulted from the SBV's initiative to send draft regulations to the BWG before they are published in order to allow our feedback to be considered.

BWG has provided comments on the following seven drafts:

- Draft circular on Forward Rates
- Comments on provisions of Ordinance on FX management
- Draft circular on derivatives replacing circular 62
- Draft circular on use of non cash payment for loan disbursement
- Draft circular amending circular 13 on Prudential ratios
- Draft circular replacing Circular 1452 on FX transactions in local FX market
- Draft circular replacing Decision 493 on loan classification and provisioning

Further, we have held follow-up working level meetings with various SBV Departments to ensure discussion of our comments. The BWG would like to thank the SBV for sending the drafts to us for consultation, and looks forward to continuing this closer dialogue with SBV at the drafting stage of new regulations.

This paper builds on our previously identified “Four Pillars”:

1. **Roadmap:** A forward looking roadmap for the banking industry, harnessing market forces rather than administrative restrictions to continue the drive for growth;
2. **Market Efficiency:** Efficiency and clarity in the way the market and the regulations should work so as to reduce the “cost of delivery” of banking products and services to businesses and consumers;
3. **Consumer Banking:** Clear guiding principles and removal of major impediments for the Consumer Banking and Consumer Finance industries.
4. **Short Term Stability Measures:** How to apply more fairly and effectively some of the measures introduced last year under Resolution 11 and this year under Circular 01 to achieve price and currency stability.

While many of the issues highlighted last time have not yet been addressed, this is understandable. The urgent need to bring stability to the macro economy and the banking system has consumed the SBV’s resources in recent months, so progress on our longer term agenda has been relatively limited. Rather than repeat all those recommendations, we simply restate their importance and ask that the authorities revisit them as they are able.

Below, we mainly set out some further recommendations, including on some of the recently introduced regulations. Our intention remains to help develop the Banking System in Vietnam to a level that will support the full growth potential of the economy. We commit to working closely with the SBV to achieve this, and are fully supportive of the SBV in this aim.

I. Roadmap (Pillar 1)

1. Circular 40 on the issuance of licenses, and the organization and operation of commercial banks and foreign bank branches

The circular provides clear provisions on the issuance of licenses, and on the organization and operation of banks. However, the circular now requires each bank’s licence to state every activity it wants to undertake. Previously, licences permitted banks to undertake both activities specifically listed on their licence and those which were permitted on the basis of being included in SBV regulations. The new requirements could cause disruption to clients or a breach of banks’ legal obligations under commitments already made to clients.

Recommendation: that SBV should allow banks to continue to offer business activities that are permitted by SBV regulations without the need to revise licences. If there is an amendment of such SBV regulations, at that point banks should seek an amendment to their licences.

2. Foreign shareholdings in local banks

In the Banking Restructuring Plan published by the Government (Decision 254/QD-TTg), it is intended that foreign banks take part in consolidation of the sector, and for international standards of governance and risk management to be introduced in Vietnamese banks. We support both these aims. However, there is considerable uncertainty about how foreign banks can be consolidators in a meaningful way at current ownership limits. Further, while many foreign banks are already "Strategic Investors" in Vietnamese banks, the current ownership rules limit the ability of these foreign banks to implement international governance and risk management standards within their Vietnamese investee banks as their influence is relatively low.

Recommendation: To enable: (i) better banking sector consolidation; and (ii) better introduction of international governance and risk management standards, both in line with the SBV's expressed intention, there remains a need for clarity on scope and timing of further increases in permitted foreign shareholding. Higher shareholdings are needed to give foreign Strategic Investors proper incentive and ability to help implement the changes the SBV wants to see in Vietnamese banks.

3. Enforcement of rules

None of us doubt that banks have a duty to comply with regulations. As an incentive to comply with these regulations, regulators also need to enforce regulations effectively. There have been many public reports in recent months of banks either breaching deposit rate caps or using alternative means of giving value to customers in a way that effectively increases the interest rate on deposits.

Recommendation: SBV should consistently apply positive motivation for banks to fulfill their duty to comply with regulations, and impose sanctions for a failure to do so. Unless all banks adopt the same strong compliance culture, it creates an uneven market. If compliance with regulation is demonstrably more advantageous to banks than non-compliance, then they will comply.

II. Market Efficiency (Pillar 2)

1. Previously Raised Issues

We still hope for further progress on some of the points previously raised, including: introduction of a comprehensive FX Forward market; clarification on FX rules and regulations; greater transparency in the Government Bond market by way of an issuance calendar, a consolidation of the multitude of different bond issues, and the creation of a full yield curve; establishment of credit bureaux and rating agencies; introduction of a netting and offset framework; and harmonizing withholding taxes on interest. These remain important issues to be addressed to modernize the Vietnamese banking system and ensure it can properly support economic growth. We hope the SBV can focus on these again soon.

2. Circular 39 on Independent Audit of Credit Institutions and Foreign bank branches

We welcome the SBV's introduction of a new circular providing guidance on the independent audit of Credit Institutions and Foreign Bank Branches. However, the new requirements on rotation of audit firms every five years will cause difficulty for global companies which use the same auditor globally for their head office and other branches and subsidiaries.

The circular also sets out a requirement for an independent audit of banks' internal control systems. However, it does not provide specific guidance on the reporting format, nor on the scope of the audit of internal control systems. As a result, implementation of the circular will be inconsistent among banks and audit firms.

Recommendation: We recommend that the SBV should allow banks whose lead regulator sets out a policy on rotation of auditors to follow those requirements in order to ensure the benefit of a single firm auditing the whole of their global organisations. We also recommend that SBV provides more specific guidance on the required audit scope relating to internal control systems. The scope should be limited to issues of relevance to the Financial Statements, and should be undertaken to internal audit standards.

III. Consumer Banking (Pillar 3)

1. Wealth Management Products

Globally, wealth management products are a core offering for banks to their retail clients. This has proved advantageous for consumers, given that regulators and banks provide significant oversight and expertise to ensure that products are appropriately provided to customers by proper assessment of their risk appetite and investment purpose. Currently, no regulation exists in Vietnam on investment products, and each bank must seek individual product approval from the SBV. This is a poor use of time for banks, the SBV and for customers, and lacks transparency and consistency. A uniform set of rules that ensure the appropriateness of investment products for retail investors will allow banks to encourage savings by individuals, and to mobilize funds more effectively by channeling them into important investment projects.

Recommendation: Following positive feedback on this subject in our recent SBV meeting, we continue to encourage the introduction of a new, principle based regulation that allows commercial banks to offer investment products to their customers, provides protection to investors in the sales process, and requires transparency in the pricing, returns and risks of such products.

IV. Short Term Stability Measures (Pillar 4)

1. Credit growth caps

We fully support the Government and SBV in their aim of regulating both the volume of overall credit growth in the economy, and the way that such credit growth is targeted at investment rather than consumption. The SBV's classification of banks into four groups in February, with each group having a different rate of credit growth, is a marked improvement on the 20 per cent cap on all banks in 2011. It recognizes the difference in quality and capability of banks. However, within each category of banks, it still favours the larger banks, simply because a percentage of a large starting balance is significantly greater than the same percentage of a small starting balance.

In spite of the clear guidelines on credit growth, the growth of credit so far in 2012 is lower than the Government's target, with many banks reluctant to lend for a variety of reasons. In our recent meeting with the SBV, we heard there is likely to be greater flexibility in granting further credit growth to banks that have both reached their growth cap and have done so responsibly. This is encouraging, and in furtherance of this flexibility, the BWG makes the following recommendations about credit growth:

Recommendations

1. *Single Borrower Limit*

The Single Borrower Limit (15% of a bank's equity) should be applied only to medium and long term loans, in line with corporate investment licenses. Working capital requirements should not be capped under this Single Borrower Limit. This will ensure a consistent supply of working capital financing for corporate customers.

2. Credit growth cap

Higher credit growth should be encouraged for Credit Institutions that have strong credit risk controls and a large customer base in the SME, export, and manufacturing sectors. Large financing requirements for industrial projects should also be taken into consideration for higher limits.

For smaller banks in the strongest categories, the SBV should consider allowing growth up to a leverage ratio rather than up to a percentage. This would allow smaller banks to employ their capital to a level that is both prudent and efficient in terms of returns. It will also allow appreciable credit growth for all strong banks, not only for the larger strong banks.

3. *Circular 03 (extension of Foreign Currency loans)*

The Exception approval process under the new foreign currency loan regulation should be simple with clear criteria and a fast process for reasonable cases. Export companies should be able to continue borrow foreign currency for their working capital requirements. This will facilitate export companies in being more price competitive. In a direct way, this would encourage export activities.

When it comes to constraints in FX supply, there should be solutions allowing corporates to borrow foreign currency to meet their timely payment obligations to avoid any default in a commercial obligation – on the grounds of liquidity rather than solvency.

4. *Expansion of Consumer Finance Network*

The credit growth for the consumer finance industry could be boosted if the consumer finance companies were formally authorized to expand their networks through the establishment of new "Service Introduction Points" (SIPs). The efficiency of this model was well tested in 2010-2011 when the State Bank of Vietnam approved the SIPs opening on a pilot basis (SBV Official letter No. 2336/NHNN-TTGSNH dated 2010, March 30th). Since April 2011, consumer finance companies have not been allowed to open new SIPs (while the existing network of SIP is not challenged at this point), freezing the expansion of the distribution network.

5. *Loan disbursement*

Circular 09 will require banks: (i) to ensure that cash is not transferred to borrowers when loans are disbursed and (ii) to control the use of funds to ensure it is in line with the stated purpose of the original borrowing. While the BWG supports the SBV in seeking to reduce cash settlements and discourage borrowing for consumption rather than investment, we anticipate that the practical implementation of Circular 09 may be difficult logistically for banks. It is likely that significant additional manual intervention will be needed from banks in loan disbursement, particularly in relation to document checking. We recommend that the SBV keeps the operation of Circular 09 under regular review.

6. *Lending Rate Caps*

Circular 14 introduces a cap on lending rates charged by banks for several sectors. We understand the SBV's intention to reduce the cost of credit for hard-pressed sectors of the economy. However, we are concerned that this administrative measure will lead to banks lending less to these sectors than before, since they will be less able to obtain an adequate return relative to the risk taken. The Government's Banking Sector Restructuring Plan properly states the need for banks to introduce better risk management processes, including a requirement to price loans for the risk they represent. Circular 14 makes this pricing impossible, and it is positive that the SBV recognizes the temporary nature of this measure. We hope it can be removed as soon as possible.

Conclusion

Many of the issues and recommendations above are born out of the recent need to reestablish control over the macro economy and credit growth. These aims are closer to being fulfilled as each month passes, and this should mean that many of the temporary administrative restrictions can be removed, particularly as the banking sector is restructured, with weaker players' issues being addressed.

There has been significant progress in identifying a way forward to an improved and strengthened Vietnamese banking system. Implementation of the structural reform proposed by the Government is now key, and the BWG looks forward to being involved constructively in that project.