

BANKING WORKING GROUP

Speech by the Banking Working Group at the Vietnam Business Forum Hanoi, 3 December 2012

Your Excellencies, Co-Chairs, Ladies & Gentlemen,

Today at the VBF you will hear from four foreign bank CEOs, not one. In addition to our usual presentation to the State Bank on current issues in the banking sector, the Co-Chairs have asked us to address the VBF as a whole on how we would propose to resolve the biggest issue facing the Vietnamese economy - Non-Performing Loans in the banking system.

It is a privilege to be able to present today, and we are grateful to the Co-Chairs for this opportunity. What we will present is a collective work, on which we all agree.

Although the banking sector has serious problems, we start with two positive points. First, over the years, literally dozens of countries have had similar banking problems to Vietnam's - and they have resolved them. So, take courage, Vietnam - this can be done! The second positive point is that, while this is a very difficult situation, it is not yet a crisis in the sense seen 15 years ago in Indonesia, Thailand or Korea, or more recently in some Western economies. This means Vietnam still has time to act, and has policy options. But, while we support the substance of Decision 254, we have a very strong conviction that more rapid progress is necessary to implement it - after much talk, now is the time for action.

Although there is a lot of discussion about the NPL issue, there remains very little precision on the scale and nature of the problem. The banks report 4.3% NPLs, the Governor's number is 8.8%, and others speculate the real number could be double that. If we take the Governor's figure, NPLs are around USD12 billion. Using precedents from other markets, a 60 per cent loss rate implies overall losses of just over USD7 billion. This is around 5 per cent of Vietnam's GDP. Compared to restructurings in other countries, that looks very manageable. In fact, if the number were double the Governor's 8.8 per cent, it still looks manageable over time.

We have just made an obviously simplistic calculation, but as a first step to restructuring, the Authorities need to make a thorough and consistent assessment of the scale and nature of the problem. And the Authorities need to generate widespread acceptance of that assessment. There should ideally



be a universal belief in a single version of "the truth". Governor Nguyen Van Binh's statements in the National Assembly recently are a definite step in the right direction.

Another step in the right direction is that the SBV is already engaged in thorough inspections of the banks' loan books. The data collected should lead to a clear assessment of the problem, both systemically and on a "bank-by-bank" basis.

The next necessary action will be to recognise and allocate the assessed NPL losses. An NPL of 100 is worth less than 100, and taking that loss in some form is unavoidable over time. It is a question of who takes the loss, and when?

Practically, losses can only be taken by either the owners of the banks that made the bad loans, or by the State, or by a combination of the two. We believe that the final cost to the State of a banking restructuring programme should be minimised. Since the main purpose of a bank's equity capital is to absorb losses, bank equity should be used for that purpose before the State takes on any permanent restructuring cost. If bank owners do not lose equity value because of past mistakes, there is "moral hazard" that they will have no incentive to ensure prudent management of their banks in future.

We fully understand how difficult a decision it is to recognise the losses, and to allocate them to bank shareholders. It is difficult economically, and it is difficult politically. But unless this happens, we believe that there is no credible solution to Vietnam's NPL issues that will sustainably return the economy to annual growth of over 6 per cent within an acceptable timeframe.

Once this difficult decision has been taken, it will not seem difficult at all, because every other element of the restructuring flows from that initial loss recognition. Until the decision is taken, the burden of the problem, and the lack of a solution to it, will continue to weigh on the economy as they currently do. Please be courageous - and decisive - and take that decision.

Although speed is important, not all of the losses need to be taken immediately. The restructuring needs to happen fast enough to restore disciplined access to credit, while maintaining confidence in the banking system. Move too slowly, and confidence in undercapitalised banks will fade. Move too fast, and it may cause the very crisis of confidence it aims to avoid. Each bank must develop a credible plan whereby NPLs are recognised over a defined period, which will build confidence and credibility.



But having recognised and allocated the losses on NPLs, two very big questions need answering:

First, how are NPLs managed and resolved?

Second, how do the banks get recapitalized, and ensure that recent mistakes are not repeated?

How are NPLs managed and resolved?

Experiences in the aftermath of the Asian Financial Crisis of the late 1990's and the recent Global Financial Crisis provide a number of valuable principles on how to best manage and resolve NPLs.

Various approaches and tools are available to tackle concerns related to capital and asset quality, including: 1) the establishment of an Asset Management Company, an AMC, to address widespread systemic problems, 2) creating a Good Bank/Bad Bank structure for problems that are contained within one or a few large institutions, and 3) Government risk-sharing and guarantee structures.

These solutions are not mutually exclusive and are more effective when applied concurrently. Based on experience and Vietnam's current situation, a solution involving both an Asset Management Company and a public-private recapitalization process would likely yield the best results. The SBV is clearly well-advanced in their assessment of the situation and they have already announced the establishment of an AMC.

How does this solution work? There is a mandatory or incentivized transfer of troubled assets from financial institutions' balance sheets to one or more external asset management companies, who then have a clear mandate to dispose of the assets, restructure the underlying loans or companies, or otherwise warehouse the assets for disposal over time. The AMC is managed to realize value within a pre-determined time frame. Assets may be handled in-house, restructured, or sold to third party investors.

After the NPL transfers and the likely required bank recapitalizations the banks are de-risked and free to concentrate on their core business, rather than focusing on the problem assets.

Public ownership of the AMC is the norm with funding either coming from direct government or central bank funding or from Government-guaranteed AMC bonds that are normally issued to the banks in exchange for the NPLs. It is important to point out that the transfer of assets takes place at market-



determined fair values with the losses being recognized by the banks and their shareholders.

History shows that AMC's recover a significant amount of capital over a reasonable time frame and are generally in a strong position to repay public money.

AMCs function with a "carrot and stick" approach. Regulators can 'encourage' banks to transfer NPLs to the AMC by using levers that might restrict banks' balance sheet flexibility. Or the regulator can require NPL write-downs if banks choose not to sell to the AMC or impose an NPL ceiling as a regulatory requirement.

At the same time the government can incentivize the banks by offering new capital and restricting access to such capital if NPLs are higher than a certain level. Some levels of NPLs inside a bank are acceptable and the banks should be allowed to decide which ones to keep and which ones to sell. Banks should also be allowed to determine their capital structure as long as they meet key regulatory requirements. The most successful AMC's often incentivize participation by allowing partial clawback of profits (if any) to the selling bank when assets sold to the AMC are finally disposed.

The key success factors that facilitate speed of recovery and value maximization include:

- Establishing the independence of AMC management with strong governance parameters and proper incentives
- Insuring transparency in all activities with frequent reporting and audits of activity
- Staffing the AMC with experienced professional staff, including outsourcing/insourcing key functional experience that does not exist in the public sector.
- Strengthening the legal infrastructure related to the transfer of the NPLs is likely required to facilitate an efficient disposal of assets by the banks and the AMC. To the degree that foreign capital will be involved, an active international market exists for problem assets. However, enforceability of creditors' rights and speed of legal dispute resolution are key concerns for such investors. Assurance that capital FX flows and the transfer of assets from one investor to another are unimpeded would encourage participation.



- Finally, the AMC should have a pre-determined life and target time for being shut down. This is recommended to be 5-7 years. A shorter life would face insufficient liquidity and be too costly to the whole system, while a longer lifetime would encourage the warehousing of problems with assets getting worse if not transferred to the private sector.

In summary, the Bank Working Group recommends that the government move swiftly to establish and determine the funding source for a State-owned AMC that fully interacts with the private sector in the sharing of risk and rewards; valuing assets at market-based fair value prices. The AMC needs to be vested with the authority and powers to expedite resolution beyond the existing legal framework. The AMC should be professionally-staffed with local, and when necessary, global management expertise that conducts all activity with complete transparency and accountability.

How do we recapitalize banks?

We now would like to discuss how we can replenish the capital in Banks to allow them to achieve capital adequacy ratios and to strengthen them for future growth. And, once we have successfully transferred NPLs and recapitalized banks, how do we ensure that we do not repeat the mistakes of yesterday.

We can broadly categorise the banks in the system into Viable banks and unviable banks. Viable banks are those banks which are either strategic or strong, with reasonably professional management and relatively low levels of NPL. These banks should be able to recapitalize with support from their existing shareholder base or by attracting capital from new shareholders.

Banks which are neither strategic nor strong should be classified as unviable. These banks are likely to have high NPLs and may not have any capital base left. These banks may need to be merged with stronger banks or need to be closed.

Unviable banks should sell any good loans to other banks, with the remainder being taken into the AMC and their banking license should be cancelled. It should be compulsory for these banks to sell bad loans to the AMC at prevailing market pricing.

Viable banks are likely to need new capital. There are many potential instruments such as preferred stocks, Tier 2 bonds, convertible bonds, etc, but the best option for increasing capital in banks in Vietnam is pure equity.



There are 3 primary sources for new capital - private domestic investors, the Government and foreign investors.

- a) **Domestic investors** have limited capacity to participate at present due to difficult macro conditions. However, it is important that the banking system is able to attract responsible domestic investors looking for a sustainable return, and these investments should be encouraged.
- b) **The Government** can participate in the recapitalization exercise but the Government has finite resources and it should not stretch these resources too thin. The Government already has significant shareholding in SOE banks, and it might send wrong signals to the international market if they were to take large stakes in JSBs as well.
- c) **Foreign investors** have access to capital, technical expertise and appetite to invest in Vietnam. However, their appetite to invest further in Vietnam is likely to depend on higher foreign ownership than currently permitted. Current levels provide some element of management influence but no management control. If this were changed, it could not only attract capital, but could also help to implement the bank governance reforms set out in Decision 254

How to ensure we do not repeat past mistakes?

Unless corporate governance and risk management within banks is upgraded, we could well have another NPL issue in a few years. We need to put in place a sustainable system which enables strong banks with professional management to flourish while weak and poorly run banks should be ring fenced and be governed by a more stringent set of regulations to avoid contagion in the system.

It is recommended that the SBV should significantly tighten controls over cross holding and related party lending. This has been the root cause for many of the problems in the banking system today and we need to act firmly to stop this going forward.

Corporate governance norms and guidelines in banks should be reviewed. The roles and responsibilities of the Board of Directors, as well as the management team, should be clearly established and there should not be undue concentration of powers in the hands of any one individual or group of individuals.

Banks should be encouraged to invest in risk management systems and to develop a strong risk management culture. Banks which are found violating



lending guidelines/regulations should not be allowed to grow or remit profit to shareholders.

Finally, the government should advocate adoption of international accounting standards to ensure transparency and proper accounting.

Summary

The problems being faced by Vietnam today are not new or unique – other countries have faced these problems before and have vanquished them. Vietnam can overcome these problems as well and emerge even stronger.

This is a great opportunity for us to make the structural changes required for the long term viability of the banking system in Vietnam, and the BWG is committed to working with the SBV and the Government to make these changes happen.

All four of us are guests in this great country of Vietnam - as are the banks we represent. And we are passionate in wanting to see Vietnam achieve its full potential. Much of what we have said today is difficult, but often the right thing is difficult. We have given our honest view on how the current situation can be resolved in a way that will allow Vietnam to realise its potential better and sooner. We remain absolutely committed to assisting the Authorities in creating a banking system that can fully support the abundant development opportunities open to the Vietnamese economy. What we have said today is intended in that spirit.

Xin cảm ơn quý vị.

