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BACHELOR THESIS

The Institutional Analysis of Banking Reforms in Vietnam

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Declaration of Authorship

The author hereby declares that he compiled this thesis independently, using only the listed resources and literature.

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Signature

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Abstract

The main goals of the bachelor thesis is an institutional analysis of the banking reform in Vietnam. The author analyzes how the banking reform influences the institutional development. Modern institutions require flexible and efficient rules, both formal and informal. Hence, a legal framework is analyzed as well especially as to whether the *de jure* banking legal framework corresponds with the *de facto* one. Liberalization and internationalization of Vietnamese economy has a big impact on the development of the banking sector. Albeit institutions are *de jure* well developed they are not sufficiently efficient due to the inability of enforcement of laws, lack of confidence, and corruption in the banking sector. Vietnam has chosen the right direction but the establishment of efficient institutions has to go hand-in-hand with the change of informal rules. Since the diffusion of information is limited due to lack of codification of laws, connections relationship and informal rules play a crucial role in the banking sector. Informal rules are deeply entrenched and tenacious, and hence difficult to change in the short time.

JEL Classification	G21, G28, P21, P34, P37
Keywords	Banking sector, privatization, Vietnam, Institutional analysis

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Abstrakt

Hlavním cílem bakalářské práce je institucionální analýza bankovních reforem ve Vietnamu. Autor analyzuje vliv bankovních reforem na vývoj institucí. Moderní instituce vyžadují flexibilní a efektivní pravidla, jak formální tak i neformální. Tudíž právní rámec je též součástí analýzy. Autor zkoumá, zda *de jure* právní rámec odpovídá *de facto* právnímu rámci. Liberalizace a internacionalizace vietnamské ekonomiky má velký vliv na vývoj bankovního sektoru. Ačkoliv instituce jsou právně dobře definované, jejich efektivnost je nedostačující z důvodu nedostatečné vymahatelnosti práv, nedůvěře a korupci v bankovním sektoru. Vietnam si vybralo správný směr své transformace. Musí však brát na zřetel, že tvorba efektivních institucí jde ruku v rukou se změnou neformálních pravidel. Jelikož difuze informací je limitováno nedostatečnou kodifikací právních norem, konexe a neformálních pravidla hrají velkou roli v bankovním sektoru. Neformální pravidla jsou hluboce zakořeněna a proto bude těžké je změnit v krátkém časovém horizontu.

Klasifikace JEL G21, G28, P21, P34, P37
Klíčová slova Bankovní sektor, privatizace, Vietnam, institucionální analýza

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Acronyms

FDI Foreign Direct Investment

MNC Multinational Company

SOEs State-Owned Enterprises

OECD Organization for Economic Co-operation and Development

SBV State Bank of Vietnam

WTO World Trade Organization

SOCBs State-owned Commercial Banks

VND Vietnamese Dong

AMCs Asset Management Companies

BIDV Bank for Investment and Development of Vietnam

Vietcombank Foreign Trade Bank of Vietnam

Agribank Vietnam Bank for Agriculture and Rural Development

Incombank Industrial and Commercial Bank of Vietnam

Vietinbank Vietnam Bank for Industry and Trade

JSCBs Joint Stock Commercial Banks

JSBs Joint Stock Banks

DATC Debt and Asset Trade Company

DM Doi Moi

IMF International Monetary Fund

WB World Bank

CPV Communist Party of Vientam

NPLs non-performing loans

Thesis Proposal

Author	Nguyen Quang Dung
Supervisor	Doc. Ing. Pavel Mertlík, CSc.
Proposed topic	The Institutional Analysis of Banking Reforms in Vietnam

Topic characteristics The objective of the bachelor thesis is the institutional analysis of banking reform in Vietnam. Since 1986 Vietnam has imposed the economic reforms in order to foster economic growth. The one-tier banking system was replaced by the two-tier banking system. Unfortunately, the legacy of social economy is a big amount of non-performing loans. I would like to analyze reforms of banking system in Vietnam and how they form institutions over time.

Outline

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Chapter 1

Introduction

Vietnam undertook the reforms of the banking system in the past two decades. These reforms included measures such as the partial liberalization of interest rates, the removal of quantitative controls on lending, lifting barriers to competition, the privatization of public financial institutions, the introduction of market-based securities, and the establishment of more flexible exchange rate mechanism. The principal aim of the reforms is to raise both a level of investment and efficiency of its allocation, and to enhance financial services to all sectors of the economy. (Hardy & di Patti 2001)

A financial system is a cardinal part for market-based economy and its importance in itself and influence on the other sectors require that the undertaken reforms need to be evaluated comprehensively. Nonetheless, an impact of the financial reforms on Vietnamese economy is hard to gauge. The institutional development of banks, a prerequisite for developing a good financial system, is currently the most meaningful indicator to assess the progress in banking reforms (Claessens 1996).

Since the late 1980s Vietnam has undertaken many banking reforms, especially it changed its banking system from one-tier to two-tier banking system. In the onset of the banking reforms, State Bank of Vietnam (SBV) used both rehabilitation and new entry approaches to deliver the best results. There has been a lot of learning by doing and mistakes made along the way. Vietnam's banking system evolved rapidly during the last two decades. In the transition years, beside five state-owned banks, new banks emerged. Many banks are generally of poorer quality, being small, undercapitalized and not engaged in much financial intermediation. Hence, a current structure of the banking system is weak and prone to potential banking distress. A banking crisis is costly in two dimensions. Firstly, it undermines economic growth by disrupting credit intermediation. Secondly, it imposes large fiscal costs (Tang *et al.* 2000).

Reasons for the banking reforms relate to opening up of Vietnam's economy and a legacy of the central planning. Firstly, the Asian financial crisis exposed the fragility and vulnerability of Vietnam's banking system. A banking crisis could have adverse real economy effects. Hence, strengthening of Vietnam's banking sector is understood to be a prerequisite for eventual opening of capital accounts (O'Connor 2000). Secondly, the inefficiency of State-Owned Enterprises (SOEs) poses a big threat to Vietnam's banking system since banks, especially State-owned Commercial Banks (SOCBs), directly finance SOEs economic activities.

The banking system plays a crucial role in the financial market. An effectively non-existent stock market underlies the importance of the banking system in Vietnam.[1] Many Vietnamese observers and scholars perceive the stock markets as casino with a random distribution of money. The traders in the stock markets lack technical skills and most of the shares are undervalued or overvalued due to lack of the public disclosure of information about firms. Hence, speculation is a main instrument of the traders in the stock markets. As a result, in 2007 in Ho Chi Minh City stock market, it had lead to the stock market bubble that inevitably burst. Vietnamese stock index decreased from 1,171 points to 366 points. The equity finance is also cumbersome with uncertain result. Hence, debt financing is mainly used to finance business activities with the banking sector operating as the source. Both types of financing (equity and debt financing) entail information asymmetries and moral hazard.

In Vietnam's economy there are a few things associated with slow progress of weak banks: preferential treatment by the government, constraints for foreign banks, and overconcentration of SOCBs. It seems that in the context to a potential banking distress the government has to undertake banking reforms or restructure the banking sector to avoid any kind of a future banking crisis. The experience from Asian economies in the late 1990s suggests that development of the stable, efficient domestic banking system, and the mature financial market should be established before a full integration with international financial markets (Gottschang 2001).

The objective of the thesis is to analyze the banking reforms in Vietnam qualitatively and analytically using institutional approaches. The main scope

[1] Vietnam has two stock markets, in Hanoi and Ho Chi Minh City.

of the analysis is the institutional development. To the knowledge of the author and as of the time of writing the thesis, there have been no papers focusing on an institutional development in the banking sector from introduction of Doi Moi (renovation) reforms to present. [2]

Doi Moi reform was launched in 1987 in the aftermath of the economic turmoil at the beginning of the 1980s. It had a big impact on all economic activities including the banking sector.

Many papers describe the process of transition of the banking sector or strategies applied in transition. Román (1995) analyzes institutions in transition and reforms of Vietnam's banks in period 1951-1995. She focuses on SOCBs and not on the whole banking sector. However, since that time Vietnam's banking sector changed rapidly but no comprehensive analysis has been performed in the field of institutional change in the banking sector. Son (2009) assesses an impact of strategies applied by the Vietnamese government on the structure of the banking system. However, the research paper lacks a comprehensive institutional analysis. The latest book focused on an institutional analysis was published in 2009 and it was written by Lan Nguyen. Nguyen (2009) comprehensively analyzes institutions in Vietnam with special reference to SOEs. His study focuses on SOEs as a whole. Hence, the banking sector is not analyzed separately and thoroughly.

Hence, the institutional analysis is the main scope of the thesis. Since there are a few reliable sources of information about institutions in the banking sector, author can not avoid theorizing but at the same time tries to minimize it.

The thesis is structured as follows: Chapter 2 underlies the theories of institutions and institutional change, and a methodology, Chapter 3 introduces two approaches of banking reforms, Chapter 4 analyzes the institutional development of the banking sector, and finally Chapter 5 concludes.

[2]The program of economic reform of Doi Moi has following goals: 1. Decentralization of state economic administration so that the enterprises could be independent 2. Substitution of administration measures with economic measures. Setting of monetary policy that could lower high inflation. At the early stage of reform, new monetary policy could not offset high inflation 3. Acceptance of external measures that lead to convergence of exchange rate of VND and interest rate responding the situation of Vietnam in the world market. 4. Change of agriculture policy. Prolongation of hire of land for peasants so that operate with land more flexible, i.e. they can create surplus and dispose with it and operate in the market. 5. Economic growth should depend on the growth of private sector. 6. Integration of private sector with foreign sector to level up import and export.

Chapter 2

Theories and methods

2.1 Institutional theories

2.1.1 Institutions

In the world of zero transaction costs, institutions do not matter. Since this world does not exist, institutions matter. Each society possesses a different bulk of institutions. They evolve over time and change accordingly. Institutions have been created to facilitate and shape human interactions by creating humanly devised constraints. Fundamentally, institutions are the rules to which the players of a game should adhere (North 1990). The society consists of institutions that function as a structure to everyday life. Hence, institutions exist to reduce uncertainty by establishing a stable structure to human interactions and improve the predictability of actions. We may say that institutions define and limit the set of choices of individuals (North 1990).

Transaction, measurement, and enforcement costs[1], are the sources of social, political and economic institutions (North 1990). Measurement costs involve acquiring of information and it is burdensome in the presence of asymmetries of information.

Institutions may be either informal or formal. Informal institutions are constraints or rules that are unwritten and hence they are not easily enforceable (e.g. codes of behavior, conventions, customs, etc). Informal institutions are parts of the culture that influences how informal rules evolve over time. Formal institutions are those rules that are devised by human beings, codified, and

[1] These costs involve the costs of measuring attributes of the goods being exchanged and the costs of protecting rights and policing and enforcing agreements.

they are enforceable (e.g. codified rules, written constitutions, etc). Formal rules may support informal rules and increase their effectiveness. They may lower information, monitoring, and enforcement costs and facilitate exchange. Formal rules may be used to modify, revise or replace informal rules (North 1990)

Formal institutions become more important, relative to informal institutions, the more the scope for market exchange broadens and deepens, possibly because establishing formal institutions has high fixed costs but low marginal costs while informal institutions involve high marginal costs (Rodrick 2003). Formal institutions influence the balance of diversionary (rent-seeking) and productive activities in society (Hall & Jones 1999). Countries with long-lasting history of institutions that support productive activities produce higher levels of output per worker.

Formal institutions entail political and economic institutions that influence each other over time. Political institutions form the political process that produces legislation and regulation. They influence the legal system and coordinate the processes that create and enforce laws (Frances 2004). For effective institutions, the state should be strong enough to specify good property and contract laws and must be committed to enforce them, even when this means constraining itself from violating these laws for its own ends (Borner *et al.* 2004).

Economic institutions are those that determine property and contract rights and thereby reduce transaction costs. Good economic institutions can be described as those that provide security of property rights and relatively equal access to economic resources to a broad cross-section of society (Frances 2004).

If a rule lacks enforcement it is either the perfect one or the useless one. The former is rare and the later is unneeded. Hence, enforcement is crucial for rules to be efficient. Nonetheless, enforcement is typically imperfect (North 1990). In the world of complete information, there is no reason for institutions to exist. Since this state of the world does not exist, the world of incomplete information is conducive to violation of rules. To avoid violation, there have to be institutions assuring cooperation. According to North (1990) i) it is necessary to form a communications mechanism that provides the information necessary to know when punishment is needed and ii) institutions must provide incentives for those individuals to carry out punishment when called on to do so. The institutional environment that induces credible commitment requires the complex institutional framework of formal rules, informal rules and enforcement that together make possible low-cost transacting (North 1990). There is a difference in enforcement in developed countries and Third World.

"In developed countries, effective judicial systems include well-specified bodies of law and agents such as lawyers, arbitrators, and mediators, and one has some confidence that the merits of a case rather than private payoffs will influence outcomes. In contrast, enforcement in Third World economies is uncertain not only because of ambiguity of legal doctrine (a measurement cost), but because of uncertainty with respect to behavior of the agent." (North (1990), p. 59)

Property rights and contract enforcement enhance the environment for economic activities by reducing transaction costs faced by firms (Frances 2004). Without effective enforcement, valuable exchanges may not be accomplished.

It is important to make a distinction between institutions and organizations. Organizations are influenced by an institutional framework and they are established with purposive intent as consequence of the opportunity set resulting from the existing set of constraints and in the course of attempt to accomplish their objectives are a major agent of institutional change (North 1990). Organizations economize on transaction costs and maximize their wealth. Organizations include political, economic, social, and educational bodies. They are groups of individuals with the same purpose to achieve objectives (North 1990).

Institutions affect the exchange among individuals and, therefore, they influence the performance of the economy. In combination with technology, institutions determine transaction and transformation costs. Institutions are not always created to maximize social wealth, they, at least formal rules, are rather created to serve the interests of those with the bargaining power to devise new rules (North 1990).

2.1.2 The theory of institutional change

Institutions have been constantly changing. As new problems occur both formal and informal rules change to adapt to a new environment. The process of institutional change is rather complicated. Institutions typically change incrementally rather than in discontinuous fashion and it is a result of imbeddedness of informal constraints in society (North 1990). Formal rules can be changed and come into force immediately, informal rules are entrenched and the changing process takes a long time. Alchian (1950)'s evolutionary hypothesis suggests that ubiquitous competitions weed out inferior institutions and reward by survival those that better solve human problems. North & Thomas (1973) made institutions the determinant of economic performance and relative price changes the source of institutional change, i.e. changes in relative prices create incentive to construct more efficient institutions.

Institutions determine the opportunities in a society. Organizations are created to seize those opportunities and as organizations evolve they alter institutions. Hence, an institutional framework constantly reinforces incentives for organizations to engage in productive activities however admixed with some adverse consequences because an institutional framework has frequently perverse incentives (North 1990). Apart from organizations, individual agents also have impact on institutional change. According to North (1990), a path of institutional change is shaped by:

1. the lock-in that comes from the symbiotic relationship between institutions and the organizations that have evolved as a consequence of the incentive structure provided by those institutions and

2. the feedback process by which human beings perceive and react to changes in the opportunity set.

and it is described as follows:

"A change in relative prices leads one of both parties to an exchange, whether it is political of economic, to perceive that either of both could do better with an altered agreement or contract. An attempt will be made to renegotiate the contract. However, because contracts are nester in a hierarchy of rules, the renegotiation may not be possible without restructuring a higher set of rules (or violating some norm of behavior). In that case, the party that stands to improve hos or her bargaining position may very well attempt to devote resources to restructuring the rules at a higher level. In the case of a norm of behavior, a change in relative prices or a change in tastes will lead to its gradual erosion and to its replacement by different norm. Over time, the rule may be changed or simply ignored and unenforced. Similarly, a custom or tradition may be gradually eroded and replaced with another." (North (1990), p. 86)

2.2 Data sources and data collection methods

The thesis used a variety of data sources. Various government documents were used, including laws, regulations, statistics, discussions and comments on Vietnamese official newspapers, and reports. World Bank and International Monetary Fund provide priceless insightful information about Vietnam's banking sector, both theoretical and practical.

The thesis refrains from using only one data source to come to the conclusion. Firstly, many data are missing and it is difficult to find them. The newest report of Vietnamese central bank available is from 2010. Secondly, in many cases, the validity and reliability of information is questionable. In some cases, I compare Vietnamese institutional framework with Chinese institutional framework since the studies about Chinese banking sector are more accessible. Both institutional frameworks have many features in common. The recent studies use questionnaires to qualitatively analyze the specific problems (see Nguyen (2009) or Tran (2008)). The problem of getting data and the difficulty of doing researches in Vietnam is documented by Vietnamese and foreign researchers (see Fforde & De Vylder (1996), Malesky *et al.* (1998) or Nguyen (2009)). Hence, the thesis refrains from predictions.

The validity and reliability of Vietnamese data sources are sometimes questionable. Those data sources use different calculation methods and hence the outcomes differ from calculations of World Bank or International Monetary Fund.[2] The author prefers data sources of International Monetary Fund or World Bank to Vietnamese data sources for their accountability.

The new research papers about Vietnam's banking sector are missing. Nonetheless, within five years no breakthrough reforms were undertaken to change an institutional framework of the banking sector. Hence, a deficit of new research papers on Vietnam's banking sector is not cumbersome as it may look.

[2]The banking sector still use Vietnamese Accounting Standard instead of International Accounting Standard (IAS). Nonetheless, there is a pressure from SBV to use IAS.

Chapter 3

Banking Reforms

3.1 Banking reforms approaches

According to Claessens (1996) there are two different approaches to banking reforms, *rehabilitation* and *new entry. Rehabilitation* approach is characterized as recapitalization and institutional development of existing state banks, some limited break-ups of banks, limited privatization, and more limited entry. On the contrary, *new entry* includes spontaneous break-ups and privatization of state banks, a policy of liberal entry of new banks, and sometime the liquidation of old banks (Claessens 1996). The alternative distinction sometimes made for banking reforms approaches is *decentralized* (where banks work out their problem loans) versus *centralized* (where loans are restructured or forgiven on the basis of general principles and/or where the state takes a larger role). To some extent this distinction overlaps with the distinction *new entry* and *rehabilitation.*

Since the 1990s Vietnam has not chosen a consistent banking reform strategy. Depending on circumstances, Vietnam chooses either *new entry* or *rehabilitation* approach. The inconsistency of the banking reform approach has an impact of imbalance of the structure and slow reform speed of the banking system (Son 2009). Since Vietnam and China share the similar initial conditions, the Vietnamese strategy to reform the banking sector is similar to strategy chosen by China.[1]

[1]"China and Vietnam are fundamentally different from the other "emerging" economies in Asia because the deficiencies in their financial institutions are direct results of the Soviet-style centrally planned economic model that both employed for nearly 30 years. Under the central planning model, investment decisions were made by plan. Financial markets did not exist, and banks served only to hold deposits of individuals and enterprises, and to disburse funds to meet the needs of enterprises for planned activities. Banks made no consumer loans.

A governor of SBV and a prime minister are the diehard proponents of China's policy. The history shows Vietnam's tendency to model its institutions on China's ones (O'Connor 2000). Hence, both two countries tend to follow mainly the *rehabilitation* approach. *Rehabilitation* approach allows to retain the state control over SOCBs and SOEs. The banking reforms in two countries are not undertaken at once, rather than Vietnam's reforms are undertaken with delay. In theory, Vietnam has the second-mover advantage of exploiting China's experience to deliver better outcomes. In practice, applying the same policy does not lead to the identical outcome even though the countries are similar. In addition SBV's technical skills is not as good as in central banks in Western economies or in China. Reforms change formal rules immediately but informal rules requires substantial time to change. For reforms to be efficient the informal rules have to change as well (Kouba *et al.* 2005). Informal rules in Vietnam are deeply entrenched. Hence, in case of Vietnam we can partially conclude that an establishment of efficient market institutions requires substantial time due to rigid informal rules.

3.2 A brief review of Vietnam's banking reforms

3.2.1 Pre-transition period - up to 1986

Vietnam's banking system is relatively young in comparison with banking systems in Europe. In 1986 the government imposed economic reforms Doi Moi (DM). Before DM, Vietnam had an one-tier banking system with an unique mono-bank serving purely as a planning and administrative instrument of the government.

The monobank, SBV, was established on May 6^{th} 1951 during the war time. The government also established a few specialized banks to impose government policy and facilitate capital to some area of economic activities: 1. The Vietnam Reconstruction Bank (1957), renamed to The Bank of Investment and Construction in 1981, since 1990 is called Bank for Investment and Development of Vietnam (BIDV); 2. Foreign Trade Bank of Vietnam (Vietcombank)

Loans to enterprises were allocated on the basis of planned activity, or under government direction, with no consideration of risk. Enterprises – firms – were owned either collectively, or by the different levels of government. There were no significant privately owned firms, no stocks, and none of the panoply of financial instruments that support the operations of firms in market-based industrial nations. The only form of financial asset was the savings account." (Gottschang 2001)

(1963); 3. Vietnam Bank for Agriculture and Rural Development (Agribank) (1988); 4. Industrial and Commercial Bank of Vietnam (1988), renamed to Vietnam Bank for Industry and Trade (Vietinbank) in 2008.[2]

3.2.2 Transition process - 1986 to 2008

Since 1986 Vietnam's banking system has undergone through a reform process. On March 9^{th} 1988 a chairman of Minister Council issued Decision 53 allowing all economic organizations to borrow and mobilize money from public. This experiment without creating a stable institutional framework and reforms of other sectors resulted in an accumulation of bad loans. Many lenders, mostly people's credit organizations, defaulted as a result of the rapid liberalization, the macroeconomic instability, and no concomitant legal and enterprise reforms. This caused a low confidence in banking system that is still present nowadays.

In May 1990, the State Council issued two banking ordinances[3] to officially transform a Soviet model of the banking system, under which the unique bank (a monobank) conducted both monetary policy and commercial activities, to a market-based banking system (two-tier). The structure of the new banking system was composed of two levels. At the first level, SBV is positioned as a central bank. At the second level, there are commercial banks. In December 1997 these two ordinances were replaced by the Law on State Bank and Credit Organizations. The period of 1990 - 1997 was characterized as the macroeconomic stabilization with fast economic growth. During this period a number of Joint Stock Commercial Banks (JSCBs)[4] has been created (see Figure 3.1). The foreign banks are allowed set up branches or to form a join-venture with Vietnamese banks. The government also established two additional policy banks.[5] Asian financial crisis in 1997 - 1998 did not hit Vietnam's banking system seriously since the openness of Vietnam's banking system was limited. Nonetheless, it exposed many weaknesses of domestic banks.

With a new structure of the banking system new problems occurred. Although Vietnam experienced the rapid economic development, banks were in-

[2]These banks are known as policy banks or state-owned commercial banks

[3]Ordinance on State Bank of Vietnam; Ordinance on Banks, Credit Cooperative and Financial Enterprises

[4]The Joint Stock Commercial Bank is the same as the Joint Stock Bank. The State Bank of Vietnam uses only the term Joint Stock Commercial Bank but some research paper use the term Joint Stock Bank for the same organization.

[5]Bank for Poor (1995), renamed to Social Policy Bank in 2002; Mekong Housing Bank (1997)

capable of avoiding inefficiency and non-performing loans (NPLs) mushroomed. These problems related mostly to SOCBs and banks with a state majority. As a result, in 2000 government decided to launch a restructuring program using *rehabilitation* approach[6] (Son 2009). At the outset of restructuring, the government decided to retain full ownership of SOCBs. Within the restructuring program the government established Asset Management Companies (AMCs) for four SOCBs. AMCs supervised NPLs of SOCBs. Bad loans strongly related with SOEs to which SOCBs granted loans. In order to offset NPLs of SOCBs, in 2003 government established Debt and Asset Trade Company (DATC).[7]

In 2001 Vietnam signed a bilateral agreement with the USA leading to opening up of a domestic market to US firms and promulgation of the new market reforms. The following acceptance of Vietnam to World Trade Organization (WTO)[8] was based on Vietnam's determination to continue the market reforms. According to WTO provisions, Vietnam has to open its banking sector within 7 years since its admission.

In 2004 SBV was assigned to create equitization[9] plan for SOCBs. At the same time, due to inefficiency and bad loans a few JSCBs were closed, merged or consolidated. Thus a number of commercial banks reduced significantly. The aim of the plan was to equitize all SOCBs until 2010. Nevertheless, in 2012 only three SOCBs are partly equitized.

3.2.3 Transition and Contemporary Economic Development - 2008 until now

In 2008, there were 50 applications for establishment of new banks. [10] On one hand, only few were granted permission. On the other hand, a number of banks is still high. A number of joint - venture banks and joint-stock commercial

[6]Reduction of NPLs, increase in capital, separation of policy credits from commercial credits, the administrative reorganization, the diversification of banking services, the establishment of risk management mechanism and equitization

[7]AMC is a part of a commercial bank. The aim of AMC is to aid the collection and disposal of long term bad debt. DATC was set up by the government with mandate to help SOEs dispose of their NPLs and Non Performing Assets.

[8]In 2007 Vietnam was accepted as 150^{th} member of WTO

[9]Equitization is a process of selling part of the equity of an SOE or SOCB to the public or a strategic investor. In recent years, equitization has mostly taken place through an Initial Public Offering followed by listing of the company in the stock exchange.

[10]http://vneconomy.vn/20080810112958943P0C6/quanh-chuyen-tam-ngung-cap-phep-lap-ngan-hang.htm; accessed on February 1^{st}, 2012

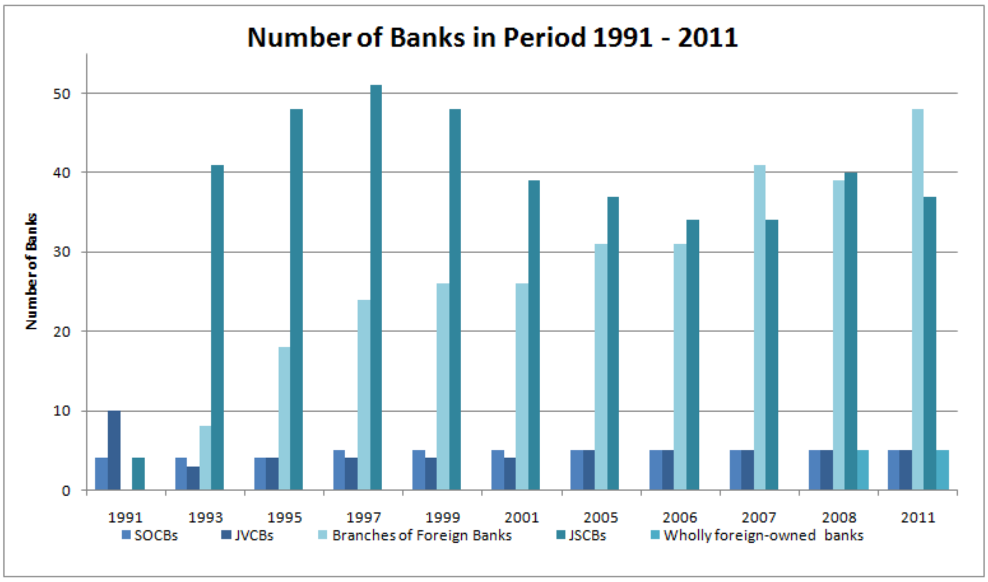

Figure 3.1: Number of banks in period 1991-2011

Source: Author's summary from SBV's Annual Reports.

banks are about to shrink in years to come within the restructuring of banking system.

Table 3.1: Vietnamese Credit Institutions System by December 31th, 2011

Source: State Bank of Vietnam database

Form of Credit Institution	No
State-owned Commercial Banks	5
Joint-stock Commercial Banks	35
Branches of foreign banks	50
Joint-venture banks	4
Wholly foreign-owned banks	5
Finance Companies	18
Leasing Companies	12
Representative Offices of Foreign Banks	51

Table 3.2: Important data in banking reforms road

Source: Son (2009) and author's edit

Key events	Time
one-tier banking system (State Bank of Vietnam and other policy State-owned Banks)	1951 - 1990
Experiment with people´s credit organization (Decision 53 of Chairman of the Minister Council)	1988 - 1990
Two-tier banking system officially introduced Ordinance on State Bank of Vietnam, and Ordinance on Banks, Credit Cooperative and Financial Enterprises Law on State Bank and Credit Organizations	1988 1990 1997
Growth of commercial banks	1990s
Bilateral agreement with USA	2001
Restructure of commercial banking system 1 - Establishment of AMC, DATC Equitization of state-owned commercial bank	2000 - 2008 2008 2008
Vietnam became 150th member of the WTO	2007
Permission of 100 percent foreign-owned banks	2008
New Banking Law	2008
Restructure of commercial banking system 2 - Consolidation of banks, M&As of small banks - Equitization of SOCBs	2012 - present

3.3 Determinants of progress

3.3.1 The Institutional Legacy at the Start of the Transition

Before the onset of banking reforms Vietnam had a Soviet model of banking system, under which a unique mono-bank conducted both monetary policy and commercial activities. The Gordian knot binding together the SOEs and the mono-bank, later SOCBs, means that financial losses and inefficiency of the former had a big impact on the later. SOEs are still under protection of Vietnam's government and they hardly go bankrupt. A substantial number of enterprises was so far unable to adapt to more market-based environment. Whether this is primarily because of principal-agent problems or because the principal (the state) imposes heavy policy burdens on the agents (the SOEs managers) remains a matter of disputes (O'Connor 2000).

Vietnam's weak judicial system is burdensome for reformists. During the war and before the end of the war people practicing law were sent to working camp or punished for wrongdoings. Most of the lawyers were educated in Moscow. Hence, the judicial system possesses attributions of the Soviet legal system with many deficiencies. Many laws are unambiguous and the interpretation depends on an individual judge (see Figure A.1).

3.3.2 Macro-developments

In East and South-East Asian countries, the savings rate is usually high (see Figure 3.2). On one hand, Vietnam's gross savings rate (30 per cent of GNI) is comparable with ones of Thailand, Philippines, and Laos, though the measured savings rate may not correspond with actual rate. On the other hand, adjusted net national savings rate is significantly lower than in ASEAN countries.[11] In addition, a significant amount of savings are held in non-liquid assets or in US dollar balances outside the banking system. As for 1997 there was a low rate of financial intermediation and the bank deposits amounted for only 17 per cent of GDP. The confidence in the banking system was low as a result of state's *new entry* approach to banking reforms in the early 1990s. Many financial institutions (mainly people's credit organizations) went bankrupt. After restructuring of the banking system in the 2000s, the confidence has increased again. As for

[11] Adjusted net saving, (also known as genuine saving), is a sustainability indicator building on the concepts of green national accounts. Adjusted net savings measure the true rate of savings in an economy after taking into account investments in human capital, depletion of natural resources and damage caused by pollution. *Source:* World Bank

2006 the bank deposits is estimated to 78 per cent of GPD (see Figure 3.3). The increasing remittance has been contributing to higher savings rate and influenced the bank deposits as well.[12] It is argued that even though the economic growth has been high, there is still a number of people with low wage. For these people having a bank account has no meaning. This fact is underlined by the penetration rate of approximately 10 per cent according to International Finance Corporation report 2008. It also may reflect that the informal finance plays still a crucial role in the banking sector and has a comparative advantage of solving information asymmetries. Hence, financial deepening as an indicator of the banking sector development in Vietnam should be used sceptically. Instead, the level of sophistication on part of banking sector should be used rather than the process of increasing bank deposits.

On the contrary, the investment rate is higher than savings rate. Saving-investment balance (as percentage of GDP) has been negative except for period 1999-2001. To fill the savings-investment gap Vietnam depends on the official development assistance (ODA). On one hand, a great scarcity of capital should provide stronger incentive to its efficient allocation, on the other hand, the heavy dependence of Vietnam on ODA implies that a significant additional portion of investment in Vietnam is allocated directly by the state, with correspondingly high risk of inefficiency (O'Connor 2000).

The issue of dual-currency in Vietnam is long-lasting, with a wide circulation of US dollar and it is broadly used as the store of value. It is assumed that the degree of dollarization is above 20 per cent which is significantly higher than in other ASEAN countries.[13] The degree of dollarization negatively correlates with Vietnam's currency. The stronger Vietnamese Dong, the lower degree of dollarization and vice versa.

As of 2006, deposits in foreign currency, mostly in US dollar, amounted to 26 per cent of all deposits. 22 per cent of the total bank credits are extended in foreign currencies, mostly in US dollar. On one hand, quasi-dollarization holds in check any tendency towards significant currency over-valuation. On the other hand, it exposes the banking sector to a significant currency risk since the SOEs that are the main dollar borrowers use their loans mostly for domestic operations (O'Connor 2000).

[12]In 2010, remittance to Vietnam was 8,000,000,000 USD, one of the highest remittance in the world. The trend is increasing with a number of high profit investments in Vietnam

[13]The result for high degree dollarization lies in the high remittance, foreign direct investment and increased export earnings in the past. The remittance to Vietnam is one of the highest in the world.

Figure 3.2: Savings rate of ASEAN countries and China in 2008

GNS = Gross National Savings
ANS_E = Adjusted Net Savings

For Brunei, Cambodia, Malaysia and Myanmar the data are unavailable

Source: World Bank Website and author's edit

3.3.3 Legal and Enterprise Reform

Progress of legal and enterprise reforms significantly affect the progress of the banking reforms. The legal reform creates the legal framework for all players and is a cardinal pillar for the banking system. Banks rely on the judicial system, including procedures for collateral recovery and bankruptcy, to enforce their claims and perform their roles as a monitor of firms (Claessens 1996).

As for an enterprise reform, the change from Soviet model to a market driven model poses a big threat for inefficient SOEs. They have to face hard budget constraint rather than soft budget constraint they adhered under the Soviet model. Restructuring is important to resolve the NPLs widespread in SOCBs. Financially healthy firms create the demand for better banking services and spur institutional progress in the banking sector. Substantial enterprise privatization and the entry of new private firms are also preconditions for large-scale bank privatization to produce meaningful benefits (Claessens 1996).

Enterprise reforms started with DM reforms. On one hand, we can see the big progress in restructuring of SOEs. On the other hand, the transform of SOEs

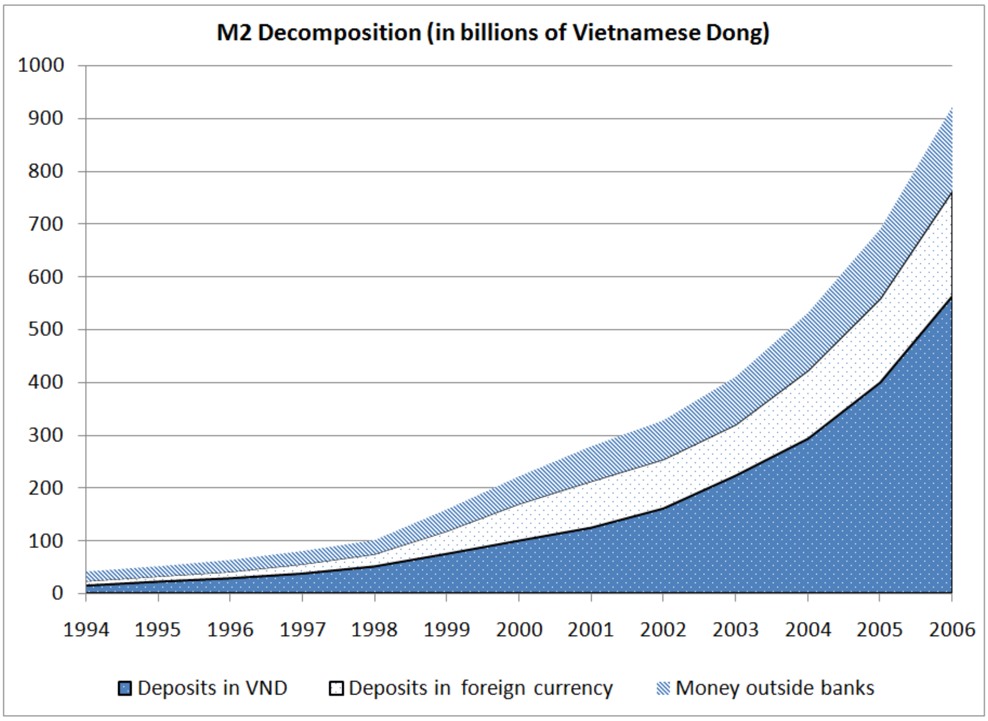

Figure 3.3: Decomposition of M2

The Latest Statistical Appendix on Vietnam published by IMF includes only the period 2002 - 2006.

Source: Author, based on Statistical Appendix IMF

to market-driven firms has been slow. Both enterprise and legal reforms are hindered by vested interest of members of Communist party of Vietnam. Since the early stage of economic development, Vietnam has remained a capital-scarce economy. For capital modernization, debt financing is more appropriate than equity financing.[14] The efficient utilization of the capital ought to be a high policy priority. The Asian financial crisis that began in mid-1997 exposed a common problem across much of region, namely, that growth rates were both supported by increasingly inefficient use of capital, with adverse effects on the rate or return to capital (O'Connor 2000). Hence, both the enterprise and banking reforms have to go hand in hand and undertaken simultaneously to make progress.

[14]http://www.federalreserve.gov/boarddocs/speeches/1999/19990312.html

Chapter 4

Progress in the Banking Reform

Progress of the banking sector could be evaluated by indicators expressing the absolute terms, e.g. EBRD[1] transition index and World Bank - Doing Business indicators, or by progress of the institutional development of the banking sector, i.e. the ownership structure, the judicial system, etc. We divide indicators into two groups, ones indicate the institutionalization of the banking sector and ones indicating the openness and liberalization of the banking sector.

4.1 Indicators of Progress of the Banking Reform

EBRD transition index

To evaluate progress of the banking sector in Vietnam, we use the EBRD indicator of the banking reform and interest rate liberalization which is one of transition indicators. The scoreline is in Table 4.1. Since EBRD does not evaluate progress of the banking sector in Vietnam, our evaluation is based on experts' judgments. The average score given by the experts is 3- (Son 2009).

Doing Business - Indices

Beside the EBRD indicator, we use World Bank - Doing Business index, especially index concerning fields "Getting Credit" and "Investor Protection".

Getting Credit indicators measure (i) the strength of legal rights, (ii) depth of credit information, (iii) public credit registry coverage, and (iv) private credit bureau coverage. A credit information system and the legal rights of borrowers

[1] European Bank for Restructuring and Development

Table 4.1: EBRD indicator of banking reform and interest rate liberalization

Source: http://www.ebrd.com/pages/research/analysis/surveys/ti_methodology.shtml

1	Little progress beyond establishment of a two-tier system.
2	Significant liberalization of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
3	Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalization with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
4	Significant movement of banking laws and regulations towards Bank for International Settlements standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
4+	Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

and lenders in collateral and bankruptcy laws are pillars for the efficient credit allocation. The credit information system allows assessing risk and eliminate the problem of information asymmetries that are proliferated in developing countries. Without any data about clients, assessing becomes difficult and it may lead to bad loans. The collateral law is important in Vietnam since it enables businesses to use assets as the security to the generate capital. The bankruptcy law enables firms to easily exit and facilitate money flow to lenders.

To evaluate the indices, we have to bear in mind that Doing Business index assumes that borrower (i) is a private, limited liability company, (ii) has its headquarters and only base of operations in the largest business city, (iii) has 100 employees, and (iv) is 100 % domestically owned, as is the lender. These assumptions may be misleading since a high number of businesses are small or medium-size and operations in big cities are different than in small towns or villages. Nevertheless, the indices may reflect the pressure to move business to big cities and a high ratio of urbanization supports the indices.

The ease of getting credit has improved. In 2012, Vietnam stands at 24 in the ranking of 183 economies. In case of Vietnam, this may reflect the presence of connections lending (more in Subsection 4.3.4) and policy lending. To compare Vietnam with ASEAN[2] countries and regional average (East Asia & Pacific) see Figure 4.1.

[2] The Association of Southeast Asian Nations

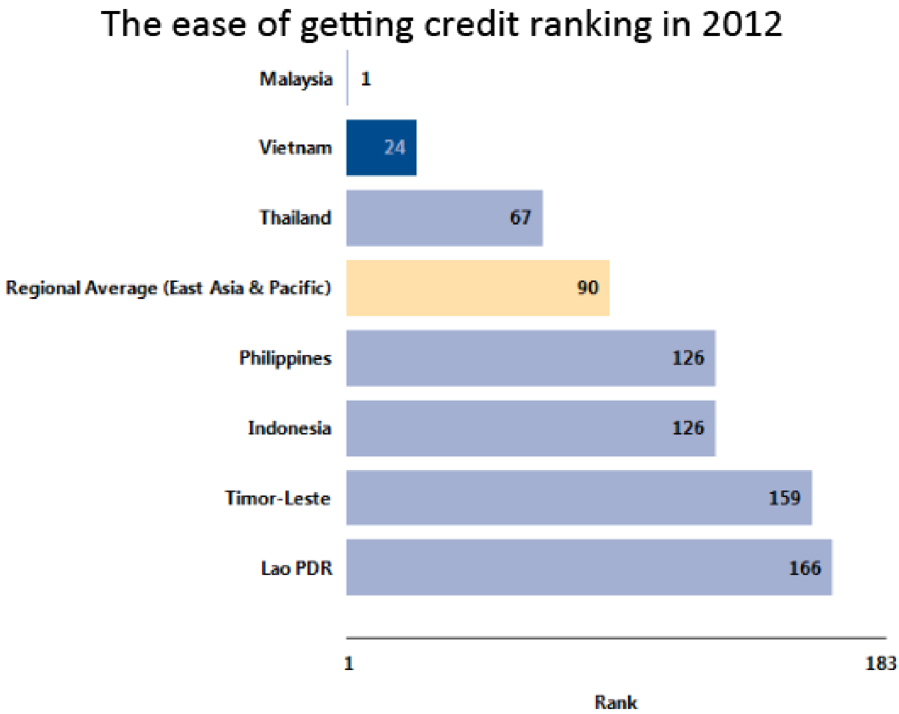

Figure 4.1: How Vietnam and comparator economies rank on the ease of getting credit in 2012

Source: Doing Business database

Table 4.2 shows how indices have changed over time. The environment for getting credit has strengthen but not substantially (Vietnam ranked at 21 in 2005 and at 24 in 2012). It is noteworthy that the strength of legal rights index is high. Nevertheless, the number does not reflect the strength of enforcement of laws. Depth of credit information index has improved rapidly, from 2 in 2005 to 5 in 2012. Credit depth of information index measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. Nevertheless, in Vietnam there is only a state-owned credit information company in function.[3] On one hand, the high evaluation of depth of credit information index may reflect that the problem of information asymmetries can be solved efficiently and hence it leads to an improvement of risk managements in the banking sector. On the other hand, high NPLs do not support this index and may reflect the presence of low risk managements, connections lending and policy lending. It is noteworthy that Credit Information Company does not distribute credit information from retailers, trade creditors,

[3] There is also a private credit information company but it is not properly functioning.

utility companies, and financial institutions. Therefore, this index should be taken skeptically.

Table 4.2: Getting Credit index over time

Indicator	05	06	07	08	09	10	11	12
Rank	...	...	...	...	...	...	21	24
Strength of legal rights index (0-10)	6	6	6	8	8	8	8	8
Depth of credit information index (0-6)	2	3	3	3	4	4	5	5
Public registry coverage (% of adults)	0,8	1,1	2,7	9,2	13,4	19	26,4	29,8
Private bureau coverage (% of adults)	0	0	0	0	0	0	0	0

When economies strengthen the legal rights of lenders and borrowers under collateral and bankruptcy laws, and increase the scope, coverage and accessibility of credit information, they can increase entrepreneurs' access to credit.[4] In Table 4.3 we can see what government did to improve the access to credit from 2009 to 2012.

Table 4.3: Getting Credit Reforms from 2009 to 2012

Source: Doing Business database

DB Year	Reform
DB2012	No refom
DB2011	Vietnam improved its credit information system by allowing borrowers to examine their own credit report and correct errors.
DB2010	No refom
DB2009	The public credit registry now keeps information on record longer, providing financial institutions with more data on the repayment history and debt capacity of potential borrowers.

In Table 4.4 we can see the indices of other countries. It is clear that in OECD high income countries, the private bureau coverage is substantially higher than in Vietnam or East Asia & Pacific. The reason is that in OECD high income countries, governments support private registries running by financial institutions and focus on prudential regulation and supervision. By the same token, it reflects higher financial deepening and financial depth.

[4]Doing Business Report for Vietnam

Table 4.4: Getting Credit Comparison

Source: Doing Business database

Indicator	Vietnam	East Asia & Pacific	OECD high income
Strength of legal rights index (0-10)	8	7	7
Depth of credit information index (0-6)	5	2	5
Public registry coverage (% of adults)	29,8	10,3	9,5
Private bureau coverage (% of adults)	0	18,1	63,9

Investor protection creates an environment for companies to raise money from external sources. The legal framework should therefore facilitate investments in companies and protect investors, otherwise they do not invest until they can be a majority investor, i.e. having more than 50 percent of shares. Concerning the limited share cap[5], Vietnamese government is not willing to abolish it. It may reflect the presence of the socialistic ideology. On the contrary, two state-owned banks have managed to attract foreign investors indicating the attractiveness of the banking sector for investors.

The indicators distinguish three dimensions of investor protections: transparency of related-party transactions (extent of disclosure index), liability for self-dealing (extent of director liability index) and shareholders' ability to sue officers and directors for misconduct (ease of shareholder suits index).[6]

Again, we have to bear in mind assumptions that the business (i) is a publicly traded corporation listed on the economy's most important stock exchange (or at least a large private company with multiple shareholders), and (ii) has a broad of directors and a chief executive officer who may legally act on behalf of the business where permitted, even if this is not specifically required by the law. The transaction involves following details: (i) Mr. James, a director and the majority shareholder of the company, proposes that the company purchase used trucks from another company he owns, (ii) the price is higher than the going price for used trucks, but the transaction goes forward, (iii) all required approvals are obtained, and all required disclosures made, though the transaction is prejudicial to the business, and (iv) shareholders sue the interested parties and the members of the board of directors.

To compare ranking of the strength of investors protection with ASEAN

[5]Foreign firms can own only 30 % of shares
[6]Doing Business database

countries and regional average (East Asia & Pacific) see Figure 4.2. Vietnam is judged very low. Despite the strength of investors protection does not measure aspects concerning protection of minority shareholders, we can assume that high ranking is more conducive to prudential regulation and prone to create better environment for investors. Low ranking also may reflect the discrepancy of registered and implemented investments (see Figure 4.3).

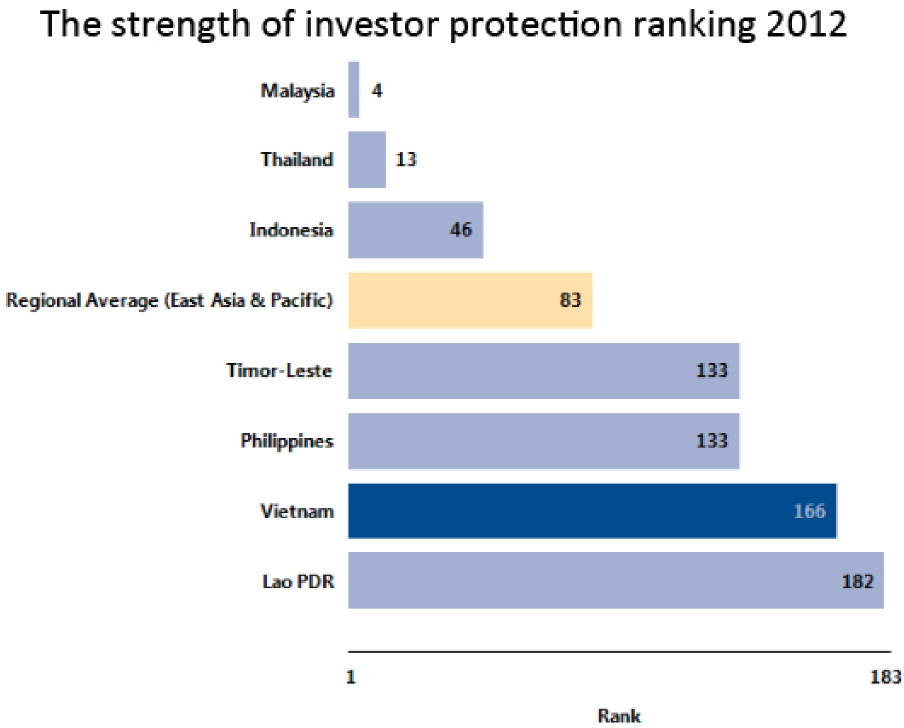

Figure 4.2: How Vietnam and comparator economies rank on strength of investor protection index in 2012.

Source: Doing Business database

Table 4.5 shows how indicators changed over time. The environment for investors has slightly improved but it is still far from perfect. Vietnam has some good laws on the book[7] such as Enterprise Law but problem of many laws are their ambiguities and enforcement. Gelfer (2000) found that in transition economies, the effectiveness of legal institutions has a much stronger impact on external finance than does law on the book. Hence, for Vietnam the government should put priority on strengthening of legal institutions to help law on the book to be efficient. Legal reforms alone are not sufficient for evolution of

[7]A law on the book is written law.

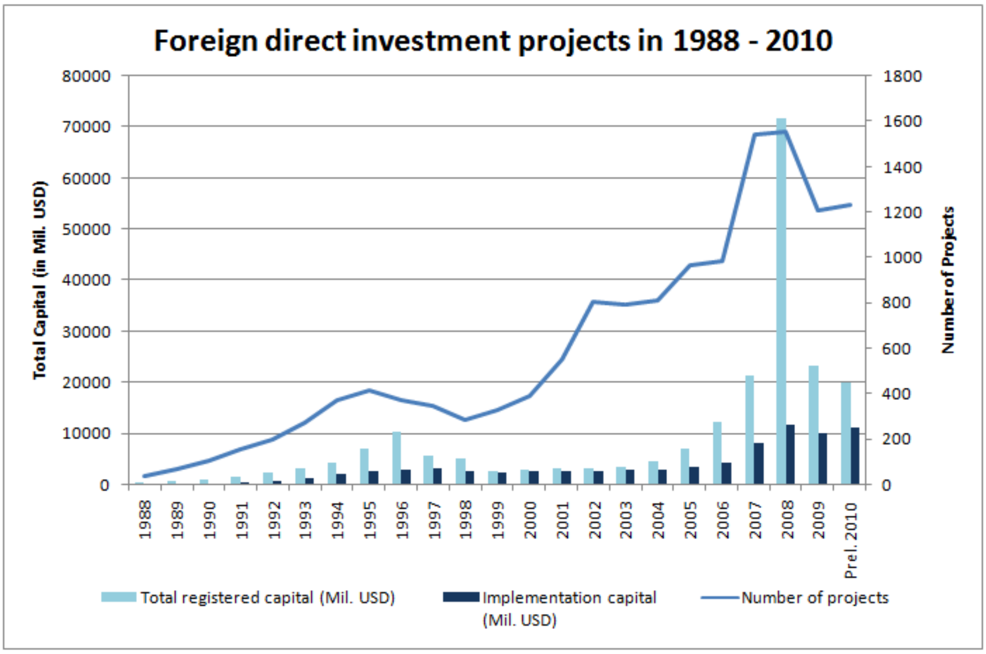

Figure 4.3: Registred and Implemented Investment in 1988-2010

Source: Author based on General Statistics Office of Vietnam

Table 4.5: The strength of investor protections in Vietnam over time

Source: Author based on Doing Business database

Indicator	06	07	08	09	10	11	12
Rank	...	...	...	...	...	172	166
Extent of disclosure index (0-10)	3	3	6	6	6	6	6
Extent of director liability index (0-10)	0	0	0	0	0	0	1
Ease of shareholder suits index (0-10)	2	2	2	2	2	2	2
Strength of investor protection index (0-10)	1,7	1,7	2,7	2,7	2,7	2,7	3

effective legal and market institutions (Gelfer 2000). Table 4.6 shows what the government did to protect investors in period 2009 - 2012.

4.2 How to measure the institutional development

Even though the EBRD indicator of the banking reforms and interest rates liberalization evaluate the institutional development expressing the absolute terms, we analyze the institutional development more in details. For this reason we evaluate the legal framework, the ownership structure, the regulation and

Table 4.6: Protecting Investors - Reforms 2009-2012

Source: Author based on Doing Business database

DB Year	Reform
DB2012	Vietnam strengthened investor protections by requiring higher standards of accountability for company directors.
DB2011	No refom
DB2010	No refom
DB2009	No refom

Table 4.7: protecting investors indicators - comparison

Source: Author based on Doing Business database

Indicator	Vietnam	East Asia & Pacific	OECD high income
Extent of disclosure index (0-10)	6	5	6
Extent of director liability index (0-10)	1	5	5
Ease of shareholder suits index (0-10)	2	6	7
Strength of investor protection index (0-10)	3	5,4	6

supervision of the central bank, and the bank infrastructure. The deep scrutiny of these areas show how institutions have changed over time.

4.3 Institutional development

Claessens (1996) compared the institutional development in 25 transition economies including Vietnam. In 1996, Vietnam was in an early stage of developing a two-tier banking system and experienced a financial turbulence and low confidence of the banking system as a result of bankruptcy of people's credit organizations at the beginning of the 1990s. According to Claessens (1996)' study, there was not a big gap between the worst and the best bank but the average bank was characterized close to the worst banks. In that period, most of the banks were state-owned banks and facilitated the government policy. Hence, those banks were not market-driven and did not put a priority on efficiency and profitability.

Claessens (1996) created a classification of banks that is done for the best segment and used a clustering technique. Based on the classification, in 1996, Vietnam belonged to a group consisted of Slovak Republic, Argentina, Lithuania, and Romania. Now those countries have better and sound banking systems than Vietnam. It may be caused by the different initial stages of transition including macroeconomic conditions, political situations, openness of the economies etc. The same study shows that Vietnam scored low in the banking infrastructure and the legal environment. It stipulates that regulation and supervision has less of an impact on the development of the banking system than the banking infrastructure since regulation and supervision take time to develop and the period of ongoing transition was too short at the time of study.

4.3.1 Regulation and Supervision

Ministry of finance and SBV are responsible for regulation and supervision of the financial markets, corporate sectors, and economic policy. Both of them supervise and regulate the banking sector (see Figure 4.4). The current allocation of supervisory responsibilities among various departments involved in SBV is complex and may need simplification. Enforcement mechanism where banks violate laws needs to be tightened. In addition, supervision by the central bank may be affected by SBV's co-ownership function of SOCBs which appears to undermine credibility of enforcement (Unteroberdoerster 2004).

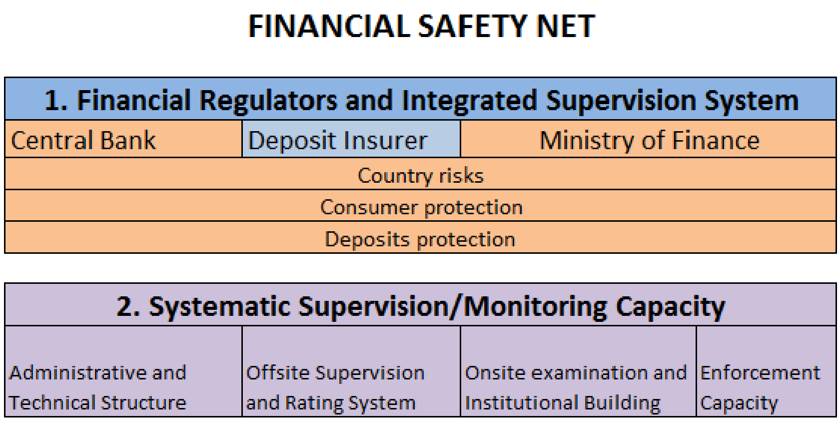

Figure 4.4: Financial Safety Net

Source: Author based on SBV Annual reports

In period 1986 - 2000 SBV used the *entry* approach to reform the banking sector and regulation was not prudential. Since 2006 it has applied *rehabilitation* approach to reform the banking sector and has imposed better regulation. In between, SBV used a mix of both approaches without consistent strategy for regulation of the banking sector. In 2006 SBV increased the capital adequacy ratio to 8 per cent. In the long run, this requirement may have a prudential role in thickening banks' capital cushion against a banking distress. In the short run, it could affect an entry of new banks. In 2007, SBV ceased licensing new JSCBs but unclear licensing conditions may be open to manipulation. In the short run, this could be reasonable since there is many inefficient banks. At the same time, SBV imposed interest rates ceiling that is still present nowadays. This constraint creates serious difficulty for the banking sector in mobilizing funds.

The best practice in regulation is not present and poor regulation may lead to disorder in Vietnam's banking sector. Vietnam should make a further step toward liberalization in the banking sector. The presence of foreign banks and the quantity of commercial banks contribute to efficiency of the banking sector by spillover of know-how and the best practice (Claessens *et al.* 2000).

SOCBs' market share and credit to total credit is high but both indicators are progressively declining (see Figure 4.5). High concentration of SOCBs may hinder the competition[8] and lead to collusion. The monopolistic position of SOCBs is slowly vanishing. Foreign banks' market share is about 10 per cent in 2012.

The equitization program of SOCBs reflects the fact that Vietnam is moving away from Marxist fundamental but still not moving away from Leninism fundamental.[9] Regulation of the banking sector is cumbersome since SBV keeps a controlling share in SOCBs and is a member of boards of SOCBs. This makes regulation more difficult since there is possible preferential treatment of SOCBs. The equitization of SOCBs could resolve this problem and SBV could focus on prudential regulation and supervision.[10]

Currently, State Capital Investment Corporation (SCIC) manage the state-owned shares in equitized SOCBs. SCIC is a market oriented organization and it is allowed to exercise ownership rights in SOEs on the behalf of the government (World Bank 2008). In theory, the SCIC could eliminate the interest conflict of SBV and SOCBs. How it works in practice remains to be seen.

[8] Many Joint Stock Banks (JSBs) complaint that in the countryside they cannot compete with SOCBs since state banks offer lower lending rate or higher deposit rate

[9] The government give in the socialistic possession and strengthen the regulation of economic activities including the banking sector.

[10] Anecdotal evidence shows that the government wants to control the banking sector system because this sector is considered to be an important source of economic rent for government officials from central to local level. As long as the government still holds the controlling share in SOCBs, governmental officials can still dictate these banks' operation in the way that serves their own interests. This would never resolve the banks' inefficiency problem, thus negatively affecting the whole banking system (Dinh 2010)

The raising importance of foreign banks in Vietnam suggests that SBV should act solely as a supervisor and liaise closely with banking supervisors in foreign countries whose banks are active in Vietnam. If foreign banks in Vietnam need to bail out, both SBV and supervisors of foreign banks in their home countries should cooperate with each other to deliver the optimal outcome. If foreign banks default, it poses a systematic risk for Vietnam's banking sector. Hence, SBV should put a high priority on prudential regulation and supervision. At the same time, SBV should also liaise closely with other financial supervising authorities, such as National Financial Supervision Committee (Leung 2009).

According to Jens Kovsted (2005), SBV legal and political independence are comparable with other central banks in the region. Nevertheless, the operational independence and the ability to choose the right measure for problems are assessed to be low. Unless SBV is legally, politically, and operationally independent, supervision would be cumbersome.

	2002	2003	2004	2005	2006	2007 Mar.
			(In billions of Dong)			
Total credit to the economy 3/	231,078	296,737	420,335	553,106	693,800	738,300
To state enterprises	89,500	105,400	142,900	181,306	218,547	231,826
To other sectors	141,578	191,337	277,435	371,800	475,253	506,474
Credit extended by state-owned commercial banks 4/	175,489	214,800	315,335	381,406	440,500	456,800
To state enterprises	81,600	95,700	145,800	158,006	175,700	182,400
To other sectors	93,889	119,100	169,535	223,400	264,800	274,400
Credit extended by other banks 5/	55,589	81,937	105,000	171,700	253,300	281,500
To state enterprises	7,900	9,700	16,300	23,300	42,800	49,400
To other sectors	47,689	72,237	88,700	148.400	210,500	232,100
Total dong loans 3/	184,829	231,700	317,400	418,700	547,500	575,500
To state enterprises	66,500	74,900	96,700	124,800	154,700	162,300
To other sectors	118,329	156,800	220,700	293,900	392,800	413,200
Credit extended by state-owned commercial banks 4/	149,877	177,700	234,400	302,800	362,800	370,800
To state enterprises	61,500	68,700	87,100	109,900	125,500	128,800
To other sectors	88,377	109,000	147,300	192,900	237,300	242,000
Credit extended by other banks 5/	34,952	54,000	83,000	115,900	184,700	204,700
To state enterprises	5,000	6,200	9,600	14,900	29,200	33,500
To other sectors	29,952	47,800	73,400	101,000	155,500	171,200
Total foreign currency loans 3/	46,249	65,037	102,935	134,406	146,300	162,800
To state enterprises	23,000	30,500	46,200	56,506	63,847	69,526
To other sectors	23,249	34,537	56,735	77,900	82,453	93,274
Credit extended by state-owned commercial banks 4/	25,612	37,137	61,735	78,606	77,700	86,000
To state enterprises	20,100	27,000	39,500	48,106	50,200	53,600
To other sectors	5,512	10,137	22,235	30,500	27,500	32,400
Credit extended by other banks 5/	20,637	27,900	41,200	55,800	68,600	76,800
To state enterprises	2,900	3,500	6,700	8,400	13,600	15,900
To other sectors	17,737	24,400	34,500	47,400	55,000	60,900

1/ Figures on credit to the economy by sector of ownership are estimated rather than actual data.
2/ Data comprise six state-owned commercial banks and 77 non-state credit institutions.
3/ Excludes net credit to the government.
4/ Includes four large state-owned commercial banks.
5/ Includes two small state-owned commercial banks, joint-stock banks, joint-venture banks, branches of foreign banks, and the Central People's Credit Fund and since December 2005 includes also 5 finance companies.

Figure 4.5: Distribution of Credit, 2002–07

Source: IMF - Vietnam statistical appendix 2007

For years 2008 - 2011 the data are missing.

Many banking operations are still restricted. Banks find difficult to mobilize deposits in the presence of interest rates ceiling and make loans as result of policy loans and some regulations against loans to the private sector (Dinh 2010). There is a case when in order to mobilize deposits banks set up a deposit rate up to 30 per cent. This leads to high "velocity" of deposits and creates a maturity mismatch. Most of the deposits are short-term and loans are medium or long-term. Interest rates ceiling is strongly criticized and easily breached. Interest rates policy is not effective since this measure distorts bank operations. It leads to the unsound and non-transparent competition among banks and it plants seed for corruption between bankers and supervisory officials and a higher risk to the banking sector. Hence, SBV should avoid interest rates ceiling in the future.

High concentration of SOCBs and presence of the state ownership in JSBs retain policy loans. It could crowd out lending to the private sector. Regarding the private sector, the best non-state firms do not apply for bank loans. They either find it difficult to obtain a loan or have other options (e.g. retain earnings). High loan interest rates (12-15 per cent) put pressure on return on investment rates to be high. According to IMF officials, the Asian financial crisis has the biggest impact on countries where unwise lending practices coincided with an attempt to sustain the pegged exchange rate. Banks during the Asian financial crisis financed overvalued real estate development projects or activities of SOEs with short-term foreign loans denominated in US dollars. The same happens in Vietnam now. If real estate projects failed and SOEs went bankrupt, there would be a pressure on domestic currency to depreciate and the debt services become more expensive. Hence, there will be higher probability of firm default and the banking distress.

The government highly restricts the foreign exchange business. Both price and quantity are controlled. Hence, it leads to discrepancy in official and market exchange rates. The big gap creates incentive for proliferation of the shadow market that is difficult to supervise. A capital adequacy ratio is set up but most of banks do not meet the requirement, especially JSBs. Weak regulation and low enforcement contribute to worsening the situation in the banking sector. Rapid credit growth and failure to supervise JSBs lead to significant overheating of the economy in 2008 and resulted in higher vulnerability of the the banking sector (Leung 2009).

4.3.2 Ownership Structure

Quality of the shareholder protection influences the development of a stock market and an ownership structure of banks. In comparison with ASEAN countries the legal and financial development in Vietnam lags behind. The investor protection is very low. Except for wholly owned foreign banks, law does not allowed an ownership structure of banks in Vietnam to be prevailed by foreign banks. The restriction hinders following equitization plan since the controlling stakes are not allowed. Moreover, inability to control corporate governance and a lack of information disclosure about banks' financial conditions distract potential investors. With the strong shareholder protection investors can afford to take minority position rather than controlling stakes (Gelfer 2000). According to Doing Business Report 2012 [11], Vietnam is judged very low in terms of Strength of Investor Protection Index, getting only 3 of 10 (see Table 4.5). It may reflect low interest from new investors and incumbent investors put pressure on lifting 30 % foreign shareholder cap in order to obtain controlling stakes. The state ownership in policy banks[12] operating in special sectors worsen the impact of competition and constraints limiting enterprise reform protect these banks. The high market share of state-owned banks poses a threat to progress of the institutional development.

Presence of foreign banks

According to Levine (1996), the presence of foreign banks may (i) have impact on better quality and availability of financial services by increasing bank competition, application of new technology and spillover of know how and best practices, (ii) stimulate the development of the underlying bank supervisory, regulation and legal framework and (iii) facilitate a country's access to international capital. The presence of foreign banks may have significant effects on domestic banks. Based on a study of 80 banking systems, Claessens *et al.* (2000) found that in developing countries foreign banks have higher interest margins, overhead expenses and profitability than domestic banks (the opposite holds for developed countries).

SOCBs' policy lending allocates a credit that is not based on commercial criteria and it leads to downward pressure on margins. The market inefficien-

[11] http://www.doingbusiness.org/data/exploreeconomies/vietnam/protecting-investors/
[12] Vietnam Bank for Social Policies and The Vietnam Development Bank

cies and rudiment practices of domestic banks allow foreign banks[13] to gain higher net interest margin than domestic banks, outweighing the information disadvantages they possibly may face (Claessens *et al.* 2000). High overhead expenses are also attribution of Vietnam's banking sector. The presence of information asymmetries and absence of efficient borrowers registries increase transaction costs and therefore it leads to higher overhead expenses. It also leads to adverse selection and moral hazard. Foreign banks also obtain higher non-interest income ratio than domestic banks. This reflect that foreign banks provide better services and are more client-conscious than domestic banks.

The presence of foreign banks contribute to better practices, superior banking techniques that domestic banks can copy. At the same time, foreign banks increase competition and put pressure on domestic banks to increase both cost and profit efficiency. According to Claessens *et al.* (2000), the inflation and real interest rate variables are positively correlated to the net interest rate margin, before tax profits, and overhead. It means that higher interest rate and a higher inflation lead to higher net margin, profits, and operating costs. This is true for Vietnam (see Figure 4.6). Vietnam has experienced a high inflation rate but banks report high profits. [14]

In developed countries, domestic banks do better than foreign banks due to domestic advantages. Domestic banks are more profitable than foreign banks (Claessens *et al.* 2000). The difference of variables in developed and developing countries, in this case Vietnam, suggests that Vietnam's institutional framework is not perfect and it needs to be reformed.

If we take the joint venture as foreign banks, the ratio of foreign banks to total number of banks in Vietnam's banking system is 0.25. This reflects that foreign banks are small scale. Based on those ratios it may seem that there is a lesser barrier for an entry of foreign banks. Nevertheless, if we define a bank to be foreign if at least 50 per cent of its shares is foreign-owned - there is foreign control, the ratio decreases significantly to 0.09. This reflects the strong barrier for an entry of foreign banks.

Nonetheless, the strict bank regulation toward foreign banks constrains their further proliferation. So far the foreign banks are engaged in wholesale banking but the accession of Vietnam to WTO committed Vietnam to further liberalization of the banking sector. Hence, a market share of foreign banks may increase

[13] Vietnam has only five foreign banks, i.e. wholly foreign owned banks that are internationally active.

[14] http://vietnambusiness.asia/interest-rate-margin-helps-banks-report-high-profit/; accessed on February 5^{th}

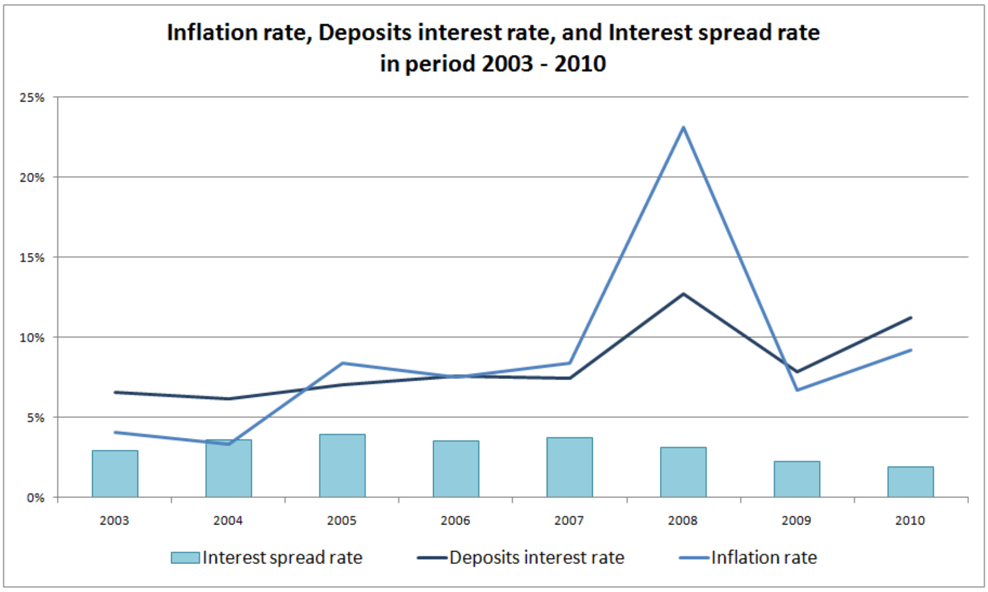

Figure 4.6: Inflation rate, Deposits Interest Rate, and Interest spread rate in period 2003-2010.

Source: Author based on World Bank and Mundi index

The interest spread rate is a margin of lending and deposit rates.

in the future. Hence, foreign banks rather create JSCBs than set the wholly owned foreign banks. In this case, new JSCBs exploit the best practice and know-how brought in by foreign banks and knowledge of the Vietnamese culture brought in by Vietnamese banks. Nevertheless, foreign banks could have only 49 per cent of the equity capital and it constrains foreign banks' investments. Those banks cannot mobilize additional fund by foreign banks and hence they have to borrow in the financial market with higher interest rates. Foreign banks are not allowed to purchase more than 30 per cent of local banks' shares in order to avoid danger of the takeover of domestic banks. Onshore foreign bank branches are now allowed to open other transactions outside their head office. Until 2011 they were not permitted to accept local-currency deposits in excess of 1 000 per cent of their charter capital from Vietnamese residents with whom they have no credit relationship. Vietnam maintains moderate restrictions on both temporary and permanent movements of physical persons with the time limits being 90 days and three years, respectively. The government requires at least 20 per cent of managers, executives and specialists in joint-venture to be Vietnamese (Dinh 2010). For foreign banks, establishment of new banks requires higher equity capital than for domestic banks. Hence, foreign banks are more stable and less sensitive to a banking distress.

State-owned banks

In a regulated economy dominated by state-owned enterprises, managers have weaker incentives to maximize efficiency and profitability of SOEs(Sjöholm 2006). It is a result of appointments of managers on political decisions rather than on the professional capacity. Salaries and job securities of these managers are not correspondent with economic performance of firms (Sjöholm 2006). On the contrary these managers due to preferential treatment of the government gain substantial rents. Hence, there is a room for rent-seeking and managers complicate the evaluation of economic performance and assets of companies (Radics 2010).

In the early 2000s, SOCBs contributed to the substantial erosion of interest rates margins while lending at low interest rates to SOEs and mobilized money by setting high deposits rates. In short history of banking reforms we could see the negative interest rates margin.[15] The diversity of services in Vietnam's banks is still far behind ones in Thailand or Singapore. As for 2011, the non-interest revenue in Vietnamese banking sector creates only 10 per cent of total revenue, whereas in ASEAN countries it was over 60 per cent.

SOCBs are still strongly influenced by Communist Party of Vientam (CPV). The equitization program for state banks, on one hand, may strengthen SOCBs, on the other hand, limited shares cap for investors constrains better corporate governance and spillover of know-how. So far, foreign banks can only own 30 per cent of shares of total shares.

SOCBs' performances are below the Asian average. The capital charter adequacy of state banks meets the requirement of 8 per cent but it is still below the regional average of 13.1 per cent of Asia and Pacific. The indifference of interest rates in SOCBs may imply low competition among SOCBs (Jens Kovsted 2005). A number of SOCBs has progressively declined and a number of JSCBs has firmly increased. Currently, there are only two banks with 100 per cent state ownership, i.e. Agribank and BIDV. The rest of SOCBs (Mekong Housing Bank, Vietcombank, and Vietinbank) have state ownership between 80 and 100 per cent. This fact may reduce targeted policy lending in the banking sector and put pressure on their practice and improvement of their operations. Nonetheless, the non-prudential regulation of JSCBs lead to disorder in the

[15] A margin of lending and deposits rates.

banking sector and increase systematic risk. Moreover, the state has ownership, directly or indirectly, in 27 banks, both SOCBs and JSCBs (see Figure 4.10). A number of JSCBs with state ownership has increased during the last seven years. In 2005 there were only five JSCBs but in 2010 there are 22 JSCBs with state ownership (see Figure 4.7). It implies that nearly 63 per cent of JSCBs have some charter capital from the state. Figure 4.7 shows that the amount of state capital in JSBs has increased rapidly.

At the beginning of the 2000s, the credit and deposit allocation was between 70 and 80 per cent but with the increased equitization and growth of domestic private banks and foreign bank these numbers declined to 45 to 50 per cent by 2010. Nonetheless, relative to JSCBs, SOCBs are actually doing well and their business is growing at a healthy pace. The opposite holds for JSCBs. The credit growth among JSCBs reached 95 per cent in 2007 and credit were channelled to speculative projects, booming real estate projects or to stock markets (Leung 2009). In 2007, the market capitalization of listed firms in Ho Chi Minh Exchange Market was nearly 45 per cent, in 2008 the market capilatization plunged to 15 per cent. The burst of the stock market bubble lead to higher NPLs in JSCBs.

The government has direct ownership only in nine banks, five SOCBs and four JSCBs (see Figure 4.10). In the rest of JSCBs it has ownership indirectly through SOEs. This is a result of government policy to encourage SOEs and SOCBs to subscribe to the charter capital of JSCBs to make the equitization process successful (World Bank 2011). Figure 4.10 shows that the size of the state share of the charter capital in individual banks is small. The share of the state capital in the banking sector has been progressively declining (see Figure 4.8). The dilution of the state ownership is not the result of the intentional policy, rather it is largely due to the poor financial health of SOEs (World Bank 2011).

The overall share of the state capital in JSCBs is small and declining and a number of JSCBs with the state capital has been increasing. The reason is that even the thin ownership carries benefits for the state, in this case for SOEs. Figure 4.9 shows that there is a positive correlation between the ownership structure of banks and their loan exposure to SOEs sector implying that SOEs do not always require a controlling stake in JSCBs to influence lending activities in favor of their sector (World Bank 2011) (more in connection lending).

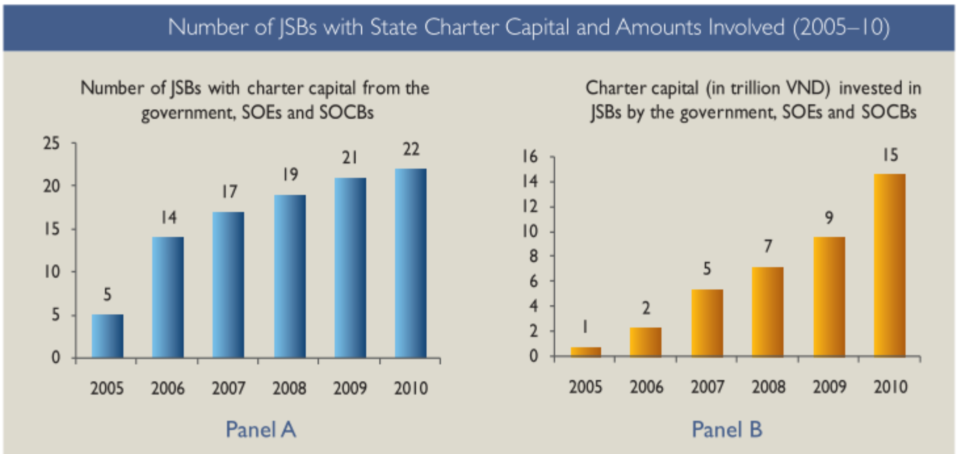

Figure 4.7: Number of JSBs with State Charter Capital and Amounts Involved

Source: Vietnam Development Report 2012

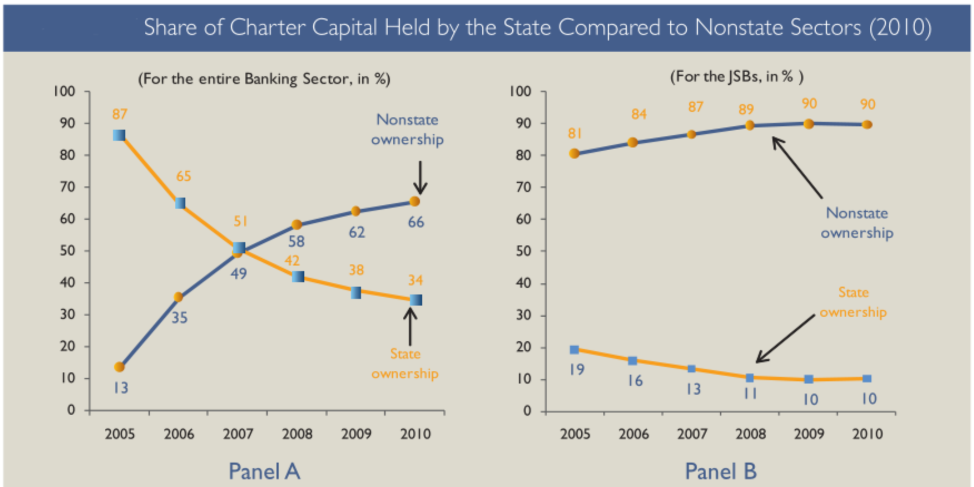

Figure 4.8: Share of Charter Capital Held by the State Compared to Nonstate Sectors

Source: Vietnam Development Report 2012

4.3.3 The information Infrastructure

Publishing research results and providing reliable information have not been major functions of Vietnamese top management institutions such as SBV, State Securities Commission, and Ministry of Finance. In transition progress, authorities prefer ordering and supervising implementation of central government decisions to facilitating interactions among economic agents. The government insti-

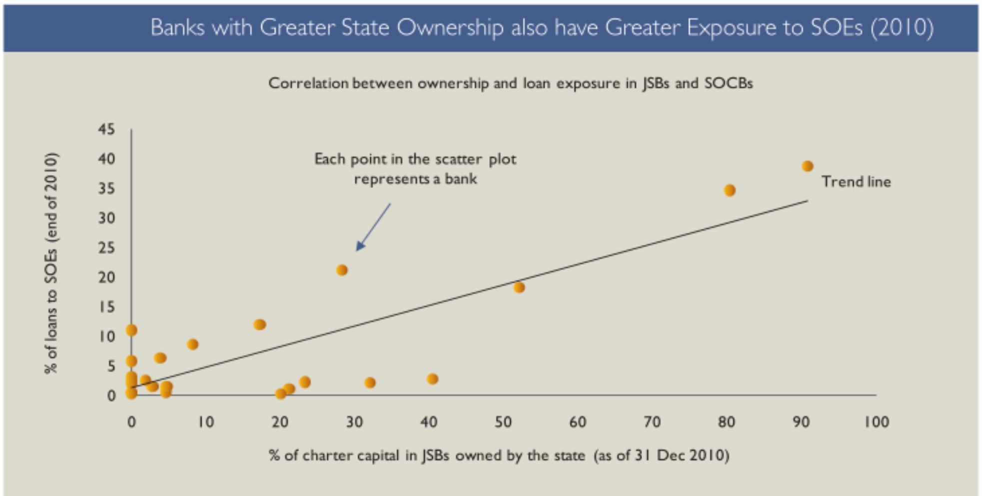

Figure 4.9: Banks with Greater State Ownership also have Greater Exposure to SOEs

Source: Vietnam Development Report 2012

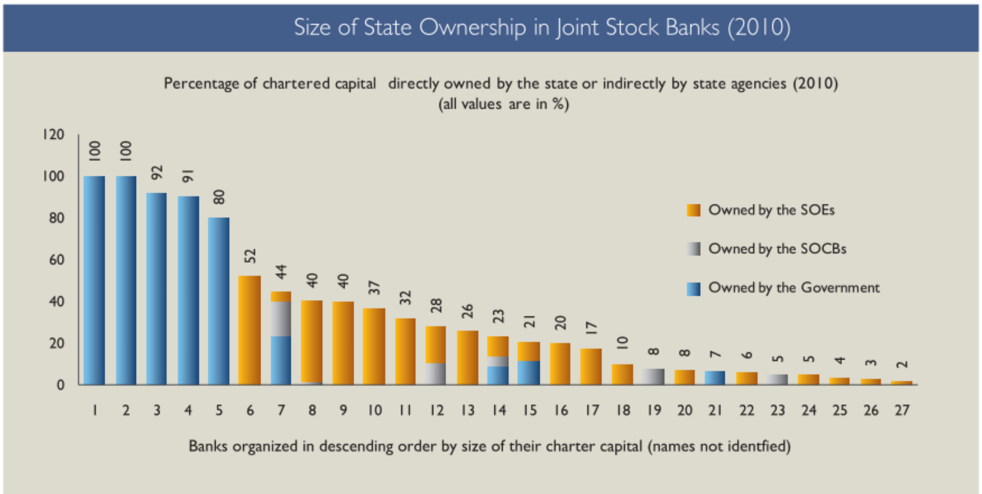

Figure 4.10: Size of State Ownership in Joint Stock Banks

Source: Vietnam Development Report 2012

tutions should shift from controlling to a research-information-communication-promotion market forces mechanism (Hoang & Dung 2009).

After a collapse of many people's credit cooperations, SBV established Credit Information Center (CIC) in 1992. In 1999 it became an independent unit of SBV. Its function is to collect, analyze, forecast, process and provide the following information to other departments of SBV, Credit Institutions, foreign and domestic organizations, and individuals: information on borrowers, information relating to the monetary and banking sector. Despite long-lasting existence of

CIC, the registry of borrowers is far from perfect. SBV should rather encourage establishing of private credit information companies and create incentives for banks to share information about borrowers in order to eliminate transaction costs.

A lack of proper information for financial institutions lead to adverse selection and moral hazard. The unwise lending practice could lead to an unsound banking sector, especially in the presence of high ratio of NPLs. In addition, the penetration rate[16] in Vietnam is about 10 per cent. This may reflect the importance of informal/shadow banking sector, since they could solve better information asymmetries, especially in the rural areas [17] (Leung 2009). The inability to solve information asymmetries leads to granting more loans to SOEs at the expense of the private sector. In addition, the credit provision for the private sector is more stringent than for SOEs. [18] This may change with the SOEs reform.

Credit depth of information index[19] measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. The index ranges from 0 to 6, with higher values indicating the availability of more credit information, from either a public registry or a private bureau, to facilitate lending decisions. Index for Vietnam is good, in the scoreline it gets 5 which is in the line with developed economies. We still have to bear in mind, that there is only one official credit information company run by the government consisting mostly information about SOEs. Hence, the score should be taken skeptically.

4.3.4 Legal Framework

The legacy of Socialist period is still present in the judicial system. Firstly, enforcement of laws is not always possible. Secondly, laws promulgated by the government are usually vague and ambiguous and therefore it may be not effec-

[16] A percentage of the population using financial services.

[17] Especially from family members or group savings.

[18] SOCBs are allowed to provide unsecured loans only for firms with previous two consecutive years of profits. Hence, the start-up firms can not accessed to loans. Furthermore, the difficulty to obtain Land Use Right Certificate leads to problem to use land as collateral. Assets of SOCBs are still considered as state assets and any loss is strictly assumed as capital offence. Hence SOCBs prefer SOEs to the private sector (Leung 2009).

[19] Credit Depth of Information Index is one of indices in Doing Business Report.

tive.[20] It reflects the fact that government wants to control economy entirely instead to prudently regulate and supervise. Hence, the Vietnamese judicial system may be best understood not as a set of institutions and processes but as a network of personal connections affecting and dictating the judicial system operations.

As mentioned in Subsection 4.3.2 the shareholder protection is salient for the development of a stock market. The ability of firms to access external finance may be used as an indicator for the creditor protection and progress of restructuring Vietnam's banking sector. Nevertheless, the indicator is not significant for Vietnam. Even though credit granted for firms are increasing creditors and borrowers operate within the state sector, i.e. SOCBs lend to SOEs or SOEs lend to SOEs.

Connections lending

Without an efficient legal framework and strong legal institutions, financial flows to potentially profitable companies are hindered (Malesky & Taussig 2009). Despite *New Banking Law* clearly stipulates that nobody is entitled to borrow from a bank with more preferential, favourable conditions in comparison with general provisions of applicable laws and of the bank, loans are still granted to "connected" firms that are not *a priori* solvent or profitable.[21] In non-democratic countries the disobedient behaviour to formal rules is assumed and tolerated (Kouba *et al.* 2005). In Vietnam connections play a crucial role in the process of applying for loans, especially in rural provinces. Inefficient enforcement of laws contributes to relation-based lending. A lack of legal enforcement is substituted by informal lending market mechanism based on personal connections. The preferential access to loans may under-perform the unconnected counterparts and hamper the economic growth. It can also crowd out the firms that need the finance the most. On the contrary, the difficulty of banks' screening of borrowers and information asymmetries may result to relationship-based lending. The stringent laws on lending to the private sector may contribute to a high level of loans to SOEs since NPLs to private firms is severely punished. For bankers to eliminate any risk of such NPLs to private firms, it is better to lend to firms with connections to the state officials. Com-

[20] Many articles in newspapers daily show the problem with the lack of enforcement in different fields, e.g. see http://www.thanhniennews.com/index/pages/20120323-as-vietnam-develops–things-only-getting-worse-for-mother-nature.aspx

[21] New Banking Law, article 28

mercial banks partly apply this pattern. The possession of Land Use Right Certificate significantly improves the accession to loans. Malesky & Taussig (2009), on range of models, found that for Vietnam's banks the previous profitability of firms is insignificant or has the negative impact on an access to bank loans and banks do not take previous performance into account in valuation of firms' worthiness. Banks take a priority on collateral over business prospect of firms. This may reflect the uncertainty in the banking sector and in the whole economy. Prevalence of connections lending may creates disincentives for banks to solve the problem of information asymmetries.

The absence of enforcement of laws and unwillingness to reform SOEs retain the connections lending with all its attributions. Nonetheless, in the presence of better legal institutions the long credit histories of firms either with connections or without connections may contribute to further bank development. Banks record all histories of firms, improve information asymmetries and make better decisions in the future. Therefore, connections lending may converge to arm-length lending practices where soft information is acquired to measure all risks.

According to Malesky & Taussig (2009), expansion of connections lending and the private sector investment growth may occur in parallel, but the causality of two variables in not clear. It may be caused by the government policy. Nevertheless, the connections lending may cause less economic growth than under the prudential borrower assessment, especially in the presence and legal protections and efficient legal institutions. They also found that there is no evidence that an access to loans is related to firm performance. Connections loans are usually granted to SOEs. It may reflect that there is still strong connections between banks and SOEs because SOEs has not adjusted fully to the market driven mechanism. A small share of connections loans are granted to SOEs that operate in industry with a significant entry barrier or oligopolistic features. It may increase the profitability of banks. The hypothesis stipulating that the connections lending can serve as an effective substitute for legal institutions within the formal banking sector should not be rejected. Nonetheless, it could solve the problems so long as the enforcement of law is not efficient.

Banking Laws

According Malesky & Taussig (2009), the efficiency of the formal banking sector has been significantly undermined by a poor structure of the judicial system.

Banking activities are regulated by Enterprise Law, Law on Credit Institutions and New Banking Law.

The Enterprise Law puts domestic and foreign invested firms in the same line and is meant to protect the enterprises from governmental intervention (Radics 2010). The Law on Credit Institutions is meant to "create a level playing field for all credit institutions and prevent preferential treatment". [22]

The core pillar of the legal framework for commercial banks is a decree 59/2009/ND-CP (On the organization and operation of commercial banks or known as New Banking Law that is in effect from 2009). New Banking Law is more stringent than previous one and introduces more provisions on operations of credit institutions. New Banking Law is pursuant to the Law on the State Bank, Enterprise Law, Criminal and Investigation Law, and Law on Credit Institutions. Therefore, the overall quality of New Banking Law is based not only on the quality of the law itself but also on the quality of those laws it uses as the base. New Banking Law is meant to govern the organization, administration, management, and operation of banks (Radics 2010).

New Banking Law defines the term "bank" for the first time ever and the license can be issued in accordance with provisions of the Law on Credit Institutions and guidance of the State Bank.[23] This is crucial for regulating the banking sector and elimination of misunderstanding about the term bank. In comparison with Enterprise Law and Law on Credit Institutions, New Banking Law allows the government more control over banks' managers, remove managers based on stringent provisions on qualifications, and more prohibitions against managers.

New Banking Law does not allow a person to serve as a manager of a bank if he/she was suspended from the previous position by SBV.[24] New Banking Law relies on loopholes of Penal Code and Criminal Procedure Code that allow SBV to remove banks' managers arbitrary from their office (Radics 2010). Hence, the criminal investigation may easily close the door for anyone who desires to serve as a manager in banks. In addition, Law on Credit Institutions prohibits the members of the managing board or the control board, and executive officers[25] from serving if they are under investigation for penal liability. Moreover it does not stipulate whether those under investigation are suspended until exonerated

[22] http://vietnamnews.vnagency.com.vn/politics-laws/Talking%20Law/188184/mergers-of-credit-institutions-regulated.html

[23] New Banking Law, article 3 and 11

[24] New Banking Law, article 19

[25] in article 19, New Banking Law extend prohibition to more positions

(Radics 2010). Hence, based on New Banking Law, even criminal investigation triggered by fraudulent claims may result in removal of managers.

As for bankruptcy, New Banking Law does not allow anybody to serve as a member of the managing board, the control board, and as a executive officer if he/she was a former director of bankrupt companies, a partner in the bankrupted company, a council member, a control commissioner, and a member of management of cooperatives and their chair.[26] Hence, New Banking Law does not make any difference between the one who is blamed for bankruptcy and the one who barely serves in the board (Radics 2010). With the high ratio of bankrupt companies, especially the small and medium size, New Banking Law prohibits the one who was unfortunate to be a part of a bankrupt company to serve in a bank in the future. In addition, New Banking Law may partly hinder restructuring of SOEs by not allowing firms to go bankrupt since it prohibits many managers to serve in banks in the future. The government prefers mergers and acquisitions of SOEs (including state-owned banks) to the bankruptcy because it wants to retain the confidence in the banking sector. The experience from the past shows that transaction costs to regain the lost confidence in the banking sector is very high. SOEs reform is slow and the government is not willing to reform SOEs since state firms are a good opportunity for rent-seeking.

In addition, there is a problem of overlapping of laws. The lesser overlapping of laws, the easier to interpret and it eliminates any ambiguities. Most of Vietnamese laws are ambiguous and allow judges to award in favour of persons with vested interest and hence creates more room for corruption. New Banking law is stricter as for criminal investigation than Law on Credit Institutions and Enterprise Law. The same case are settled differently and hence it creates confusion which law to apply (Radics 2010). New Banking Law also relies on problematic Penal Code and Criminal Procedure Code. This may lead to preferential treatment by judges who are usually connected to the government.

Despite the problematic parts, New Banking Law is a step in the right direction. It is more sophisticated and eliminates vagueness and ambiguity of the previous law (Radics 2010). However, to remedy the problematic parts, the government should review the loopholes in Penal and Criminal Procedure Code,

[26]New Banking Law, article 19

rely more on updated laws such as Enterprise Law[27], and rely on Bankruptcy Law rather than creating its own provisions on bankruptcy (Radics 2010). New Banking Law is an attempt for the further equitization of SOCBs but at the same time, it retains a strong control of the government over the banking sector.

In sum, New Banking Law retains government control over managements of banks. In the short run, this may strengthen banks by professionalizing the managements. In the long run, many strict provisions may hinder an entry of foreign investors and contribute to rigid corporate governance in the banking sector.

4.3.5 Infrastructure for banks

Vietnamese Accounting Standard (VAS)

Applying the internationally accepted accounting standard helps to attract investors while disclosing information and eliminating uncertainty. Internationally accepted accounting standards provide investors with information required for a better decision-making process. Since the government wants to equitize SOCBs the good accounting standard is needed.

The initial Vietnamese accounting model adopted the Soviet-style of the accounting system that suits the need of the state (Nguyen & Micheline 2007). The current VAS is based on old International Accounting Standard (IAS) and therefore lags behind the new IAS by 83 months reflecting a wide gap between VAS rules and current business environment needs and expectations (Phan *et al.* 2011). To compare VAS with the current IAS, VAS is more rules-based model rather than principle-based model. According to Phan *et al.* (2011) the more directly government intervenes to accounting standard, the more likely rules-based accounting standards will exist.

It is argued that the government prefers a tight control over the state owned firms. This environment creates a room for high degree of corruption and the rent-seeking behavior. IAS emphasizes the need of non-state stakeholders and outside users. On the contrary, VAS addresses the need of the state and inside users (Phan *et al.* 2011). Hence, VAS does not solve information asymmetries and does not help investors in the decision-making process. In comparison with old VAS, the current VAS improves understandability and comparability of financial statements and provide insiders and outsiders with better information,

[27]Under Enterprise law, many firms were established and the number of firms have increased rapidly and contribute heavily to Vietnamese GDP

however, the credibility and usefulness of financial statements is not achieved by the current VAS (Nguyen & Micheline 2007).

As for the accounting standard in the banking sector, the "Disclosure in Financial statements of Banks and Similar Financial Institutions" standard reaches a high level of *de jure* convergence of 95.6 % [28](VAS with old IAS), however this standard was withdrawn by International Accounting Standard Board in August 2005 (Phan *et al.* 2011). We have to bear in mind that similarity of old and new IAS/IFRS is insignificant. Despite this fact, it reflects that the government takes a high priority over the stable banking sector. By using VAS based on rules-based model and old IAS the government retains control over banks' activities. A high level of convergence may reflects the spillover of the best practice of foreign banks or more better banks in the sector. Nonetheless, old IAS is different than new IAS. New IAS is used to calculate the capital adequacy ratio and assesses real conditions of banks. True and fair financial statements may facilitate restructuring of the banking sector. Hence, both *de jure* and *de facto* convergence of the accounting standard is crucial to avoid the future loss and eliminate transaction costs of restructuring the banking sector.

The Payment System

The payment system in Vietnam is not properly developed since the full range financial reforms has been initiated in middle 1990s. A high ratio of the money outside the banking system and mistrust of banks contributed to underdevelopment of the payment system. Liberalization of the banking sector put a pressure on the government to improve the payment system to facilitate the flow of money and decrease a systemic risk.

From 1995 to 2003 Vietnam run World Bank's financial modernization program (Payment System and Bank Modernization Project) that consists of seven sub-projects, of which the core is the construction of the electronic inter-bank payment system developed by Hyundai Information Technology (South Korea). This system was applied in 2002. The other six projects entailed the modernization of internal systems of commercial banks, which are addressing improvements of their in-house systems subject to these projects. The objectives of the first project are to: (i) improve payment services in the economy in order to reduce float, speed up circulation of funds and increase efficiency

[28] The average level of convergence of overall convergence is 66.4 % citepphan2011

of funds transmission, while providing convenience and service to users; and (ii) strengthen the institutional capabilities of participating banks in order to stimulate commercial bank initiatives to improve internal management and customer service. The project consists of four components: a) a national inter-bank payment clearing and settlement system; b) commercial banks' intra-bank payment systems; c) commercial banks' institutional strengthening; and d) project management support. [29]

From 2005 to 2011 Vietnam run VN-Second Payment System and Bank Modernization Project whose objectives are to assist Vietnamese banking sector to (i)meet the demands of the economy for fast, reliable and safe payment services, (ii)broaden access to finance to facilitate the achievement of the government's poverty reduction targets, and (iii) improve the operations of the participating banks through the expansion of the IBPS and the CBS. Both projects have the same objective, i.e. to assist in the development of a modern banking sector able to service the needs of a growing economy, thereby increasing confidence in the Vietnamese banking system.[30]

According to Law on the State Bank of Vietnam, SBV is responsible for organizing the banking payment system, providing payment services and managing the supply of liquidity.[31] SBV has to also maintain the legal framework for commercial banks' internal payment systems and to secure these systems (including the hardware, the software, and the power sources).

Based on the latest report of World Bank in May 30^{th} 2011, progress towards achievement of project development objectives is satisfactory, overall implementation progress is moderately satisfactory (from satisfactory in 2003 to moderately satisfactory in 2011), and overall risk rating is low.

[29] Document of The World Bank, Report No: 27635
[30] Document of The World Bank, Report No: ISR3290
[31] the Law on the State Bank of Vietnam, article 5

Chapter 5

Conclusion

Since the Doi Moi reform in the late 1980s, an institutional framework has changed rapidly. Nonetheless, it is far from perfect. Many incentives in Vietnamese institutional framework are perverse and lead to the development of tacit knowledge that does not lead to the long-lasting economic growth. Informal rules are deeply entrenched in Vietnamese society and play a crucial role in the banking sector. A high rate of opportunism leads to the short-sighted decision-making.

The structure of rules in Vietnamese banking sector converge to the Western structure. Nonetheless, the crucial difference lies in enforcement of laws. Many violations are tolerated, especially ones made by members of Communist Party of Vietnam. Since Vietnam has officially only one political party, there are no rules to eliminate failed political organizations. Rules that eliminate maladapted banks function partly. The judicial system possesses many ambiguous laws. It is difficult to interpret and it allows judges to award in favour of persons with vested interest. The judicial system is still used to control the economic activities by the government.

Formal institutions become more important, relative to informal institutions, the more the scope for market exchange broadens and deepens, possibly because establishing formal institutions has high fixed costs but low marginal costs while informal institutions involve high marginal costs (Rodrick 2003). Vietnam has appropriate formal institutions, but to make them efficient it needs to change and modify informal constraints to supplement formal rules. This process is not fast and it needs time.

The presence of information asymmetries and a high level of uncertainty hinder the decision-making process of agents. This reflects inefficiency of institutions. In the banking sector this situation is reflected in a level of interest rates. The incomplete information poses a big threat in the banking sector. The more efficient institutions, the less information asymmetries. Hence, the government should support the establishment of borrowers registries and private information companies to eliminate the information asymmetries.

The ability to regulate the banking sector by authorities in unclear. Since SBV is involved in banking activities of SOCBs, regulation of the banking sector is rather soften and non-prudential. The government gave in the options to redistribute the social wealth, it prefer controlling many economic activities.

The equitization program is ongoing but the process is rather slow. There are many restrictions for foreign institutions to engage in the program. The restrictions, unwillingness of the government to finish the equitization program, and information asymmetries hinder the whole process.

There is a big gap between political and economic institutions. Vietnamese political institutions tend to reflect the interest of those in power and produce economic institutions that are redistributive or productive. Hence, the current institutional arrangement enables to maintain control and does not improve efficiency. The Vietnamese history showed that the recent political institutions were created by social institutions. By the same token, a domestic crisis, an external pressure, and underlying social institutions may drive institutional change, change in political and economic institutions.

Transition years provide a room for opportunistic behavior. Suffice to say that Vietnam is in the transition. Informal lending and the shadow banking sector are rampant and plant a seed for opportunistic behavior. This may damage the confidence in the banking sector in the future. Hence, the government should legitimize informal lending.

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Appendix A

Appendix One

Explanatory notes to Figure A.1

This chart shows the percentile rank of the country on each governance indicator. Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. Percentile ranks have been adjusted to account for changes over time in the set of countries covered by the governance indicators. The statistically likely range of the governance indicator is shown as a thin black line. For instance, a bar of length 75 % with the thin black lines extending from 60 % to 85 % has the following interpretation: an estimated 75 % of the countries rate worse and an estimated 25 % of the countries rate better than the country of choice. However, at the 90 % confidence level, only 60 % of the countries rate worse, while only 15 % of the countries rate better.

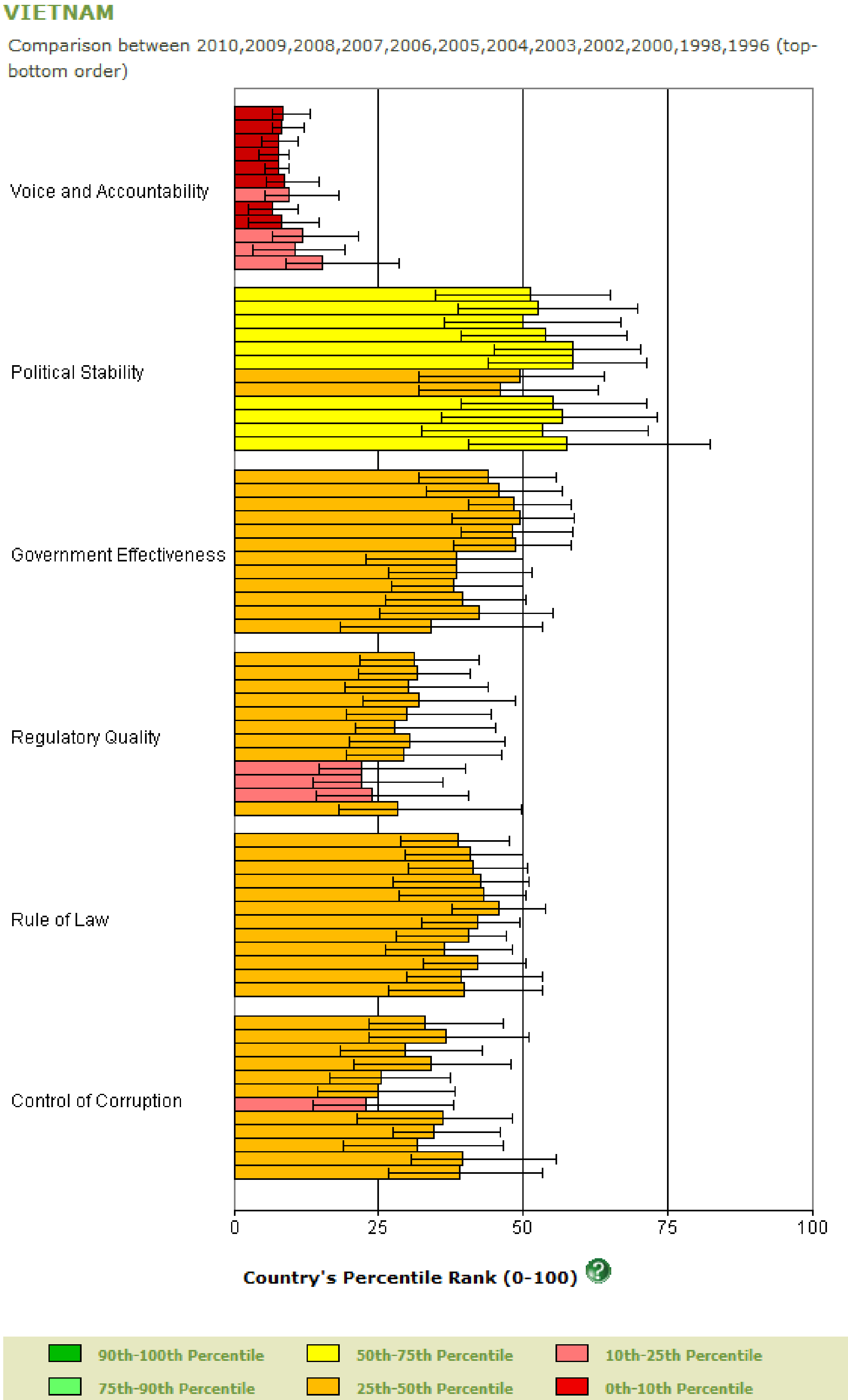

Figure A.1: Worldwide Governance Indicators - Vietnam

Source: Kaufmann D., A. Kraay, and M. Mastruzzi (2010), The Worldwide Governance Indicators: Methodology and Analytical Issues