

Executive Summary

PROJECT PREPARATORY TECHNICAL ASSISTANCE FOR SME DEVELOPMENT PROGRAM LOAN – SUBPROGRAM II – LEASING INVESTMENT LOAN TA – 4781 (VIE)

**Report
March-May 2007**

Hanoi, May 15, 2007

The Consultants would like to extend their sincere appreciation for the assistance shown by the Government of Viet Nam during the implementation of the TA; specifically, the State Bank of Vietnam, the Ministry of Planning and Investment, the Ministry of Finance and the State Owned Commercial Banks (SOCBs) and their Leasing Subsidiaries as well as the private sector leasing companies and the Leasing Association of Viet Nam, who facilitated the Consultation Meetings, official dialogue and one-one due diligence.

The consultants wish to express their gratitude to the Government of Viet Nam stakeholders, the private sector leasing companies and to ADB for the enthusiasm and interest repeatedly demonstrated during the TA and without which, our work as Consultants would have been much less fruitful.

The results of the due diligence with the SOCBs, the leasing companies and the private sector leasing companies are confidential and will be submitted for the exclusive review of the State Bank of Vietnam, the supervisor and project executing agency, and the ADB - project financier.

Anthony Barned
Rowan Downing QC

Executive Summary

I. Introduction

1. The 2007-2010 Country Strategy Program (CSP) prepared by the Asian Development Bank (ADB) in close consultation with the Government of Viet Nam (the Government), highlights the rapid economic growth of Viet Nam. GDP growth has averaged 7.5 % per annum over the last decade, due to strong export performance (exports represented 61% of GDP in 2005), increases in the employment share of manufacturing and services sectors, and high inward remittances. It is estimated the private sector accounted for almost 90% of the 7.5 million jobs created in 2005, of which 64% were generated by Small and Medium Enterprises (SMEs). The CSP highlights the need for “the Government and ADB ... to focus on facilitating increased private sector investment and developing market institutions needed to promote competitiveness and create jobs”. It is expected that accession to WTO in January 2007 will facilitate sustained export growth and ongoing diversification in the manufacturing and services sectors as well as the ongoing development of the private sector. However, the financing constraints of SMEs need to be addressed in order to ensure the ongoing export and domestic-led growth of these enterprises as well as the ongoing absorption of new labor entering the market.

2. The World Bank Investment Climate Survey (2005) indicates access to finance to be a more significant constraint to enterprises in Viet Nam than to those in other countries. SMEs in Viet Nam have difficulty accessing financial services and securing financing which is mainly due to (i) a strong risk-averse bias of the banks with respect to SME lending; and (ii) the absence of a diversified financial sector capable of servicing SMEs (especially lack of specialized financial institutions to provide loans for SMEs).

3. From a development perspective, a well functioning leasing industry is an important financing tool for SMEs. SMEs are particularly constrained by the lack of assets that can be used as collateral for bank loans. When credit is available from informal sources, it tends to be short-term and too costly for investment financing. The advantages of leasing over alternative forms of finance for SMEs include: a lower down-payment – thus preserving enterprise working capital, availability, simpler documentation and security arrangements, speed, and tax incentives. In fact, leasing and supplier credit are often the only source of credit available to SMEs. By improving access to capital, leasing has a role in enterprise growth and employment generation. In turn, the development of lease companies also supports the development of the factoring market, inter-bank lending based on mortgage of lease receivables, as well as the eventual development of asset backed securities.

4. Internationally, a growing number of companies engage in leasing, including: subsidiaries of banks and bank holding companies (as in Vietnam), captive finance companies of industrial corporations, independent finance companies, and manufacturers and dealers providing financing for their products. Banks or their subsidiaries, provide leasing to make a profit, meet customer demand, protect their customer base, and develop new accounts.¹

5. ADB has provided support in the area of financial and legal policy reforms, and is presently formulating the sub-sovereign/private sector investment project, in order to support the development of the leasing industry in Viet Nam. The Financial Sector Program Loan II (FSPL II) developed the initial legal and regulatory guidelines for the operation of financial leasing companies, and the SME Sector Development Program Loan (SDPL) formulated the concept of the Leasing Investment Loan to facilitate SME access to finance.

6. The \$20 million Ordinary Capital Resources Leasing Investment Loan was agreed with Government during the 2006 Country Programming Mission and is listed in the 2007-2010 CSP.

¹ Peter K. Nevitt, and Frank Fabozzi, *Equipment Leasing* (Published by Frank J. Fabozzi Associates, New Hope, Pennsylvania, 4th Edition, 2000) p. 61.

The project is a pilot to assist leasing companies with improved access to leasing/finance for SME companies.

7. Over the second phase of the Technical Assistance (June to end-August 2007), ADB will undertake additional advisory support to the leasing companies, Government stakeholders and the Leasing Association. The additional areas of proposed advisory support include: (i) improved risk management – particularly with respect to upgrading the lease agreements, (ii) improved risk pricing of leases according to client risk and profitability targets of the leasing company(ies), and (iii) review modalities to streamline the legal inconsistencies within Decree 65 (65/2005/ND-CP) on repossession and between Decree 65 and the Judgement on the Enforcement of Contracts Law. (See paragraph 50.1. for specifics).

8. The ADB Leasing Investment Loan will seek to undertake a series of sustainable pilots, to facilitate a credible demonstration effect on the sale of lease receivables and thus assist with streamlining funding gaps in the industry in the medium-term. The implementation of the pilots will need to be closely coordinated with the streamlining and upgrading of the regulatory framework on enforcement of lease contracts.

II. Background

9. Presently there are eleven leasing companies operating in Viet Nam. The leasing sector is supervised by the State Bank of Vietnam (SBV) and the leasing companies operate under “Decree No 16/2001 ND/-CP of May 2, 2001 on the operations of financial leasing companies” which authorizes only companies licensed by the State Bank of Viet Nam as financial leasing companies to undertake finance leasing transactions. The decree establishes four types of financial leasing companies; State Run Financial Leasing companies of which there are 6, Joint Stock Financial Leasing Companies of which there none, Affiliate Financial Leasing Companies and Joint Venture Financial Leasing Companies of which there are 3 and 2 respectively.

10. The Government issued Decree 65 “Decree No 65/2005/ND-CP of May 19, 2005” amending Decree 16, Article 7 to allow financial and leasing companies to manage operating leases. Decree 65 also provides for a limit of thirty percent of all capital of a finance leasing company to be exposed to one client. While Decree 65 authorizes leasing companies to repossess assets in case of contract violation by the lessee, the provisions of Decree 65 do not provide for procedures on the enforcement of legal contracts. Thus, there is a strong requirement to develop streamlined and consistent implementing guidelines on enforcement of lease contracts between the State Bank of Viet Nam, the Ministry of Justice, the Economic Court and the Economic Police.

11. In order to mitigate inflationary pressures, the Government issued Decision No. 03/2007/QD-NHNN on 19 January 2007, amending Decision No. 475/2005/QD-NHNN regulating the safety ratios of credit institutions’ operations. Decision 3 places a cap, equivalent to 10 percent of parent bank equity, on parent bank funding to subsidiary companies, including leasing companies, and also requires on-lending to be extended at commercial inter-bank rates. SBV indicated planned amendments to Decision 3 in fourth quarter 2007 to facilitate issuance of new leases based on ongoing funding from the parent bank. It is expected that ongoing bond issuance by the parent banks, to improve capital adequacy ratios and prepare for equitization, may create additional lending margins by the parent banks on behalf of the subsidiary leasing companies. Due to the opaque legal environment in the area of enforcement, lending institutions other than the parent banks are reluctant to lend to leasing companies or buy lease receivables. This places a constraint on lending to the leasing companies, by an institution other than the parent bank.

12. It is understood the Vietnam Leasing Association is commissioning a survey on the size of the leasing industry, demand for type of leasing services by the SME sector, and growth of demand by major geographic area in Viet Nam. The results of the survey, in addition to own

client surveys by leasing companies, will facilitate positioning of new lease products in the SME market.

III. Selection of Participants for the Project

13. At present, the activity of leasing companies is constrained by the need to borrow short-term lines of credit from the parent bank to fund a business that lends at a longer maturity (3-5 years). The total assets of the leasing sector remain small, i.e. estimated to be less than 3 percent of total bank assets. The proposed ADB loan to short-listed leasing companies will provide access to medium- and long-term funds and thereby enable the leasing industry to promote alternative financing instruments to SME entrepreneurs in order to enhance enterprise growth and competitiveness.

14. The ADB Technical Assistance over the period March – May 2007, undertook a review of both the State-Owned Commercial Bank (SOCB) owned leasing companies and non-SOCB owned leasing companies. The review indicated a proactive policy by SOCB leasing companies to expand lease financing to SMEs – at market-based terms.

15. The present market share of SOCB leasing companies is estimated to be in excess of 60% of the total leasing market and while the branches of SOCB leasing companies are generally restricted to Hanoi and Ho Chi Minh City, the companies have leasing officer teams that cover the country. They also cover a wide number of industries and are developing an understanding of both the risks of financing those industries as well as an understanding of the needs of the industries.

16. The TA consultants conducted an initial review of 8 of the 11 leasing companies in Viet Nam. Having identified SOCB leasing companies as the participants with a strong focus on SME leasing (at terms of under 5 years), with a requirement for ADB funding, the TA consultants undertook a detailed due diligence of each company's financial statements, operating policies and procedures. The source of data for the financial review was the 2004, 2005 and 2006 financial statements as well as the review of market segmentation and Non Performing Loan (NPL) data. The review of the non-financial activities was conducted with the management of each company using the same set of questions with each company.

17. While all the leasing companies have been taking steps to improve their financial strength and reduce non performing assets, the size of the ADB loan limits the potential to adequately support all six companies. A series of small loans would likely increase the fee structures with respect to the management time and legal costs to establish the loans.

18. In order to ensure fair process in the selection of the leasing companies to participate in the ADB loan, a ranking system was developed that took into account both financial and non-financial criteria of the leasing companies. The short-listed leasing companies need to demonstrate a history of maintaining high quality assets and good profitability providing the source of the loan repayment.

19. Given the similar history of the leasing companies, and their ownership by SOCBs, there were many similarities between the companies in the non-financial criteria. Thus, the financial criteria became the key determinants with respect to the selection of the short-listed companies.

20. The Government of Viet Nam has been explicit in stating they wish the market-based and revenue generating ADB loan be extended on a sub-sovereign basis – i.e. that the ADB loan not be coursed through the Government to the leasing companies. ADB's risk management criteria limits the amount of the loan to no more than 25% of the equity of the recipient, thus, any loans undertaken directly to a leasing company would be limited to around US\$2.5 million. Loans of this size may not be practical. Based on the feedback received through consultations with the leasing companies and the parent banks, it was decided the ADB loan be issued to the

parent banks. Thus, the loans will be coursed through the parent banks requiring both the leasing companies and the parent bank to meet ADB private sector risk criteria. ADB will sign the loan agreement with the parent bank of the short-listed leasing companies.

21. Two leasing companies and their parent banks have been short-listed to date. One bank expected to receive subsidized pricing while it has always been made clear that the loans would be market rate. Discussions are ongoing with two other leasing companies and their parent banks to identify and agree on final short-listing as per ADB risk and lending criteria by May 18, 2007.

IV. The Legal Environment

22. It is noted that the legal and regulatory environment supporting the development of the financial sector, is currently being upgraded. The following major laws are currently being drawn:

- Audit Law
- Credit Insurance Law
- Commercial Bank Law
- Central Bank Law
- Financial Inspections Law
- Securitisation Law

23. These laws will further enhance the legal environment in the financial sector by adding transparency of process in respect of audits, provide the framework for credit insurance, and modernise the establishment of commercial banks to bring it into line with the Enterprise Law. Significantly, the Financial Inspections Law will upgrade the powers of the credit institution inspection regime from a decree to a law. The Securitisation Law will expand legal regime in respect of securitisation, providing for a more certain system of registration and dealing with certain securities, including leases receivables

24. Leasing requires a supportive legal environment to facilitate (i) the establishment of financial and operational leasing companies, (ii) the formation and registration of leasing contracts, (iii) the regulatory regime, (iv) a securities market, and (v) fund raising. Vietnam has such a regime in broad terms and is in the process of strengthening the enabling environment.

25. Dispute resolution is a vital part of any legal environment provided by the State. It is a tool to be used in (i) recovery of assets, (ii) to assert rights in respect of collateral security, (iii) to sue to resolve any disputes and (iv) to recover losses incurred on an agreement. Dispute resolution includes the courts and the ability to enforce the orders of the court. Vietnam has an Economic Court, but enforcement of its judgements is difficult. There seem to be some practical implementation difficulties as appeals can take 10 years to resolve.

V. Examination of the Legal Environment for Leases

26. The Decree on the Organization and Operation of Financial Leasing Companies No 16/2001/ND-CP of May 2, 2001. (as amended) by Decree No 65/2005/ND-CP of May 19, 2005 (the Decree) forms the basis for the formation, operations, and governance of financial leasing Companies. In general terms the Decree is adequate, but there are a number of inconsistencies and conflicts. Of concern is the conflict between the immediate right to self help in clause 1 a of Article 28 of the Decree on Finance Leasing Companies and the need to give 30 days notice of recovery in clause 1 e of the same Article.

27. The assets that may be the subject of a financial lease are limited to tangible assets only and do not contemplate intangible assets

28. It is unclear whether foreign investors can purchase and deal in receivables, this requires clarification as it will inhibit the development of a secondary market. It is also unclear whether the holder of a receivables contract has rights of subrogation back to the lessee.

29. **Rescheduling of Leases.** Rescheduling of leases requires additional and supporting attention from the inspectors of the State Bank of Vietnam (SBV). By way of illustration, while there is a requirement that financial leasing companies notify of any changes to procedure in their rescheduling policy - there is no actual requirement that they have such a policy. This is inferred. Furthermore, the financial leasing companies use and adopt the rescheduling policies of their parent banks in respect of non-performing loans. The structure of a lease is different from a short or medium-term credit as is the underlying risk and collateral taken by the leasing company. This situation requires attention to facilitate the sustainable and prudent growth of the leasing sector.

30. **Recovery of Leased Assets by Self Help.** Article 28 of Decree 65 (defined as “the Decree above”), provides for the recovery of assets through the use of self help by the financial leasing company. In this regard its provision is appropriate. The conflict mentioned above (refer to section on Examination of the Legal Environment for Leases) does not assist in the operation of this Article. There may have been an oversight to have the Decree disseminated on a timely basis to concerned agencies and for its impact to be appreciated. Training in respect of the operation of new laws is mostly overlooked in most jurisdictions in the world. However its impact is extenuated in a developing economy where the systematic review of the laws may be subject to greater financial and human resource constraints.

31. **Evidentiary Matters in Respect of Debts Owed to Leasing Companies.** To facilitate the reading of Decree 65, a Circular made pursuant to Article 28 of Decree 65 could be developed. The Circular could additionally provide that - in any action taken by a finance leasing company for the recovery of debts due under the lease and any other loss - the lessee is bound by a certificate of indebtedness, given by the head accountant of the leasing company, as to the amount outstanding, including costs, under the lease, unless it is proven by the lessee to be in error. This would address a problem of proof that is met by finance leasing companies when attempting to recover debts by realising on secondary security or through an action in court.

32. **Prudential Limits.** Article 30 most properly provides for the maintenance of prudential limits as contemplated in the Law on Credit Institutions, as administered by the SBV. It also provides for a limit of thirty percent of all capital of a finance leasing company to be exposed to one client. This is a necessary control to limit concentration.

33. **Inspection.** The Inspection Branch of SBV has a reasonably comprehensive jurisdiction in respect of its inspections. The sanctions regime at its disposal is apparently ultra vires in respect of revocation and suspension of licences. This is a matter that should be addressed in the new Law on Inspection, as it will more fully provide for the powers of the inspectors. SBV is moving from transactional inspection to risk based inspection. It has advised that it requires additional capacity building in respect of this transition. The administrative sanctions also may need to be strengthened to ensure greater deterrence and improved market discipline on operation of leasing companies.

34. Once the leasing companies are equitised and thus no longer in receipt of government guidance at the same level as currently received, the motivation of the entities will be primarily that of profit. Clarification of the sanction regime will be of assistance in ensuring that the regulations are complied with in all respects under the evolving business procedures and marketing strategies of the leasing companies.

35. **Consumer Protection.** Decree 65 and the entire legal regime concerning leases and credit institutions generally contain no provisions for consumer protection. Such protection ensures that people understand the liabilities and obligations that they are incurring before they

enter into an agreement. This empowers people to make choices as to the personal cost and exposure that may have by entering into the agreement. They may then decide not to proceed with a transaction. This is of advantage to both the credit institution and the consumer, as the credit institution will not have the same risk of loss through a possible NPL as it might have, and customers are able to fully assess the obligations and whether they can be easily met. The lack of consumer protection is not in line with best practice.

36. **Implementing Circular for the Decree 65.** Circular NO. 06/2005/TT-NHNN, the Implementing Circular for Decree 65 (the Implementing Circular) is a competent document closely following the provisions of the Decree. Its provisions in respect of the scrutiny of those who are involved in the management of finance leasing companies are appropriate and in general terms consistent with best practice.

37. **Trust Services.** Trust services can be provided by financial leasing companies, however there are no guidelines providing any details of the obligations as a trustee and the rights of those who use such services. This must be rectified so that in the event of a dispute the parties, and possibly the courts, have certainty as to the rights and obligations of both parties. Without such guidelines there is no certainty and dispute resolution may be constrained under the law

38. **Repossession, Enforcement and Recovery Rights and Risk Management.** Financial leasing companies advise that the greatest problems that they encounter relate to repossession and the recovery of indebtedness from lessees. The right of self-help for a lessor to regain possession of its assets is axiomatic, as the assets are their property and any right to possession of a lessee terminates immediately upon breach of the terms of the lease.

39. Financial leasing agreements are essentially to provide for the management of risk for the lessor. They should provide for all the legal weapons possible for use in aid of the recovery of a leased asset in the event of default and the unwillingness by a lessee to surrender of the asset to the leasing company. The current agreements used by the financial leasing companies do not maximize the rights of the financial leasing companies and require to be redrawn.

40. **Court Proceedings.** Court proceedings are generally not regarded by the leasing companies as being of great assistance in respect of repossession or enforcement of debt recovery. The Economic Court, whilst being assigned as a specialist court, does not have specialist judges assigned to it.

41. **Enforcement of Court Orders.** The Enforcement Branch of the Ministry of Justice is constrained to enforce judgements in a timely way due to the large number of cases for review and the limited number of trained commercial judges.

42. The largest problem in respect of enforcement for leasing companies is the conflict between the legal right, as perceived by the Enforcement Branch, of a person/lessee to retain the means of production and the right of the owner/lessor over that means of production. This subrogates the ownership rights of the lessor but is based on an error of legal interpretation. The lessor may be left with reduced or no residual value in the asset, as it cannot gain access to it for its realisation.

43. **The Bankruptcy Law.** The need to have an effective bankruptcy system is vital in a market economy, as it provides unsecured or partly secured creditors with an opportunity to recover some of their debts. The Law on Bankruptcy is an additional tool in the armory of a financial leasing company to assist it in the recovery of debts without the need to obtain a judgment from the courts in respect of an unsecured part of any debt from a lessee. This law is little used. This law is reasonably well drawn, supported by an adequate implementing decree. There are deficiencies in respect of the relation back period and the composition of the property management and liquidation teams. The Economic Court requires experts with appropriate training in this area.

44. **Registration of Lease Agreements.** Registration of lease agreements allows for maximized protection from fraudulent dealing, but not a guaranteed protection. The system is largely functional. The fields of registration require expansion to include serial numbers wherever possible to minimise third party fraud.

45. The provision for compensation in the event of an error on the register is entirely inadequate, as it provides for the civil servant responsible to make payments of compensation. There is no apparent right to compensation in the event of erroneous information being provided during a search if the register was correct, but the reporting of it was not.

46. Complete computerisation of the registration system is justified. The regulatory regime is being upgraded into law.

47. **Next Steps.**

- Obtain in principle agreement with the borrower and their written expression of interest
- Obtain ADB's in principle agreement to the borrower, amount, term, rate and conditions
- Discuss ADB's in principle agreement with the borrower(s)
- Obtain ADB's and Borrowers approval of final loan terms and conditions

VI. Recommendations to Improve the Enabling Environment for the Leasing Industry and the Financial Sector

48. **Short-term (from June 1 to August 31 2007) and within the scope of TA 4781**

- Assist the loan participants in establishing reporting systems and procedures for the ADB loans
- Conduct a high level diagnostic in the following areas;
 - Present organization structure and responsibilities of each unit
 - Document current business profile and business unit structure
 - Understand overall data management and particularly the availability of data to develop a pricing model
 - Review and document any credit rating system that may exist.
- The drawing of new leasing agreements and the training of the staff of financial leasing companies in the use of such agreements and legal risk management.
- The training of staff of financial leasing companies in respect of repossession rights and the modalities of self help.
- Drawing amendments to Decree 65 to provide for the grant of a power of attorney in aid of repossession and the removal of the conflict in Article 28 of the Decree for consideration by the SBV.
- Undertake initial training on upgraded corporate governance – specifically, the rationale and modalities to structure an independent audit committee and the rationale and modalities to recruit independent/external board of director members.

49. **Medium-term – Review Scope of Potential Advisory Support with Bilateral Donors and Provide Feedback to Government and Short-Listed Leasing Companies**

50. **Long-term – Coordinated Donor Effort – Outside the Scope of the Leasing Investment Loan**

- Assistance to the Economic Court by the provision of training in respect of the commercial laws, in particular those dealing with the financial sector.
- Specialist training to judges of the Economic Court and members of the legal profession in respect of the operation of the Bankruptcy Law. The development of manuals for the courts, legal and accounting professions in respect of bankruptcy.

- Consideration of the amendment of the Bankruptcy Law to replace the property management and liquidation teams with expert administrator and liquidators, particularly in respect of bankruptcy of medium to large enterprises.
- A review of the legal impediments to the development of the financial sector generally, but including impediments to the giving of security over land.
- A review of the laws and regulations concerning the enforcement of judgments.