SUMMARY PROGRAM IMPACT ASSESSMENT

I. Introduction

1. This program impact analysis (PIA) documents the formulation of the Financial Sector Program III (FSPL III) and presents estimates of the costs and benefits of the Program on the economy. The methodology used draws on the regulatory impact assessment used by governments in over 50 countries. The cost-benefit estimates are used as inputs to the determination of the loan amount of $60 million. The results of the PIA indicate that the FSPL III could produce potential gains to the economy amounting to $489.0 million annually or 0.6% of GDP. The adjustment costs of the Program are estimated to amount to at least $56.8 million indicating a substantial net benefit to the economy. Beyond the FSPL III, the PIA also estimates the potential gains to the economy from reforms that shift Viet Nam's finance sector to outcomes similar to the best regional performers (Korea, Rep, Malaysia, and Singapore). These gains could be at least $4.8 billion annually to the economy, equivalent to 5.5% of GDP. The remainder of the PIA is divided into two sections. Section II presents the assessment of the developmental impact of the Program on the economy. Section III concludes with a discussion on the Program financing amount.

II. Program Impact Assessment - The Developmental Impact of the Program

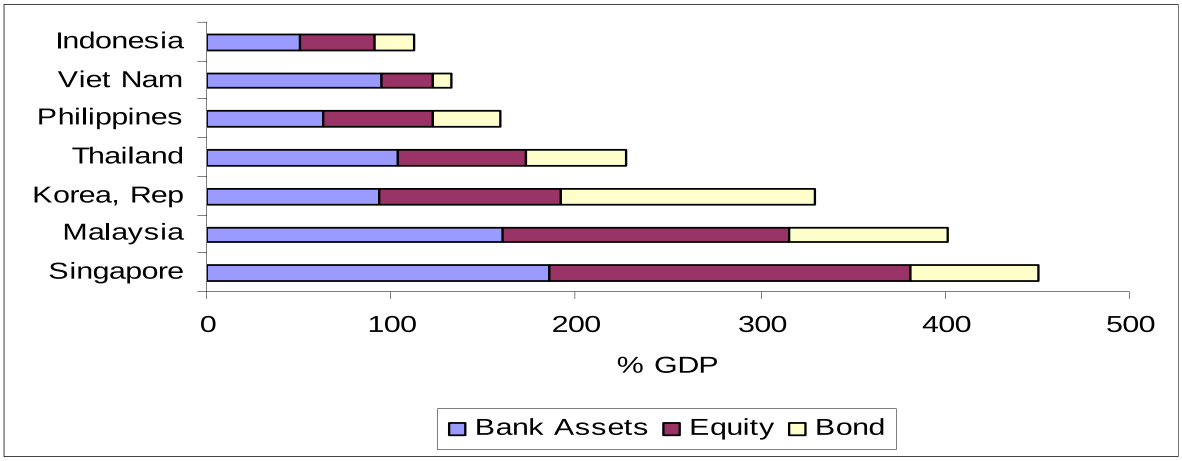
2. This section presents the PIA for the FSPL III. It summarizes the problem, identifies the intended impact and outcome of the proposed FSPL III, options reviewed, and estimates of the potential benefits and costs of the FSPL III.

1. The Problem

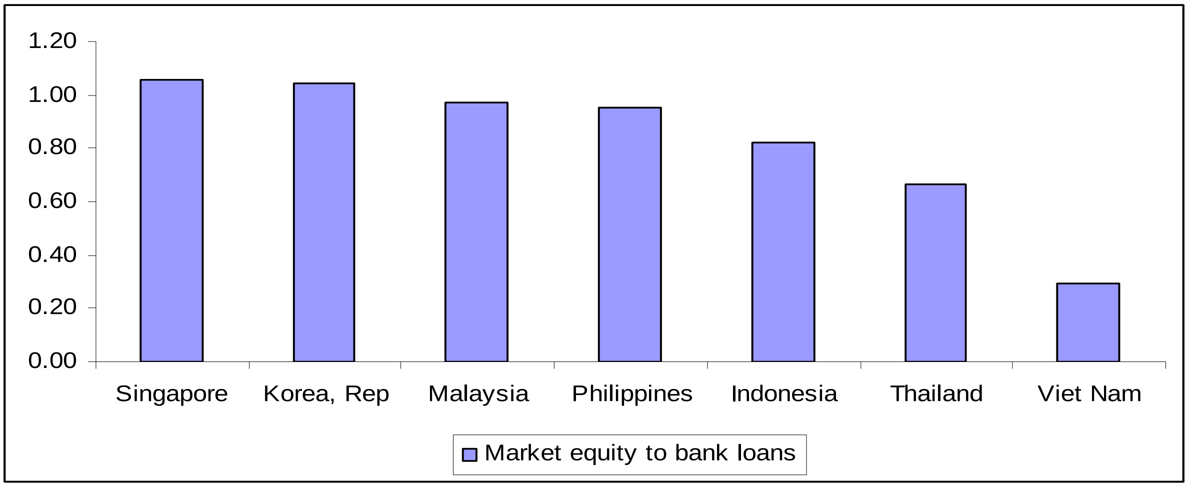
3. Viet Nam's financial depth measured by financial assets to GDP is relatively low compared to regional neighbors (Figure 1). Since Viet Nam's financial sector is at an early stage of development, measures of financial depth appear to widely fluctuate from year to year indicating much more financial sector volatility (and potential financial system instability) than in neighboring economies. It is also less diverse compared to regional economies. Financial assets are about 132% of GDP well below that of neighboring countries—Hong Kong, China at 947% of GDP, Singapore at 451%, Malaysia at 401%, the Republic of Korea at 329%, and Thailand at 227%. The banking sector dominates the finance sector. The bond market is at a rudimentary stage of development accounting for approximately 8.9% of GDP. Government bond issuances dominate the market and account for 93.0% of all bond issuances, equivalent to 8.3% of GDP. Corporate bonds outstanding amount to $600 million or 0.5% of GDP. There is a limited primary dealers market, no active secondary market, and no published yield curve for government bonds to benchmark corporate bonds. Due to the small non-bank corporate debt market there is no credit rating agency monitoring the domestic bond market and publishing corporate default and risk indicators; thus limited market information about corporate risk is available. Consequently, the bulk of corporations rely on more expensive bank loans for financing investments: interest rates on bank loans average about 14.0% whereas bond rates for larger corporations (primarily with state shareholding) average about 10.0% per annum. Similarly, the equities market is small with combined daily trading of the Hanoi and Ho Chi Ming stock exchanges amounting to about $74 million, compared with $533 million in Bangkok.

Finance Sector – Regional Comparison

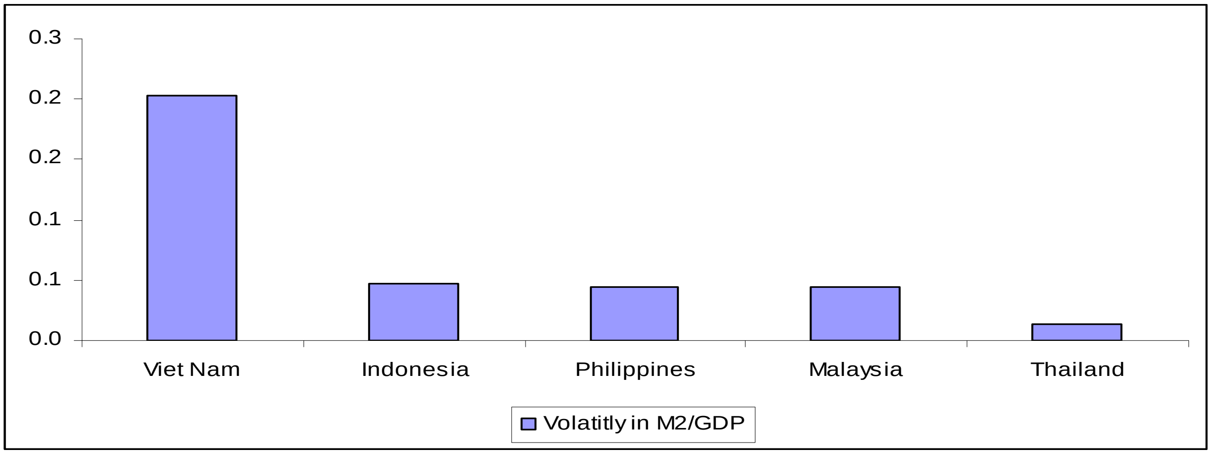
(a) Finance Sector Depth



(b) Finance Sector Diversity



(c) Finance Sector Stability



Notes: Finance sector diversity measured by the ratio of market capitalization to GDP ratio over bank credit to GDP ratio. Finance sector volatility measured as the ratio of the standard deviation of M2/GDP to the mean M2/GDP ratio from 2004 to 2008. The larger the deviation from the mean, the greater is the instability in the M2/GDP ratio.

Source: CEIC data and ADB staff estimates.

4. The relatively shallow depth of Viet Nam's financial sector is a drag on efficient investment and sustainable economic growth. Combined with a weak regulatory framework, it also increases the potential for financial system instability. There are significant structural and regulatory impediments to the development, growth, performance, and stability of the financial sector. Transaction costs in the Viet Nam financial sector are high, which makes it costly or difficult for firms to borrow or raise capital. This is primarily due to the underdeveloped infrastructure of the non-bank sector as noted in paragraph 3. The government restrictions and caps on commercial bank deposit and lending interest rates, and periodic use of interest rate subsidies are aimed at offsetting these high transaction costs for borrowers but have created a distorted interest rate structure and this discourages the development of the capital market. It potentially leads to inefficient investment decisions as interest rate restrictions tend to encourage directed lending or rationing. Recent reports including ADB technical assistance reports on the Viet Nam financial system have identified key impediments to Viet Nam realizing efficient, deeper, and more liquid capital markets on a par with the regional benchmarks of Malaysia, Singapore, and the Republic of Korea. These include weaknesses in the regulatory oversight of the financial system, inadequate capital market infrastructure, weaknesses in the legal framework (although substantially improved in recent years), distorted interest rate structure and exchange rate and capital controls. ADB staff estimates indicate that many of these impediments cost the economy as much as $4.8 billion annually or 5.5% of GDP.

5. The Government recognizes these impediments and potential risks to financial system instability and its impact on the poor. In response, the Government has implemented a series of reforms over the last decade to enhance stability and develop the non-bank finance sector. Most recently, it has developed the Securities Market Development Strategy 2010-2020, which includes a detailed set of measures to implement from 2010 to 2020 with the aim of developing a diversified, deeper, stable, and inclusive finance sector. These measures both complement and build on the reforms under the FSPL III program. The proposed FSPL III will support the government's key reform priorities aimed at creating a more diversified, deeper and more resilient financial sector in Viet Nam. The reform priorities under the FSPL III include efforts to develop the securities, bond and money markets, enhance financial sector stability through increased transparency disclosure and strengthening the legal, regulatory, and enforcement frameworks, and enhance human resource development in key regulatory agencies. The FSPL III aims to strengthen regional cooperation by enhancing cooperation with regulators in other securities markets in the region.

2. Impact and Outcome

6. The impact of the FSPL III is a more diversified, deeper, and resilient financial sector in Viet Nam. By 2015, the Program is expected to have increased the size, depth, and stability of Viet Nam's financial system and capital market in particular. This will be done through improved legal, regulatory and enforcement capabilities of regulators, improved capital market infrastructure, measures to develop the bond and equities markets, and actions to enhance human resource development in key regulators.

7. The outcome of the FSPL III will be an increased share of capital markets in financing domestic investment, which will promote and facilitate sustained high growth rate in the economy with reduced refunding risks.

3. Options

8. In formulating the FSPL III, several options were considered in addressing the key impediments to capital market development. Consequently, the FSPL III draws on ADB's experience with capital market development in the region and previous financial sector programs in Viet Nam. A key lesson is the increased recognition of the need to create a legal and institutional basis for the capital market and human resource development. In Viet Nam the key priority is to create the institutional basis for the government's debt management, developing the short end of the government's securities and augmented money markets, and reform prudential regulations and supervisory functions of key regulators to enhance financial system stability. Currently, the institutional and regulatory framework in Viet Nam is largely government designed and driven. Another general lesson from international experience is to develop an institutional framework comprising of a mix of regulatory, industry self-regulatory, and non-regulatory initiatives to develop the capital market and strengthen stability. Options explored under FSPL III include, for example:

- The Program supports several legislative initiatives to strengthen regulators powers and enforcement capabilities, protect small depositors, enhance disclosure of financial institutions and corporations, and promote the development of the capital market (i.e., new legislation and or amendments to the Law on Insurance Business, State Bank of Viet Nam Law, the Law of Credit Institutions, regulations on corporate bond issuances, Securities Law, Law on Public Debt Management, establishing the public debt management office, regulations on disclosure of information, draft a law on independent audit, among other).

- The program supports measures to enhance corporate governance through converting the Hanoi Stock Exchange into a limited liability company, implementing international accounting standards, draft law on independent audit, among others.

- The program supports the development of the basic infrastructure to improve capital market efficiency such as Viet Nam Securities Depository pilot implementation of automatic synchronization of records between head office and HCMC branch, improving the framework for registration, deposit, and clearing and securities settlements, and improving the framework for money market and open market operations, among others.

- The Program had initially proposed to the government to gradually liberalize interest rate ceilings. However, the government believed it is not ready for this initiative until it has strengthened its framework and tools for monetary policy including effective open market operations. ADB is providing technical assistance to the State Bank of Viet Nam to strengthen the development of the money market and open market operations.

4. Impact Analysis

9. This section presents estimates of the economy-wide benefits and costs of the FSPL III. Benefits of proposed reforms are difficult to estimate especially the second round benefits. In this section, the methodology used is to first estimate benefits to the Viet Nam economy assuming Viet Nam achieves outcomes similar to regional best performers (Korea, Rep, Malaysia and Singapore) and the US (the benchmark countries). These are static benefits of a complete long term reform program. The FSPL III addresses some of those key impediments that raise the cost of capital in Viet Nam and aims to *partially* shift Viet Nam towards outcomes

of the benchmark economies. Therefore, we then estimate the potential benefits of the FSPL III assuming a *partial* shift towards the outcomes of the benchmark countries. The potential benefits from these reforms are the savings to investors, borrowers and households from lower cost of borrowing and a larger variety of financial products to increase incomes and wealth. The costs of the reforms estimated are primarily the short to medium term costs of administering and enforcing reforms, the direct fiscal costs of selected reforms, and costs to businesses (financial institutions and corporations) in complying with reforms.

Estimating the economy-wide gains from the FSPL III

10. Distortions in the Viet Nam financial system impose several types of costs on the economy that reduces long-term potential economic growth rate of the country. The first is the cost of operating inefficiencies. Channeling funds from savers to borrowers has a cost in every financial system, but this cost is higher in financial systems dominated by state banks, with restrictions on bank entry and branching, poor corporate governance, inefficient payments system, restrictions on competition in the equity and bond markets, and underdeveloped, high cost infrastructure. Reforms in these areas can raise operating efficiency of intermediation, and the cost savings are passed to households in the form of higher return on savings and to investors in the form of lower cost of capital.

11. A second cost arises from allocative inefficiency – misallocation of resources across the economy. Major inefficiencies arise if there are restrictions or caps on interest rates and directed lending policies that channel resources to less productive uses. This allocative inefficiency is exacerbated when policy distortions exist outside the financial system. For example, industry policy affording high rates of protection to selected sectors make them artificially profitable, thereby leading to over-investment in the sector, or restrictions on capital flows or exchange rate controls that distort investment decisions.

12. In Viet Nam there are significant regulations and policies that raise operational costs and misallocate resources. These include dominance of state owned commercial banks in the financial system, restrictions on foreign investment and entry into the banking sector, and caps on deposit and lending interest charges, as well as periodic use of interest charge subsidies. The restrictions on interest rates impede financial sector development and lead to an inefficient allocation of financing and investment in the economy. Under such restrictions the interest rate margin (lending minus deposit interest rates) is suppressed and therefore not reflective of the level of risk and inefficiencies in the financial system. Underdeveloped infrastructure in the bond, equities markets and money market raises the cost of capital in Viet Nam.

13. Thus, there are potential gains from completing reforms in the financial sector that bring the domestic financial system closer to regional and or international best practices (benchmark countries). In Viet Nam, while much has been done to reform the financial sector, and in particular the capital market, reforms focusing on improving the allocative efficiency of the banking system, an efficient mix of financial institutions (i.e., developing the non-bank financial system), improving competition in the domestic banking and capital market, strengthening financial sector prudential regulations, and incentives framework would reduce the costs of intermediation and enhance efficiency, thereby deepening the financial sector.

14. Table 1 present some quantifiable (gross) gains to Viet Nam from the reforms implemented under FSPL III aimed at moving the Viet Nam capital market closer to practices in the benchmark economies. We estimate that such reforms could create *direct* gains in the order of $489.0 million per annum, or raise GDP growth rate by about 0.6 percentage points. The

potential gain comprises of efficiency gains through the entire financial sector – banks, the corporate bond market, and the equity market, as well as shifting the mix of financing away from bank loans to bonds. The estimated figure ignores the potentially larger, second-round or dynamic effects such as the stimulation to investment through increase mobilization of savings and lower cost of capital. Hence, the benefits would exceed 0.6 percentage points of GDP. Over the long term, and beyond the FSPL III program, reforms aimed at shifting Viet Nam's financial system to outcomes of benchmark economies would produce much larger gains, estimated in the order of $4.8 billion annually, or 5.5 percentage points of GDP. The estimated figure assumes a complete shift to best international practice and therefore reflects a complete static long term gain. Table 1 presents quantifiable gains to Viet Nam from reforms under the FSPL III program and beyond.

Table 1: Potential Economic Gains from Financial Sector Reforms and Contribution from the FSPL III

	Short to medium term static gains under the FSPL III a	**% of GDP**	**Complete long term static gains from reforms b/**	**% of GDP**
1. Improve banking sector efficiency to best practice	412.0 million	0.5%	$2.4 billion	2.8%
2. Shift financing mix from bank loans to bonds	69.4 million	0.1%	$2.2 billion	2.5%
3. Reduce corporate default rates to benchmark rates	7.7 million	0.0%	$0.2 billion	0.2%
Total Gains	**$489.0 million**	**0.6%**	**$4.8 billion**	**5.5%**

Notes:
a\ This refers to estimates of potential gains from the FSPL III program.
b\ This refers to the complete long term static gains that could be achieved if reforms beyond the FSPL III shifted Viet Nam to performance levels of benchmark countries.
Source: ADB Staff estimates.

15. **Improve banking efficiency under FSPL III could add as much as $412 million to GDP annually.** Reforms that improve corporate governance, contestability of the banking sector and the incentives framework facing banks would lower the cost of intermediation and this would be reflected in narrowing of the spread between domestic lending and deposit rates. In Viet Nam the average interest rate margin from 2006 to 2009 is 3.6. However, the existing interest rate structure is highly distorted and therefore is unlikely to accurately reflect the risk and inefficiencies in the banking sector. In such a situation proxy interest rates should be used that incorporate risk and inefficiencies. The analysis uses average interest rate margins from Indonesia and the Philippines from the early to mid-1990s as proxy for interest rate margins in Viet Nam. In the early to mid-1980s both Indonesia and Philippines liberalized commercial interest rates. As a consequence, net interest margins increased to 6-7% reflecting macroeconomic and financial system risk and inefficiencies. The margins have declined over time as the financial systems become more competitive and efficient. While the Viet Nam government does not intend to liberalize interest rates under the FSPL III period, liberalizing them would likely lead to higher interest margins in the short term. The 6-7% proxy interest margin compares with average interest rate margin of 3.1 percent in our benchmark countries (an average of bank spreads in the United States, South Korea, Malaysia, and Singapore). Given Viet Nam's current volume of loans ($82 billion), this difference from the benchmark adds $2.4 billion a year to costs of the banking system. The FSPL III implements a series of reforms

that will improve operational and allocative efficiency that will be reflected in a modest narrowing of the interest rate margin. We assume these reforms reduce the margin from 6.0% to 5.4%. This reduction would add $412 million to GDP annually. These measures include efficiency gains from operational improvement in money market operations, including adoption of risk mitigating measures, State Bank of Viet Nam measures to improve banking sector prudential supervision, mergers and acquisitions in the financial sector, and measures to enforce compliance with capital adequacy ratios, among others. Measures aimed at reducing transaction costs in the capital markets such as the development of the bond market would also assist with improving competition in the financial system and place pressure on lowering interest rate margins.

16. **Shift in financing mix from bank loans to bonds under the FSPL III could save corporations $69 million annually**. An underdeveloped corporate bond market causes large, creditworthy companies in Viet Nam to seek most of their debt funding from banks. This not only crowds out less creditworthy borrowers, it also raises the cost of capital for these companies. In benchmark countries banks are a more expensive source of financing for large companies, and especially for their long term needs. Banks in these countries are more suited to funding consumers and small businesses that require close monitoring and evaluation of their investments. These additional services, combined with other bank functions, make this a more expensive source of funds.

17. In the benchmark countries, bonds account for roughly 60.0% of all debt financing in the economy, while bank loans account for 40.0%. In contrast, corporate bonds account for less than 1.0% of total private debt in Viet Nam. Shifting the mix of corporate debt funding to what we observe in the benchmark countries would save $2.2 billion annually for Viet Nam firms by lowering their cost of borrowing.[1] This is a long term effort and would not be achieved during the FSPL III period as the bond market is at a rudimentary stage of development. The measures under FSPL III are aimed at developing the legal framework and infrastructure for developing the bond market. The Government's Securities Market Development Strategy 2010-2020 includes a comprehensive set of measures to further develop the domestic bond market over the next decade. ADB staff estimates that the corporate bond amount outstanding could grow fourfold as a result of measures under FSPL III, from 0.5% of GDP to 2.0% of GDP by 2015. This will result in cost savings to the corporate sector of $69 million annually. It will be important to continue development of the bond market to realize the substantial potential long term gains from a deep and liquid bond market.

18. **Reduce corporate bond default rates to benchmark could save debt holders $7.7 million a year**. In the bond market, the cost of intermediation can be measured as the difference between the cost to companies and other institutions of issuing bonds and the returns earned by investors that buy the bonds. Most of the time this relatively small spread is outweighed by the default risk that the investor takes on. But an efficient bond market reduces defaults by providing transparent information on issuers. We estimate the cost of intermediation in the corporate bond market as the corporate default rate. However, in Viet Nam there are no data on corporate default risk. In 2010, the credit default swap (CDS) fluctuated in the range of 200-300 basis points (bps), or an average of about 220bps, and we use this to proxy the corporate default rate.[2] The FSPL III and the government's financial sector strategy include

[1] Corporate bond rates average around 10.0% in Viet Nam in recent years compared with average bank loans interest rates of 14.0% per annum. The gains are estimated by multiplying the rate difference of 4.0% by total bonds assuming they account for 60.0% of private debt.

[2] Fitch (March 2010). Press Release on Viet Nam.

reforms to enhance financial disclosure requirements, transparency and creditor rights in asset dissolution. These measures will assist in lowering corporate risk. In Viet Nam the average CDS is 220bps, compared with the average corporate default rate of 1.8% in 2004 in our benchmark countries. Because Viet Nam''s corporate bond market is currently very small, with only $600 million of bonds and private placements in 2008, improving the default rate through bond market development, improved regulatory framework, and corporate governance would save only about $7.7 million annually to these corporations during the FSPL III period. Over the longer term and with a major expansion in the bond market, savings to the corporate sector could amount to as high as $200 million a year to corporations.

Estimating the economy-wide costs from the FSPL III

19. The Government, relevant statutory agencies and financial institutions and corporations are likely to bear most of the FSPL III costs. These costs are identified as follows:

- Government and statutory agencies. (i) Government administrative costs in drafting new legislation, and amendments to existing laws, new regulations and circulars, investment costs in restructuring the HCMC stock exchange, SSC and establishing the public debt management office, public education and dissemination of new policies, drafting technical reports and the Securities Market Development Strategy 2010-2020; (ii) permanent budgetary costs due to reforms including the operation of the public debt management office and new IT systems at the VSD and SSC (calculated as present value lump sums); and (iii) enforcement costs of the Government and statutory agencies with increased legislative powers (such as the SSC and SBV).

- Financial institutions and corporations (listed companies and unlisted public companies. (i) Corporations and financial institutions have increased business compliance costs from additional responsibilities under legislative amendments and new laws (due diligence requirements and disclosure of financial information; (ii) administrative costs associated with increased reporting requirements for listed and unlisted public companies, financial institutions.

20. Table 2 highlights the key costs with quantitative estimates where possible. We estimate that such reforms could cost the economy at least present value lump sum of $56.8 million. The amount of adjustment costs is similar for the public and private sectors, as reform measures under FSPL III include additional reporting requirements and obligations of financial institutions and corporations.

Table 2: Viet Nam: Potential Costs from the Financial Sector Program III

Types of Adjustment Costs	Government and Statutory Agencies	Financial institutions and corporations
1. Administrative costs	(i) Costs incurred in legislative and regulatory initiatives (new legislation, amendments to various acts, drafting regulations and circulars) – estimated at $3.5 million. (ii) Restructuring costs at the HCMC stock exchange and investment costs for the UPCOM market and establishing the PDMO - estimated at $6.0 million. (iii) Costs involved in upgrading the CDS system and records at VSD and Hanoi Stock Exchange (HSX) – estimated at $2.0 million. (iii) Costs involved various public dissemination and education on new regulations and policies under the FSPL III, production of policy reports, and implementation of regulations (including financial disclosure etc), and drafting the securities market development strategy – estimated at $3.5 million. (iv) Investments in infrastructure to develop the bond market and money market – estimated at $3.5 million. *Total administrative costs estimated at $18.5 million*	(i) Listed public corporations and financial intermediaries increased reporting obligations (annual financial reports etc) – estimated as a present value lump sum of $13.1 million. [a] (ii) 117 credit institutions increased reporting requirements (monthly reports) – estimated as a present value lump sum of $7.0 million. [b] (iii) IT operational costs of the industry estimated at $1.6 million. *Total administrative costs of reporting requirements to the business community estimated as a present value lump sum of $22.7 million*
2. Enforcement costs	(i) SSC enhanced legal powers and responsibilities under legislative amendments will increase costs related to investigations and enforcement (increased rules of director fiduciary responsibilities, minority shareholder rights etc) – unquantifiable.	
3. Fiscal costs	(i) Permanent budgetary costs for operating the public debt management office – estimated as a present value lump sum cost of $5.5 million. (ii) Permanent budgetary costs of upgrading of IT infrastructure at VSD - estimated as a present value lump sum of $250,000. *Total permanent budgetary costs estimated at $5.8 million.*	

Types of Adjustment Costs	Government and Statutory Agencies	Financial institutions and corporations
4. Business compliance costs		(i) Corporations and financial institutions (securities firms, dealers, etc) will incur compliance costs (additional staff time, overheads and changed practices) in meeting new disclosure requirements and due diligence requirements under new legislation and regulations – estimated at least $9.8 million.[c] *Total business compliance costs estimated at $9.8 million.*
Total estimates	**$24.3 million**	**$32.5 million**

[a] Based on 750 listed corporations, securities firms, insurance corporations and fund managers as of 2008. Assume that additional reporting requirements add $700 per corporation per year
[b] Based on 117 credit institutions. Reporting costs assumed at $2,400 per corporation per year.
[c] Based on 750 listed corporations and financial intermediaries as of 2008. Assume that additional reporting requirements and duel diligence procedures add $525 per corporation per year.
Source: ADB staff estimates.

III. Program Financing

21. The government has requested a loan of $60,000,000 to finance the FSPL III program from ADB's Special Funds resources. The size of the program FSPL III loan is based on a number of factors based on the criteria set out in the Staff Operating Manual (OM) including the importance of the sector and adjustment costs, among other factors.[3] Key considerations include:

(i) The relative importance of the sector to the economy. The financial sector accounts for an increasing proportion of the economy and its development and stability is critical to support Viet Nam's economic transformation, growth and poverty reduction. The complete long run static benefits of reforms that bring Viet Nam to similar outcomes of benchmark economies are estimated at $4.8 billion or 5.5% of GDP. ADB staff estimates that the FSPL III contributes gains to the economy amounting to $489.0 million or 0.6% of GDP highlighting the importance of the FSPL III reform program to the economy (Table 1);

(ii) The direct policy adjustment costs. The policy adjustment costs to the Government, statutory agencies and financial institutions are conservatively estimated as a present value lump sum of $56.8 million (Table 2). These include the administrative, enforcement and fiscal costs to the Government in implementing and enforcing the reforms (estimated at least $24.3 million). The policy adjustment costs to these entities are likely to be higher if the enforcement costs incurred by the SSC under its legislative amendments could also be quantified. The policy adjustment costs also include the increase costs of compliance by financial institution, listed corporations and unlisted public corporations from

[3] OM Section D4/BP issued in 7 April 2010.

additional legal and reporting responsibilities under the reforms (estimated at $32.5 million); and

(iii) The program loan also reflects the government's development financing needs and the need to conform to the overall financing requirement from the country partnership strategy period.