SECTOR ASSESSMENT (SUMMARY): FINANCE

Sector Road Map

1. Sector Performance, Problems, and Opportunities[1]

1. Viet Nam has made significant progress in transitioning from a centrally planned economy to a market-oriented system. Political and economic reforms (*doi moi*) initiated in 1986 helped the country achieve lower-middle-income status and raise per capita income from $437 to $1,755 in 2013. However, Viet Nam will need to fundamentally reshape its finance sector to achieve middle-income country status, with a per capita income of at least $3,000 and significant improvements in human development and poverty reduction by 2020.[2] Reforms will need to ensure that Viet Nam's high national savings rate is used for productive investment since it has become increasingly hard to sustain high economic growth rates.[3] Structural reforms are needed to deal with poorly performing state-owned enterprises (SOEs), recapitalize the banking industry and reduce the overhang of nonperforming loans (NPLs). Complementary reforms to develop the capital market system, which remains underutilized, could help provide a more reliable supply of long-term funding to support these structural reforms. In addition, healthy and vibrant capital markets will also strengthen the economy's resilience to shocks, mitigate overreliance on the bank-dominated finance sector, and improve the allocation of resources.

2. **Weak banking subsector.** Bank intermediation, while high relative to gross domestic product (GDP), is constrained by poor asset quality, undercapitalization, low profitability, and limited operational scale.[4] State-owned commercial banks dominate the subsector and often provide directed and subsidized credit to select industries.[5] Liquidity risk remains elevated since virtually all long-term credit needs of the commercial sector are provided through funding with short-term bank deposits. However, recent developments are promising. As of end-2014, the Viet Nam Asset Management Company has acquired an estimated $5.7 billion in NPLs from banks. While the company exhibits operational and financial weaknesses, its establishment holds the potential to secure an institutional conduit for dealing with problem debt from the banking subsector.[6] Further, the State Bank of Viet Nam (SBV) has initiated efforts to raise minimum capitalization, improve the identification of problem assets, and strengthen loan underwriting and risk management. Concurrently, SBV has strengthened its supervisory efforts and, in a recent case, extinguished shareholder rights and seized a failed bank.

3. **Money market is still small and fragmented.** Finance sector development is recognized as hierarchical and begins with the short-term money market.[7] Although the larger state-owned commercial banks are keen to deploy excess liquidity, Viet Nam's money market remains underdeveloped and fragmented, and does not provide the short-term interest rate

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1 Based on M. Bezemer and S. Schuster. 2013. *Southeast Asia Department: Sector Assessment, Strategy, and Road Map – Viet Nam: Finance Sector*. Manila: Asian Development Bank. (Available on request.)

2 The Socio-Economic Development Plan (SEDP) 2011–2020 provides a road map for transforming the country into a market economy with an average annual reduction in the number of poor households of 2%–3%.

3 Average gross domestic product (GDP) growth per year exceeded 7% during 2004–2007, but fell below 6% during 2008–2013 in the wake of the global financial crisis.

4 Fitch Ratings estimated system-wide NPLs to be three to four times higher than the 4.9% reported by banks in September 2012. The Financial Sector Assessment Program estimated NPLs at 12% as of December 2012.

5 The five large state-owned commercial banks still accounted for over half of system-wide loans in 2011.

6 Currently, the company has limited capital, typically pays book value for NPLs, and must obtain the permission of the original debtor and the originating bank to dispose of problem assets.

7 C. Karacadag, V. Sundararajan, and J. Elliot. 2003. Managing Risks in Financial Sector Development: The Role of Sequencing. *IMF Working Paper* (WP/03/116). Washington, DC: International Monetary Fund.

benchmarks necessary to support the introduction of more advanced instruments and activities.[8] In the interim, the SBV has provided temporary short-term benchmarks through its monetary policy operations. However, more permanent and reliable short-term benchmark rates that are independent of the SBV's liquidity management will be needed to anchor the development of the larger financial markets. A recent requirement to trade Treasury bills across the Hanoi Stock Exchange is contributing to the development of more permanent short-term benchmarks, while amendments to Circular 21 have increased the volume of short-term interbank lending. However, stronger coordination across government agencies will be required to tackle this shared challenge. Doubts on the creditworthiness of possible counterparties must be assuaged, and transparency must be increased. The Viet Nam interbank offered rate must be improved to reflect actual market conditions, and standardized contracts must be deployed.

4. **Positive trends in debt markets.** Viet Nam's total local currency (LCY) bonds outstanding grew by 43.1% year on year to reach D866 trillion ($38.0 billion) as of end-December 2014. This represents an accelerated expansion from the 15.6% year-on-year increase in December 2013. In fact, Viet Nam was the fastest-growing LCY bond market in emerging East Asia in the fourth quarter of 2014 (quarter on quarter and year on year). Recent growth has been fostered, in part, by the release of the bond market development road map. This plan, which includes quantitative targets, has produced several enabling reforms, such as a revised framework for the issuance of government bonds, and the gradual introduction of a working primary dealer system. Nevertheless, the bond market remains thin and illiquid. The LCY bond market amounted to only 22.0% of GDP as of 31 December 2014, well below the overall average of 57.8% for emerging East Asia, while the corporate bond market is dormant.[9]

5. **Equity markets are growing.** Growth of the two stock exchanges peaked at 28% of GDP in 2007 and far exceeded the government's initial target for a combined market capitalization of 10% of GDP by 2010. While most regional equity markets recovered quickly after the global financial crisis, market capitalization in Viet Nam has only now recovered to pre-2007 levels. At 30% of GDP in 2014, Viet Nam's stock markets remain in a nascent state but hold the potential to catalyze future economic growth. Impediments include limited institutional participation, poor information disclosure, weak corporate governance, informal trading, and limited recourse against abusive practices of insiders.

6. **Contractual savings as an emerging opportunity.** Contractual savings can provide stable and sophisticated institutional demand for long-term asset classes, and strengthen the economy's resilience to shocks. However, the legal framework must first be strengthened. Insurance coverage is not compulsory and the Law on Insurance currently allows lower capitalization for national firms than for international firms, leading to uneven treatment. The Insurance Supervisory Agency requires greater autonomy, and more needs to be done to shift its role toward supervision based on principles and robust data collection. Overly optimistic accounting practices and significant conflicts of interest at the commercial end of the market require attention as well.[10] Moreover, Viet Nam relies almost exclusively on the government-run pillar of its social security system, but the system is facing the danger of future insolvency.

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[8] A deep and well-functioning money market enables: (i) financial institutions to match short-term assets and liabilities, (ii) corporations to smooth out working capital needs, (iii) more effective monetary policy, and (iv) the development of short-term benchmark interest rates. Moreover, securities dealers depend on money markets to finance their inventories and to make two-way markets.

[9] Emerging East Asia includes the People's Republic of China, Hong Kong, Indonesia, Republic of Korea, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

[10] Insured entities and insurance companies are often owned or controlled by the government.

7. **Resistance to market principles.** As the economy is in the midst of a fundamental transition from a centrally planned economy to a market-oriented system, state interventions can prevent markets from functioning effectively and efficiently. For instance, a rigid mechanism was introduced in 2009 to manage basic dong-denominated interest rates.[11] This turned into a development constraint that discouraged lending for longer tenors, prevented the development of a reliable yield curve, and limited debt issuance overall since potential investors were unable to obtain adequate returns. Fortunately, gradual liberalization of the ceiling began in 2012 for deposits exceeding 6 months. Supported by the falling rate environment, ceilings also were effectively removed from longer-tenor government debt.

8. **Weak supervision and poor coordination.** Both the public and private sectors exhibit a general lack of capacity, which hampers finance sector development. The regulatory agencies suffer from limited budgets and low capacity. As a result, finance sector development has proceeded along product lines because of an apparent preference among the authorities to develop formal systems and trading models for every product. This has created a layered patchwork of markets, and laws and regulations issued by various regulatory bodies without sufficient coordination or collaboration, as well as a capital market infrastructure that supports unique functions with limited cohesion. It is important to provide the SBV with greater independence and a mandate to implement a more advanced and effective monetary policy framework. Moreover, market surveillance and monitoring needs strengthening, and the roles of the self-regulatory organizations should be clarified and expanded.

9. **Poor overall quality of basic financial infrastructure.** International accounting standards are not fully embraced since Viet Nam requires cost-based valuations rather than fair or market value. Thus, key incentives that encourage discipline through risk management and the development of technical skills are lacking. The securities market lacks certainty regarding settlement finality and netting and there is no precedent as to how a defaulting broker or bank would be administered. Moreover, the settlement process and Viet Nam Securities Depository face various legal and operational challenges. For example, the cash leg of the securities settlement relies on a commercial bank, and emergency funds to support the settlement process are inadequate in size.[12] While operations have been strengthened, a recent money market survey identified settlement issues, transaction costs, and collateral management as primary constraints to developing a repo market.

2. Government's Sector Strategy

10. **Strategy for 2011–2020.** Under its Socio-Economic Development Strategy (SEDS), 2011–2020, the government will continue to support its equitization program as part of a larger effort to reform SOEs. Within this framework, the completion of Viet Nam's first Financial Sector Assessment Program focused the government on key risks and priorities such as solving the large overhang of NPLs and bank recapitalization.[13] The government also developed a detailed sector road map for the strategic development of a capital market to encourage greater intermediation of productive activities through the nonbank finance subsector. It fostered coordination across government agencies to support the implementation of the money market development master plan. Similarly, it issued a bond market development road map focused on

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[11] Credit institutions supervised by the SBV were to set their rates for deposit taking and lending at or below 150% of the base interest rate.
[12] The emergency fund is more or less used constantly to force delivery-versus-payment.
[13] Other focus areas involve setting up a framework for financial stability (e.g., macro-prudential supervision); (ii) stepping up supervision and surveillance in banking; and (iii) strengthening the financial infrastructure (e.g., payment system, adoption of international accounting standards).

the creation of a risk-free yield curve that can be used to price corporate bonds and other financial instruments. In the longer term, the government will enable the contractual savings subsectors to play a greater role in market development, starting with the insurance industry road map[14] and the pending plan to authorize government bonds as permissible investments for pension funds. Other priorities are to strengthen the capacity of regulators, market participants, and self-regulatory organizations; amend the accounting law to introduce market value, enhance coordination; and reduce risk in the securities settlement system.

3. ADB Sector Experience and Assistance Program

11. From 2000 to 2010, the Asian Development Bank (ADB) supported the government with three successive clusters of finance sector program loans to lay the foundations for capital market development. Starting with the introduction of the basic prerequisites (e.g., legal framework and regulatory structure), ADB continued to support the development of a market-based financial system and economy by (i) strengthening capital markets, institutional investors, and nonbank financial intermediaries; (ii) increasing alternative channels for market-based financial intermediation; and (iii) supporting the establishment of the Public Debt Management Office. More recent reforms included amendments to the Credit Institutions Law, the extension of the bankruptcy code to banks, formalization of the SBV's powers to place banks under special control, an increase in banks' minimum capitalization, and regulations to govern bank mergers. These programs have also been buttressed by a broader range of initiatives, such as the Asian Bond Market Development Initiative. Overall, the country assistance program evaluation recorded a borderline *successful* overall finance sector assistance rating for Viet Nam over 1999–2008.[15] Likewise, the special evaluation study on ADB Assistance for Domestic Capital Market Development rated ADB's capital markets assistance in Viet Nam *successful* but cautioned that financial market development in Viet Nam would be a long-term process.[16]

12. Besides its engagement in the finance sector, ADB is currently providing parallel targeted assistance to support the government's efforts to restructure SOEs, utilizing a comprehensive package of corporate and financial reforms.[17] This program, which largely depends on finance sector reform, aims to reduce the dominance of inefficient state production, promote private sector development, and boost economic growth by freeing up financial resources for more productive uses. The Second Small and Medium-Sized Enterprise (SME) Development Program provided measures to promote SME development, strengthen the framework for competition policy, and enhance SMEs' access to finance.[18] At the same time, ADB is coordinating with various bilateral and multilateral donors that are also active in this sector, including the World Bank and the Canadian International Development Agency, which provide substantial levels of assistance to the banking subsector.

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[14] Its principal aim is to (i) improve the legal system; (ii) boost the effectiveness, competitiveness, and soundness of insurance firms; (iii) develop and diversify insurance products; (iv) diversify the distribution channels; (v) strengthen management within the industry; and (vi) accelerate international integration and cooperation.

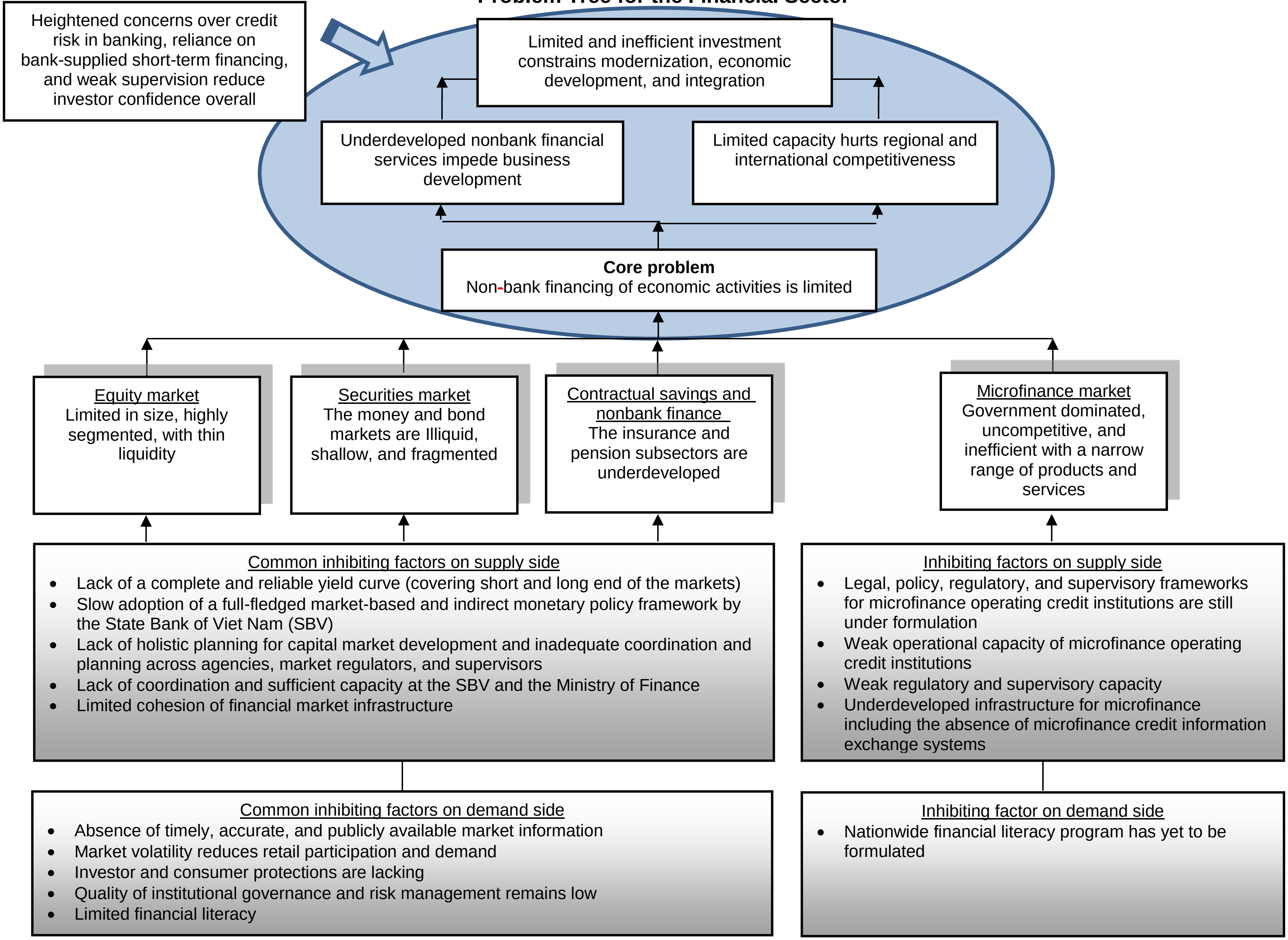
[15] ADB. 2009. *Country Assistance Program Evaluation: Viet Nam*. Manila.

[16] ADB. 2008. *Special Evaluation Study: ADB Assistance for Domestic Capital Market Development.* Manila.

[17] ADB. 2009. *Report and Recommendations of the President to the Board of Directors: Multitranche Financing Facility for the SOE Reform and Corporate Governance Facilitation Program.* Manila.

[18] ADB. 2009. *Project Completion Report: Small and Medium-Sized Enterprise Development Program Cluster, subprograms I and II.* Manila; ADB. 2012. *Report and Recommendations of the President to the Board of Directors: Programmatic Approach, Policy-Based Loan for Subprogram 1, and Administration of Technical Assistance Grant for the Microfinance Development Program.* Manila.

Problem Tree for the Financial Sector



SECTOR RESULTS FRAMEWORK (Finance, 2012–2015)

Viet Nam Sector Outcomes		Viet Nam Sector Outputs		ADB Sector Inputs	
Sector Outcome with ADB Contribution	**Indicators with Targets and Baselines**	**Sector Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Nonbank finance markets provide an increased share of financing to support domestic investment.	Share of nonbank finance sector assets to total finance sector assets increasing from 15% in 2010 to 25%–30% in 2015. Increase in the size of the local currency debt market to 20% of GDP in 2015, from 15% in 2010. Increase in combined stock market capitalization to 45% of GDP in 2015, from 38% in 2010.	Alternative channels of market-based nonbank financial intermediation developed	Increase in short-term debt papers of various maturities of less than 1 year. Increase in the proportion of government bonds with maturity of 3–5 years to more than 25% of the total government bonds outstanding by 2014. Decline in the bid–ask spread of government bonds to below 10% starting in 2014, from 13% in 2010. At least a 15% decline in the number of government issuances by 2014.	**(i) Planned key activity areas** Capital market development Microfinance **(ii) Pipeline projects** FSDP (2013, $45 million; 2014, $70 million). Microfinance Development Program loan: Subprogram 1 of ADF $40 million; Subprogram 2 of ADF $50 million (indicative). Supporting Microfinance Development Program (ADB PATA of $0.5 million). Strengthening Microfinance Operation and Regulation (ADB CDTA, $1 million). Preparing Microfinance Development Program, Subprogram 2 (ADB PPTA, $0.6 million). **(iii) Ongoing projects** Preparing Microfinance Sector Development Program (ADB PPTA, $0.5 million). Formalizing Microfinance Institutions (ADB JFPR, $1.5 million). TFSP (PPTA, $1 million). FSDP (PPTA, $0.6 million).	**(i) Planned key activity areas** Enhanced capital market size and liquidity, increased insurance coverage and old-age protection, strengthened institutional framework, and stronger staff capacity **(ii) Pipeline projects** A well-functioning money market, deeper and more liquid financial market, and improved institutional capacity. Microfinance Development Strategy and road map approved, increased number of licensed microfinance institutions and cooperative banks, reporting of microfinance client data disaggregated by sex in place. Strengthened supervisory and regulatory capacity in the microfinance regulators. Strengthened microfinance credit institutions and improved infrastructure and training. **(iii) Ongoing projects** Formalized microfinance institutions. Enabled environment, strengthened supervision, and improved standards. Money market established, a more liquid bond market, and capacity developed.
Increased access for poor and low-income households to sustainable and affordable microfinance services	Number of microfinance borrowers increasing by 10% in 2014 (2010 baseline: 12.5 million). Number of savings accounts increasing by 10% in 2014 (2010 baseline: 9.7 million).	Microfinance services expanded	Increase in the number of staff trained by about 15% from 2010 to 2015. Increase in the number of microfinance institutions from 2 in 2012 to 5 in 2014. Increase in the number of trained regulators by 30% from 2012 to 2014. Improvement of operational self-sufficiency in the VBSP to 90% in 2014 from 77% in 2010. A microfinance center established by 2014.		

ADB = Asian Development Bank, ADF = Asian Development Fund, CDTA = capacity development technical assistance, FSDP = Financial Sector Deepening Program, GDP = gross domestic product, JFPR = Japan Fund For Poverty Reduction, PATA = policy and advisory technical assistance, PPTA = project preparatory technical assistance, TFSP = Trade Facilitation Support Project, VPSP = Vietnam Bank for Social Policies.
Source: Asian Development Bank.