Vietnam's Plans for Banking Sector Reform and the Potential for Industry Restructuring

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I. Introduction

The State Bank of Vietnam (SBV) approved a merger between two second-tier domestic banks that had fallen into difficulties, Habubank and Saigon-Hanoi Commercial Joint Stock Bank (SHB)[1]. This marked Vietnam's first merger between two mid-sized banks in 2012.

Vietnam's banking sector is falling deeper into turmoil as a result of chronic recurring losses and an unstable macroeconomic environment that includes a high rate of inflation. The careless expansion in lending that has occurred over the last three years in step with liberalization of the banking sector has exacerbated the inflation rate, while the growth in nonperforming loans made to inefficient state-owned enterprises and for real estate has caused the domestic banks' balance sheets to deteriorate rapidly. In addition, the 14% cap placed by the government on deposit interest rates has reduced the liquidity of the smaller banks with less credit capability.

Under these conditions, the SBV announced a plan to consolidate and rescue by 2015 smaller banks that have experienced a weakening of their financial base over the past three years, as part of a March 2012 ASEAN initiative. One of the plan's objectives is to develop the banking sector, especially by increasing the size and competitiveness of the state-owned commercial banks.

In this paper, we summarize the latest developments, with a strong focus on what regulators are doing to reform the banking sector in Vietnam[2].

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1 Habubank was initially established as the Hanoi Housing Development Bank in 1986 as part of the Doi Moi reforms. Saigon-Hanoi Commercial Joint Stock Bank is a relatively new second-tier bank established in 1993 with designs on becoming a leader in retail banking through aggressive IT investments.

2 For an overview of Vietnam's banking sector, see Daisaku Kodomae, "Vietnam's retail financial business has growth potential," Nomura Journal of Capital Markets, Vol. 3, No. 4 Spring 2012.

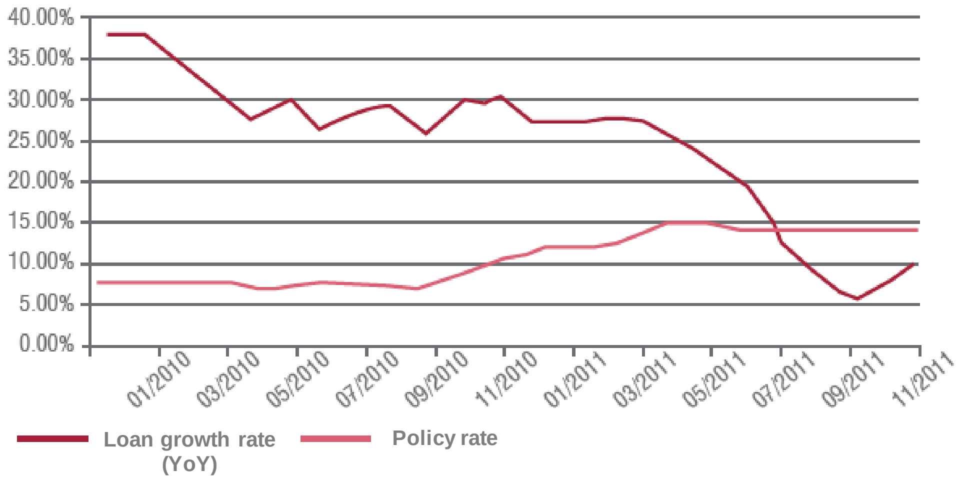
II. Recent developments affecting the banking sector

Vietnam's economy remains unstable, with inflation continuing to average above 18% in 2011. The main cause is growth in bank lending, which has been promoted by the government as a way to boost the economy since the global financial crisis in 2008.

1. Tightening monetary policy

The rate of growth in lending began to slow in March 2011 as a result of the SBV tightening its monetary policy, by raising the policy rate to 14.5%, to rein in inflation (Figure 1). It also implemented other policies, including limiting lending to non-production sectors such as real estate, capping deposit rates at 14%, and raising the required reserve ratio.

Figure 1: Loan growth rates (year on year) and the policy rate



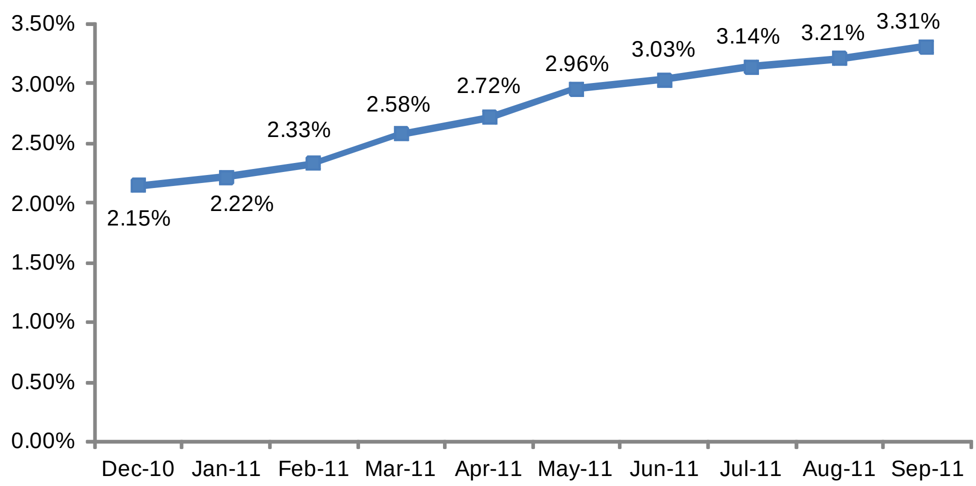
Source: Nomura Institute of Capital Markets Research, based on Saigon Securities' annual report

Tighter monetary policy has recently pulled the inflation rate down somewhat from very high levels, and this is starting to create leeway for a rate cut. Since Q1 2012, however, concerns began emerging that the economy would start to slow in reaction to monetary tightening.

2. Growing nonperforming loans

With rising interest rates putting a massive interest payment burden on small and micro businesses, the amount of nonperforming loans (NPLs) has been consistently rising (Figure 2). In early 2012, the SBV announced that the amount of NPLs at end-2011 was $3.8 billion, a 70% increase from end-2010 and equal to 3.31% of all loans,

Figure 2: Nonperforming loan ratio



Source: Nomura Institute of Capital Markets Research, based on Saigon Securities data

and then on 11 April SBV president, Nguyen Van Binh, revised up this figure to a range of 3.6% to 3.8%.

The SBV data indicates that real estate loans and loans for investing in securities total approximately $12 billion, about 12% of the total, and we estimate that if one-third of these were to become nonperforming, the NPL rate would double.

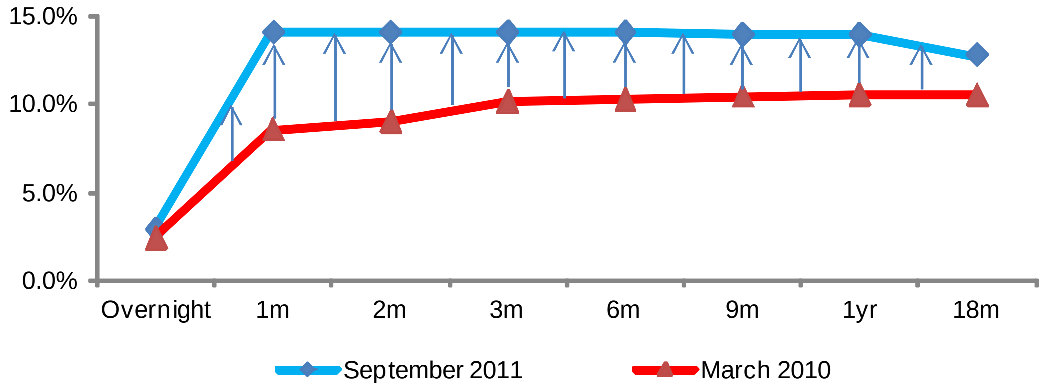
The reality is that it is difficult to accurately estimate the amount of loans that are nonperforming. This is because valuing NPLs can become tricky when the currency is constantly being devalued, inflation is raging, and the policy rate is frequently being changed. Given that the definition of what constitutes a nonperforming loan is rather vague under Vietnam's accounting standards relative to under international accounting standards, however, it is likely that the actual amount of NPLs is at least double the official estimate; in fact, the SBV president has publicly acknowledged that the actual NPL ratio is higher.

At any rate, until some trustworthy data on nonperforming loans becomes available, it will not just remain difficult to value the banks, it will remain impossible to estimate the impact that NPLs can have on the entire banking system. Accordingly, this difficulty in getting a handle on nonperforming loans will probably become a destabilizing factor for the banking system as a whole.

3. Declining liquidity

After the deposit rate was capped at 14% in 2011, the yield curve became inverted, reflecting a decline in liquidity (Figure 3). While some commercial banks started paying deposit rates of around 20%, well above the legal limit of 14%, in order to attract deposits, the smaller banks were forced to turn to the interbank market to obtain short-term funding. In step with this decline in liquidity, the 1-month interbank

Figure 3: The capping of deposit rates and the yield curve



Source: Nomura Institute of Capital Markets Research, based on data from STOXLUS

lending rate momentarily rose to 30-40% in October 2011, while the overnight rate was at least 7% as recently as end-June 2012.

Although there is no formal data on the loan-deposit ratio, the research firm Business Monitor International estimates that it was 139% at end-2011 and will rise to 170% by 2015.

4. Bank mergers and acquisitions

There is a possibility that we will also start to see not only mergers aimed at consolidating financially weak banks, as we saw in the case of Habubank and SHB[3], but also M&A between top banks. This is because these banks want to expand their business through the pursuit of greater scale. Moving forward, if the banks start considering business alliances not only with other domestic banks but also with overseas banks with sophisticated management expertise, it should increase the opportunities for foreign-capitalized banks to participate in the market[4].

In January 2012, Exim Bank, one of Vietnam's largest banks with assets of approximately $2.3 billion, purchased Australian ANZ's entire 9.7% stake in Sacombank, a leading private-sector bank[5]. Exim Bank's objective of achieving

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3 The first spontaneous merger among smaller banks was the merger of Saigon Commercial Bank, Tin Nghia Bank, and Ficom Bank, all of which had liquidity issues. The SBV announced in December 2011 that the government would inject capital in these three banks.

4 Vietnam limits the overall participation of foreign capital in preexisting commercial banks to only 30% (the highest equity stake that a single overseas financial institution can take is 10%, but that is raised to 15% if approved as a "strategic investor" and can be increased up to as high as 20% with approval from the Prime Minister. Overseas investors that are not banks are limited to a stake of 5%.

5 Although the acquisition price was not disclosed, we estimate it was around $80 million, based on Sacombank's market cap of about $800 million, computed from the market close at the time of the acquisition.

greater scale was aligned with the desire of ANZ to sell its stake in Sacombank, in which it has been a strategic investor since 2005, because ANZ already has ten branches in Vietnam and is expanding its own retail finance franchise there.

It was also reported that Vietinbank, one of Vietnam's largest banks, is preparing to sell a 20% stake to an overseas investor in Q4 2012[6]. Vietinbank's CEO, Pham Huy Hung, said it plans to reduce state ownership to 51% within the next two years. In addition, with Asia Commercial Bank, Vietnam's largest private-sector bank, having identified M&A as a critical strategy over the near term, we think it likely that there will be a wave of mergers and acquisitions in the banking sector.

The maximum foreign ownership of a preexisting bank is currently set at 20% for a single overseas financial institution, but there are reports that the SBV has started to look at raising that limit. No specific numerical targets have been mentioned at this point, but we think this bears close watching moving forward.

III. Key points in the plan for reforming Vietnam's banks proposed by regulators

Against a backdrop of troubled economies in the developed world thanks to the euro zone's lingering debt crisis, Vietnam's broader economy is also worsening. In early 2012 the Vietnamese government announced Resolution No. 01/NQ-CP, its 2012 socioeconomic development plan with these targets: (1) keeping inflation below 10%, (2) shrinking the budget deficit to 4.8% of GDP and shrinking the trade deficit to 12% of total exports, (3) raising the amount invested in economic development equivalent to one-third of GDP, and (4) raising economic growth from 6% to 6.5%. It proposed seven measures to achieve these targets, one of which was the rapid reform of the banking sector[7].

The SBV responded to the requests and the above-noted socioeconomic development plan by announcing the following bank reform scheme in March 2012[8].

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6 "VietinBank to sell stake to foreign institution: report," Thanh Nien Daily, 17 May 2012

7 The seven measures proposed in the 2012 socioeconomic development plan were (1) implement a strong and flexible monetary policy, conduct efficient fiscal management, monitor the market, and strength the trade deficit, (2) place a priority on allocating resources to revive the economy and pursue a growth model to strengthen productivity and competitiveness (the Prime Minister requested rapid reform of the banking sector from the SBV and requested a plan to rebuild private-sector investment from the Ministry of Planning and Investment, (3) improve the quality of human capital and encourage the application of science and technology to the economy, (4) provide social welfare guarantees, reduce poverty, and improve the quality of healthcare service, (5) strengthen measures to prevent damage from natural disasters, protect the environment, and deal with climate change, (6) finalize a legal framework, encourage administrative reform, and stop corruption, and (7) strengthen national defense and seek improvement in diplomatic problems.

8 For details, see “On the restructuring of credit institutions in the 2011-2015 period” (Decision No.254/QD-TTg)

➢ Overview of reform scheme for Vietnam's banking sector (2012-2015)

1) Purpose

Further strengthen the dominant role and position of state-owned commercial banks and pursue the scale and management efficiency needed to become competitive not only domestically but also overseas. The target is for at least one or two state-owned commercial banks to become significant regional players in terms of scale, management quality, technology, and competitiveness by H2 2015.

2) Chief measures

In order to reform the state-owned commercial banks, which is crucial to restructuring the banking sector, problems must be dealt with using a comprehensive approach, as outlined below.

- Make state-owned commercial banks into joint stock companies that remain under government control, and do the same for Agribank when the time is right[9]
- Recapitalize to ensure adequate capital and compliance with Basel II by 2015
- Promote mergers and acquisitions in the banking sector
- Diversify sources of funding
- Limit the NPL ratio at state-owned commercial banks to 3% based on Vietnam's accounting standards
- Improve risk management and internal controls and update bank management systems in accordance with global standards
- Expand the bank branch network (particularly in provincial areas)
- Encourage state-owned commercial banks to expand into overseas markets
- Enhance online banking
- Gradually reduce investment in nonfinancial and high-risk sectors, promote investment aimed at encouraging the development of infrastructure, exports, agricultural and provincial areas, the manufacturing sector, and small businesses
- Limit loan growth, both term length and size, and maintain a loan-deposit ratio of 90% or lower by 2015
- Quickly foster the development of talented management personnel and instill staff with workplace ethics

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[9] The Vietnam Bank for Agriculture and Rural Development (Agribank) is Vietnam's largest bank in terms of assets, number of employees, and number of customers. It was spun off from the SBV in 1988.Loans to primarily regional farmers account for 70% of its entire loan book.

3) Other private-sector commercial banks and micro finance companies

Private-sector commercial banks (including non-bank finance companies and leasing companies) will also need to be restructured together with the state-owned commercial banks to ensure the soundness and stability of the banking sector. These private-sector banks are placed in one of three categories commensurate with their financial position: healthy, temporarily lacking in liquidity, or weak. Measures for the healthy banks include improving their competitiveness and supporting their provision of liquidity to the market. Measures for the banks temporarily lacking in liquidity include assisting them with government funding and restraining growth in their loans. Measures for weak banks include, depending on circumstances, putting them under special management, preventing them from paying dividends, and providing them with special loans. Seek voluntary mergers and acquisitions, particularly among banks categorized as weak, and when that is impossible either have the SBV devise measures partly forcing an industry restructuring, or acquire shares in such banks, restructure their business, and then sell the shares to recoup that investment[10]. It is also considering approving the acquisition of weak banks by overseas financial institutions and increasing the stake that overseas financial institutions can hold in the restructured bank.

4) Implementation schedule

The timeline for implementing the scheme is broken down into four phases, aimed at completion by 2015, as shown in Figure 4.

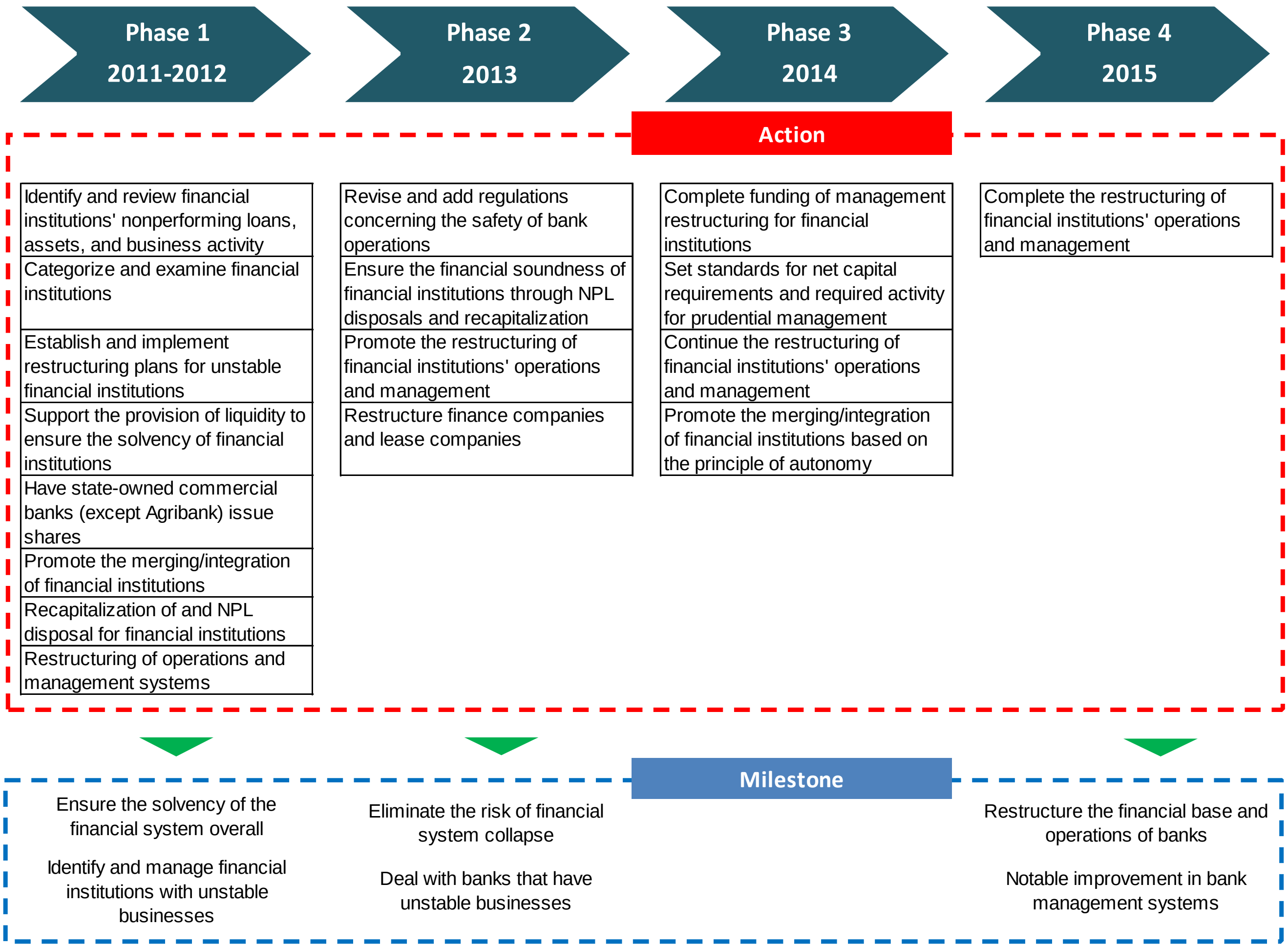
5) Major challenges to implementing the plan

The banking sector's biggest problem is that there are too many banks. Accordingly, there are probably few objections to the basic concept behind the reform plan of consolidating the troubled smaller banks and making the state-owned commercial banks more competitive ahead of ASEAN's economic integration in 2015. The plan does not include such details as the number of banks targeted or the criteria that will be used to determine which banks will be consolidated, however, and is also lacking in specifics on how the plan will be implemented. We also see the following hurdles.

- The difficulty in completing banking sector reform in such a short period of time, only three years until 2015
- The frictions involved in integrating corporate cultures and personnel, risk management, and IT systems
- The high cost of overseas M&A advisory to smaller banks with limited financial resources
- The ambiguous standards for classifying loan assets deemed necessary to capture reliable NPL ratios
- Inadequate risk management mechanisms

[10] The specific banks included in each category were not announced.

Figure 4: Implementation schedule



Source: Nomura Institute of Capital Markets Research

- The possibility of political interference
- Share crossholdings and other complex ownership structures
- Strong resistance from vested interests that hold shares in the banks subject to consolidation

This announcement of a bank reform plan does nothing more than mark the beginning of the Vietnamese banking sector's restructuring. As noted above, while the Vietnamese government is already aware of the problems with its banking sector, it has had little success with financial sector reforms in the past, and it remains to be seen what sort of specific measures the authorities will devise going forward.