



**AN UPDATE ON NON-PERFORMING LOANS
RESOLUTION AND BANKING REFORM IN VIET NAM**

by Hoang Tien Loi

**Meeting held on
27-28 April 2006**

This document reproduces a report by Mr. Hoang Tien Loi written after the Fifth Forum for Asian Insolvency Reform (FAIR) which was held on 27-28 April 2006 in Beijing, China. It will form part of the forthcoming publication "Legal & Institutional Reforms of Asian Insolvency Systems".

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AN UPDATE ON NON-PERFORMING LOANS RESOLUTION AND BANKING REFORM IN VIET NAM

by Hoang Tien Loi¹

1) Introduction and summary

Over the past few years, the Vietnamese economy has enjoyed impressive growth rates. The country issued its first sovereign bond in 2005 with a total face value of USD (United States dollars) 750 million (which was sold out in the US, having been over-subscribed by a factor of four times). The investment environment has been good with increasing interest in both direct and indirect foreign investment. This positive picture seems to have made people overly optimistic and insufficiently cautious about the risk of a potential downturn in the economy. A number of factors are possible causes for concern:

External debt now stands at about USD 20 billion, and Viet Nam is servicing this debt at a rate of USD 2 billion each year. Some analysts view the debt as controllable but, for a small economy like Viet Nam, there is rising concern. Moreover, the recent discovery of a scandal at one of the largest official development assistance (ODA) project management units (PMU 18) has placed the efficiency of ODA utilisation under heightened scrutiny. Inefficiency in the utilisation of ODA may end up burdening future generations with huge debts.

Furthermore, the burden of non-performing loans (NPLs) has slowed the reform process in Viet Nam and hampered the further expansion of the economy. At the end of 2005, Viet Nam's state-owned commercial banks (SOCBs) reported low levels of NPLs. NPLs incurred before 2000 (largely related to state-owned enterprises) were said to have been nearly completely resolved. However, stagnation in the real estate market is posing a problem

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in the banking sector that is being felt in the industrial sector, which still uses banks as its main source of funds. Finally, directed lending in several government programmes would appear to be raising NPLs again.

The efforts of the Vietnamese government in recent years have significantly improved the economy in general and the banking system in particular. The State Bank of Viet Nam is preparing a new banking reform programme for submission to the government by June 2006. Efforts are needed in Viet Nam to develop the insolvency system in order to facilitate the reform of the banking system as well as to maximise the value of non-performing assets (NPAs) by transferring capital and assets to more efficient users.

2) Non-performing loans in Viet Nam

The banking system is the main source of funding in the Vietnamese economy. The commercial banking system comprises five SOCBs; 34 joint-stock commercial banks; four joint venture banks (between SOCBs and foreign banks); and 27 foreign bank branches. The banking system manages total assets equivalent to 80% of Viet Nam's GDP. The SOCBs currently hold the lion's share (70%) of the credit market. Joint-stock banks, foreign bank branches and joint venture banks hold 12%, 15% and 3% respectively. SOCBs also have the highest NPL ratio.

Over the past decade, SOCBs have evolved from specialised policy-driven lending vehicles to more commercially oriented financial intermediaries. However, policy-driven lending practices throughout the 1990s, and limited credit assessment skills in the wake of rapid credit growth, led to the accumulation of NPLs. To address this concern, the Vietnamese government embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalisation programme in 2001. Resolving NPLs is an important part of this banking reform.

SOCBs hold most of the NPLs in the economy. The pressure on SOCBs to resolve their NPLs was not been strong enough since the government placed a higher priority on the stability of the banking and financial system, and gave support to ensure that there would be no run on banks. The main obstacles to NPL resolution in Viet Nam are:

- The lack of reliable information on the level, size, structure and characteristics of NPLs;
- The methods allowed for resolving NPLs are limited. NPLs are being resolved on an individual basis. There are no regulations or guidance on bulk sales of NPLs.

- The NPL market is underdeveloped. There is no regulation on the possible involvement of foreign investors. The Debts and Assets Trading Company, the national asset management company (AMC), is the only organisation that can buy NPLs from banks. There are no secondary buyers, which means there are few participants in the NPL market.
- The legal framework for the NPL market is inadequate. There is no comprehensive law dealing with insolvency in Viet Nam. Insolvency and creditor rights are set by many regulations, including the Law on Bankruptcy, civil law, the Ordinance on Economic Contract, etc. Since the new law on bankruptcy came into effect in October 2004, there has been no evidence to show that bankruptcy procedures contribute to NPL resolution. Court orders have not been enforced, creditor rights have not always been respected, and there are long delays in resolving debts. The use of bankruptcy procedures has, thus, been limited.

Different forms of AMCs were studied by the Vietnamese government since 1998 with the assistance of international consultants. Currently, there are 10 bank AMCs (belonging to commercial banks) and a national AMC (the Debts and Assets Trading Company) that adheres to the Ministry of Finance.

The bank AMCs were established according to a decision of the government in 2000, that provided the regulations regarding the establishment and operation of bank AMCs. Bank AMCs focus mainly on dealing, exploring, managing the mortgaging assets that are transferred from their parent entities (commercial banks) in order to recover the long-outstanding NPLs of the mother bank. With low capital and a lack of power, these AMCs are really only vehicles to collect the NPLs of the mother banks, and to consolidate paperwork with government support.

In addition to bank AMCs, in June 2003, the Vietnamese government established the national Debts and Assets Trading Company (DATC) under the management of the Ministry of Finance. The DATC has chartered capital of VND (Viet Nam dong) 2 000 billion (USD 127 million), which is considerably more than that of the commercial banks. It is the government's ambition to use the DATC as an important means to help enterprises resolve their long outstanding loans and distressed assets, and improve their financial health. At present, the DATC focuses on resolving the NPLs and NPAs of state-owned enterprises. The lifetime of the DATC is undefined.

In reality, the DATC is the only organisation allowed to buy NPLs in Viet Nam. It started its operations officially in 2004, though the NPLs resolved through the national AMC are still very limited.

By the end of 2005, it was reported that the SOCBs had resolved 92% of their NPLs that were incurred before 2000, and had successfully attained a new low. According to central bank sources, NPL levels at the SOCBs went from 7.6% in June 2005 to 4.7% in December of the same year. This reduction coincided with the application of a new loan classification system required by the State Bank of Viet Nam in May. Clearly, experts were surprised with the reduction since earlier discussions had raised concerns regarding bank NPL levels, which were expected to increase dramatically as the result of a new more stringent loan classification system. Suspicions, thus, arose regarding the reliability of the information and whether the NPLs were really resolved.

To accelerate the resolution of NPLs, the DATC recently signed a co-operation agreement with all five SOCBs to resolve their NPLs. The DATC is working together with the SOCBs to formulate a more comprehensive plan to solve the problem. The plan is expected to include the introduction of more sophisticated approaches such as bulk sales, joint ventures with foreign investors, etc. It is too early to comment on whether this approach will help resolve NPLs more quickly.

The State Bank of Viet Nam (SBV) is in the process of drafting a new banking reform programme to submit to the government by June 2006. Measures to continue improving the credit management system, resolve NPLs and prevent new NPLs from being incurred are expected to be high on the agenda of this second banking reform programme.

3) Recent legal and institutional developments in risk management and the banking sector

Continued efforts have been made to separate policy-based and directed lending from commercial lending. A bank called Viet Nam Bank for Social Policy (VBSP) was established to undertake directed and policy lending activities, to promote poverty reduction and to pursue other social purposes.

In addition, SOCBs are now given more autonomy in lending. They are now allowed to reject projects that they believe are not commercially viable. Evidence of this has been the recent denial of lending by SOCBs to a few large projects that were proposed by state-owned corporations. The change is reflective of a more conservative credit policy and should help prevent the recurrence of some bad debts.

Another proposal that is being considered by the government is to transform the Development Assistance Fund (DAF) into the Development Bank of Viet Nam. The DAF is a kind of development finance institution

that is wholly owned by the state, and under the supervision of the Ministry of Finance. The DAF provides development investment credit, post investment interest subsidies, export support credit, ODA on-lending, investment trust funds and disbursement trust funds. Under current banking laws and regulations, the DAF is not considered a credit institution and is not under the supervision of the central bank. The DAF manages total assets equal to 14% of Viet Nam's GDP. The transformation of the DAF is expected to take place in the second half of 2006, which will turn the organisation into a more transparent and effective policy lending institution, thus fulfilling one of Viet Nam's obligations in the World Trade Organization (WTO) accession process.

The DAF is working on a number of initiatives to improve its credit risk management system, which currently lags far behind those of Vietnamese commercial banks. They include: setting up a new loan classification system; designing an internal credit rating system that places more emphasis on the creditworthiness of borrowers instead of merely the feasibility of projects; human resource development; improving accounting practice; etc.

Last year also witnessed two remarkable changes in banking regulations pertaining to: i) capital adequacy and safety requirements; and ii) loan classifications and loan loss provisioning. The central bank now stipulates² capital adequacy ratios in banking businesses and for credit institutions operating in Viet Nam:

- *Minimum capital adequacy ratio (capital safety ratio):* Credit institutions, excluding foreign bank branches, shall maintain a minimum ratio of 8% between owners' capital and total risk bearing assets;
- *Credit limits to customers:* The regulation requires credit institutions to formulate internal policies with criteria to determine credit limits applicable to a single customer and groups of related customers. The total loan balance of a credit institution to a single customer shall not exceed 15% of its own capital. The total loan and guarantee balance of a credit institution to a single customer shall not exceed 25% of its own capital. The total balance of loans, and combined loans and guarantees to a group of related customers shall not exceed 50% and 60% respectively. It also stipulates that the total financial leasing amount for a single customer shall not exceed 30% of the own capital of a financial leasing company.
- *Liquidity ratio:* The regulation requires credit institutions to formulate a liquidity plan to ensure their liquidity and solvency. Credit institutions

² Decision No 457/2005/QD-NHNN dated 19 April 2005.

shall ensure a ratio of 25% between quick assets and liabilities due within the following month, and a ratio of 100% between quick assets and quick liabilities due within seven working days.

- *Maximum ratio of short-term mobilised funds used to finance medium and long-term loans:* The ratio for commercial banks is 40%, and 30% for other credit institutions.
- *Limits on capital contributions and share purchases:* Credit institutions may use their charter capital and reserve funds for investment in enterprises, investment funds, projects and other credit institutions in the form of contributions of capital, joint ventures, and share purchases. The investment in a credit institution shall not exceed 11% of the enterprise's or fund's charter capital, or of the project value. And, total investments shall not exceed 40% of the credit institution's charter capital and reserve fund.

There have been significant improvements in the methodology to calculate the above ratios, especially the capital adequacy ratio. This new regulation reflects a step forward for the Vietnamese banking sector towards international standards and best practices in banking operations.

The governor of the SBV has also promulgated a decision³ on loan classifications and provisioning for bad debts of credit institutions. Under this regulation, a loan portfolio is to be classified into five groups as follows:

- *Group 1 (standard debts):* includes undue debt, whose principal and interest are assessed by credit institutions to be fully recoverable when they become due. Debts under this category are not subject to provisioning (0% rate of provisioning);
- *Group 2 (debts to which attention shall be paid):* includes debts overdue for less than 90 days and rescheduled debts that are now no longer due according to rescheduled terms. This group shall be provisioned at the rate of 5%;
- *Group 3 (sub-standard):* includes debts overdue between 90 and 180 days and rescheduled debts overdue for less than 90 days according to the rescheduled terms. This group shall be provisioned at the rate of 20%;
- *Group 4 (doubtful debts):* includes debts overdue for between 181 and 360 days and rescheduled debts that are overdue for between 90 and 180 days according to the rescheduled terms. This group is subject to a provisioning rate of 50%;

³ Decision 493/2005/QD-NHNN dated 22 April 2005.

- *Group 5 (debts with potentially irrecoverable principal)*: includes debts overdue for more than 360 days, debts frozen pending the government's handling, and rescheduled debts that are now overdue for more than 180 days according to the rescheduled terms. This group shall be provisioned at 100%. With respect to debt frozen by the government, specific provisions shall be set up according to the financial capability of the credit institution.

Debts can be upgraded or downgraded based on the assessment of the credit institution of the ability of the borrower to pay, and its risk profile. A non-performing loan is defined as a loan classified under group 3, 4 or 5.

One of the new requirements of this decision relates to setting up a general provision. A general provision is the amount provisioned for handling non-measurable losses in the course of loan classification, and in cases where credit institutions meet with financial difficulties attributable to the declining quality of debts. Credit institutions shall make general provisions equal to 0.75% of the total value of the debts in groups 1 to 4 within five years of the date that the regulation takes effect (*i.e.* before 15 May 2010).

This new regulation is believed to be more in line with international best practices, but remains a challenge to apply fully in practice. As required by the central bank, all SOCBs have developed comprehensive credit manuals that take into account international practices in risk management. The banks are also designing and implementing new internal credit rating systems.