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Recent banking reforms

September 2005

>>> *This update discusses the main regulatory reforms in the banking sector in Vietnam over the past 12 months.*

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INTRODUCTION

In order to promote domestic and foreign investment, Vietnam has gradually developed its banking and finance regulatory framework since the introduction of its "doi moi" (renovation) policy in the late 1980s. Despite a number of reforms precipitated by the Asia financial crisis and moves towards joining the WTO, Vietnam's banking and finance sector remains tightly controlled.

As Vietnam integrates deeper into the global economy, the need for regulating the banking sector and restructuring State owned commercial banks has become a stated high priority for the Government. The number of reforms in the past 12 months indicates that the momentum for change is growing. This report reviews the mains reforms that have taken place during this period.

Despite the efforts of the Government, progress has been slow. The general consensus is that liberalisation has been moving positively, but slowly. Indeed compared with all reform agendas for WTO accession, Klaus Rohland, Country Director of the World Bank in Vietnam, recently commented "banking is the area where reforms have been the slowest" (Vietnam News Agency (28/12/2004). 'Viet Nam's economic growth remains strong in 2005, WB official says' site: www.vna.com.vn).

PART A: FORM AND ESTABLISHMENT

1. Law on Credit Institutions

The National Assembly's amendments to the 1997 Law on Credit Institutions (**LCI**) became effective as of 1 October 2004. The five primary amendments to the LCI were:

- Compliance with international agreements regarding forms of establishment – the LCI now allows 100% foreign invested banks to operate in Vietnam; and foreign credit institutions are permitted to contribute capital to and purchase shareholdings in banks operating in Vietnam.
- Enhanced decision-making autonomy of credit institutions – the amendments widen the range of the types of deposits permitted; banks may more freely make unsecured loans and more autonomy is given to State banks to make credit decisions.
- Improved safety and soundness of credit institutions – the range of functions to be performed by the board of supervisors has been expanded.
- Improved auditing process.
- Separation of policy and commercial lending.

The State Bank of Vietnam has recognised that these amendments are inadequate and that, despite these reforms, the LCI still does not meet international standards for banking, supervision and monetary policy. It has been the conclusion of a number of parties involved in the drafting process (including the National Assembly, existing banking institutions and the State Bank) that a comprehensive overhaul of the legal framework for the sector is still needed, starting with a revision of the LCI and the 1997 Law on the State Bank. The State Bank has predicted that such revisions will not happen for several years due to both the time necessary for considering proposed changes and the complex legislative process.

A number of the new rights under the LCI (eg the right to establish a 100% foreign invested bank) will not become operative in practice until the Government has issued implementing regulations.

2. Foreign credit institutions

To implement the LCI reforms relating to forms of establishment, a new decree is required to replace Decree 13-1999-ND-CP of the Government dated 17 March 1999 on organization and operation of foreign credit institutions and representative offices of foreign credit institutions in Vietnam.

A draft of the proposed new decree was released for public comment at the end of 2004 and it was expected that the new decree would be issued and become effective in the first quarter of 2005. Consultations and different opinions over content have extended this timeline (not unusual in Vietnam). Recent discussions with the State Bank indicate that the final draft will now be submitted to the Government for approval in the first week of September 2005. Taking an optimistic view, we hope to see the new decree issued by the end

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of September. More conservatively, it may take until the end of the year or longer, depending on feedback and views of the Government.

The draft released for public comment has been criticised as not meeting Vietnam's commitments under the US-Vietnam Bilateral Trade Agreement (**BTA**), in particular with respect to national treatment. Reportedly, instead of entitling foreign credit institutions to provide the same products and services which domestic banks are currently permitted to provide, the draft provided for the State Bank to issue permits to foreign banks on a discretionary case-by-case basis. The draft also imposed a number of restrictions on foreign credit institutions which do not apply to domestic credit institutions eg. foreign bank branches must have legal capital of VND20 billion; 100% foreign owned banks must have legal capital of VND10 billion.

A welcome reform in the draft was the deregulation of the ratio of a foreign party's capital contribution in a joint venture bank. However, only domestic banks (not other domestic non-banking organizations) would be permitted to partner with foreign banks in joint venture banks.

In accordance with the BTA, the operational network of foreign bank branches (ability to open branches and transaction offices) will be restricted under the new decree. This restriction is seen by the Government as an important safeguard to protect the development and competitiveness of Vietnamese banks against the threat of competing foreign banks.

3. Foreign shareholdings

To implement the LCI reforms allowing foreign credit institutions to contribute capital to and purchase shareholdings in Vietnamese banks, revision is required of regulations issued with Decision 228-QD-NH5 of the State Bank dated 2 December 1993 on foreign shareholdings in Vietnamese banks. An officer from the State Bank's Shareholding Division has confirmed that the revision is still in progress and that, for the present time, the State Bank is approving share purchases by foreign credit institutions on a case-by-case basis only. This ad-hoc approval recently occurred when the State Bank approved Australian bank ANZ to buy shares in the Vietnamese bank Sacombank. Several major foreign banks have sought State Bank approval to buy shares in Vietnamese banks but their cases have not yet been decided.

The State Bank's revision of Decision 228 is also expected to abolish the cap on the shareholding of any one foreign investor in a Vietnamese bank. Currently, the maximum shareholding of any one foreign investor is capped at 10% of the charter capital. No change in the 30% cap on total shareholdings of foreign investors in a Vietnamese bank is anticipated. But the abolition of the 10% cap would allow one foreign investor to hold the full 30% maximum total foreign shareholdings. This reform would mirror the abolition in mid-2003 of the cap on any one foreign investor's shareholdings in a listed Vietnamese company. A 30% shareholding is more appealing to institutional investors, allowing them greater participation in management.

On 6 September 2005, in VNECONOMY, Kieu Huu Dung, director of the State Bank's Department of Banks and Non-Banking Credit Institutions, announced that the cap-lifting reform was being finalised and is scheduled to be effective by the end of 2005.

We now anticipate that the reform allowing foreign credit institutions to contribute capital to and purchase shareholdings in Vietnamese banks will be introduced at the same time.

4. Microfinance institutions

From 30 March 2005, micro-finance organizations may now be established by social, political and trade organization, charitable and social funds and non-governmental organisations under Decree 28-2005-ND-CP of the Government dated 9 March 2005. The objective behind Decree 28 is to enable “small-scale finance activities” to be provided to low income people and households. To be licensed, a micro-finance organization must have a minimum legal capital of VND500 million (or VND5 billion if savings services are offered).

5. Vietcombank equitisation

It is expected that Vietcombank, the largest State owned bank, will be equitised into a commercial joint stock bank in 2006. In March 2005, the State Bank submitted Official Letter 183-NHNN-CCPT proposing that the Prime Minister approve Vietcombank's equitisation. In May 2005, under Official Letter 495-NHNN-CLPH, it again requested the Prime Minister to issue a decision on Vietcombank's equitisation. In June 2005, the Prime Minister issued Official Letter 3120-VPCP authorising Vietcombank to hire an international consulting

firm to appraise the corporate value and issue bonds to increase capital. On 21 September 2005, the official equitisation decision (which is required by law) was issued by the Prime Minister under Decision 230-2005-QD-TT.

PART B: PRODUCTS AND SERVICES

1. VND deposit limits

As of 1 March 2005, an EU foreign bank branch may now accept VND deposits from Vietnamese legal entities with which it does not have a credit relationship up to 400% of its charter capital and from Vietnamese natural persons with which it does not have a credit relationship up to 350% of its charter capital. This increase puts EU foreign bank branches on equal footing with their US counterparts (who already enjoyed such increase under the BTA). Non-EU and non-US foreign bank branches remain subject to a 50% cap.

2. Interest rates on deposits

Effective from 1 September 2005, Decision 1247-2005-QD-NHNN of the State Bank dated 26 August 2005 takes the maximum interest rates for USD deposits to new all-time highs. For USD on-call deposits, the maximum interest rate is now 0.5% per annum (up from 0.3% per annum). For USD term deposits up to 6 months, it is now 1.2% per annum (up from 0.7% per annum). And for USD term deposits over 6 months, it is now 1.5% per annum (up from 1.0% per annum). This is the second rate increase this year, following the first increase in April 2005 under Decision 272-2005-QD-NHNN of the State Bank dated 21 March 2005. Decision 272 had increased the maximum interest rate for USD on-call deposits to a then all-time high of 0.3% per annum (up from 0.1% per annum). Also, Decision 272 had returned the maximum interest rate for USD term deposits up to 6 months to 0.7% per annum (from 0.4% per annum) and term deposits over 6 months to 1% per annum (from 0.8% per annum).

3. Cheques

The use of cheques is not popular in Vietnam, partly because of the risk of non-payment. To reduce this risk, and encourage use, Circular 05-2004-TT-NHNN of the State Bank dated 15 September 2004 has been issued, and sets out measures that can be applied when a cheque is not honoured.

4. Factoring

A legal framework authorising credit institutions to undertake factoring activities (the process of purchasing commercial accounts receivable (invoices) from a business at a discount) was introduced by Decision 1069-2004-QD-NHNN of the State Bank dated 6 September 2004. A number of restrictions and exclusions apply. To undertake factoring activities, a credit institution must:

- have approval from the State Bank;
- have overdue debts of less than 5% of its total loan balance;
- not be in violation of any regulations on banking safety;
- not be under any investigation;
- (if import-export transactions are involved) have a permit to deal in foreign exchange.

5. Foreign currency trading

Now, under Decision 648-2004-QD-NHNN of the State Bank dated 28 May 2004 commercial banks are free to agree with their customers on the forward exchange rate between VND and US dollars so long as it does not exceed a prescribed limit (according to a prescribed formula); and are free to agree with their customers on the forward exchange rate between VND and other foreign currencies or as between different foreign currencies without the above limit.

Long overdue, Decision 1452-2004-QD-NHNN of the State Bank dated 10 November 2004 updates the regulation of foreign exchange transactions by credit institutions in Vietnam, replacing Decision 17-1998-QD-NHNN7 of the State Bank dated 10 January 1998. As well as regulating spot, forward and swap transactions, Decision 1452 introduced regulations for the new commodity of "option to conduct a foreign exchange transaction" (limited to transactions between foreign currencies, not involving VND) and other

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foreign exchange transactions as permitted by the State Bank. Decision 1452 has significantly simplified the foreign exchange controls of authorized banks in Vietnam. Authorized banks are no longer required to satisfy prescribed conditions and obtain specific licenses from the State Bank to conduct spot, forward and swap transactions. The mandatory contents of transaction contracts are no longer prescribed; transacting parties are now free to agree on the contents of the transaction contract. However, authorized banks must still comply with the foreign currency position specified by current State Bank regulations, but they may maintain a total value of options without corresponding transactions at a maximum of 10% of their equity. Authorized banks are no longer permitted to collect transaction fees for spot, forward and swap transactions; but are permitted to do so for options to conduct a foreign exchange transaction provided fees are specified in the transaction contract. The term applicable to forward and swap transactions between VND with a foreign currency may now be anything from 3 to 365 days. And there is no term restriction on such transactions between foreign currencies or on options to conduct a foreign exchange transaction. However, transacting parties must fix and record in the transaction contract the date of maturity for payment and transfer of monies.

6. Offshore loans

New guidelines for borrowing and repayment of offshore loans by enterprises (including credit institutions) in Vietnam were issued under Circular 09-2004-TT-NHNN of the State Bank dated 21 December 2004. Under Circular 09, the foreign loan controls include:

> Mandatory prescribed conditions (eg conditions as to loan purpose and amount) apply to the borrowing of short-term and medium to long-term loans.

> Medium to long-term loans must be registered with the State Bank in all cases (within 30 working days from the date of signing a foreign loan agreement, and prior to initial drawdown).

> Short-term loans must be registered with the State Bank if the loan is extended and the total loan term (original term plus extended term) is more than 1 year. (Previously, short-term loans were only required to be registered if the extended term was more than one year.)

> State Bank is required to issue certification of loan registration.

> Drawdown and repayment of foreign loans must be carried out through authorized banks, except in prescribed cases.

7. Finance and operating leasing

A number of reforms have been introduced to encourage the development of the finance and operating leasing sector. The major reforms include:

> Existing finance leasing companies are allowed to undertake operating leasing activities under the Provisional Regulations on Operating Lease Activities by Finance Leasing Companies issued with Decision 731-2004-QD-NHNN of the State Bank dated 15 June 2004.

> A suite of amendments improved Decree 16-2001-ND-CP of the Government dated 2 May 2001 on Organization and Operation of Finance Leasing Companies, including: new criteria for recognising leasing transactions; new provisions for the purchase-back of leased assets (including tax exemptions); addition of new activity of operating lease services; and new provisions on recovery of leased assets.

>>> See the July 2005 Issue of Vietnam Legal Update on www.vietnamlaws.com for a more detailed summary of these reforms.

PART C: REGULATORY SUPERVISION

1. Prudential ratios

Decision 457-2005-QD-NHNN of the State Bank dated 19 April 2005 issuing Regulations on Prudential Ratios in Operations at Credit Institutions is an important step in the State Bank's reform process and it regulates the following areas:

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- Minimum capital prudential ratios: Credit institutions must maintain a minimum ratio of 8% of their equity over their total assets in credit at risk (foreign bank branches are not subject to this requirement). This is consistent with the previous regulation, but importantly, Decision 457 introduces new calculations for adjustment of assets in credit, which are more sophisticated and more closely comply with the principles of the Basel I Accord.
- Credit limits for customers: A number of new lending limits to customers have been introduced. Credit institutions (except for foreign bank branches) must formulate an internal policy (which must be continually assessed every 6 months) regarding calculation of these limits.
- Payment ability ratio: Credit institutions must maintain certain minimum liquidity ratios.
- New maximum ratio of short-term capital funds which a credit institution is permitted to use to provide medium and long-term loans are introduced. For commercial banks – 40%, for other credit institutions – 30%.
- Limit on capital contribution and share purchase: Credit institutions may use up to 40% their charter capital and reserve funds to make commercial investments (with a maximum of 11% for any particular investment).
- >>> See the Banking Update – New Prudential Regulations on www.vietnamlaws.com for a detailed summary of Decision 457.

2. Rescheduling loans, reclassifying overdue debt

Decision 1627-2001-QD-NHNN of the State Bank dated 31 December 2001 was amended on 3 February 2005 by Decision 127-2005-QD-NHNN of the State Bank. Decision 127 introduces a number of changes, but the most noteworthy relate to the rescheduling of loans and the reclassification of overdue debt.

Now, credit institutions can restructure loans by allowing a change to schedule of repayments. This change can extend the maturity date of the loan (extension of loan term), or only affect particular repayments and not the final maturity date of the loan (adjustment of payment schedule). The length of the extension is at the discretion of the credit institution (previously, the maximum period of extension was 12 months for short term loans, and half of the loan term for medium and long term loans).

Interestingly, Decision 127 provides that where a loan has been restructured, all outstanding loan principal is regarded as an overdue debt and must be classified from group 2 to group 5 as provided under the regulations on classification of debts by the State Bank (see Decision 493 in C.3 below).

Subsequently, on 31 May 2005, the State Bank issued Decision 783-QD-NHNN amending Decision 127. Now, the requirement is that the outstanding loan principal is classified into "appropriate groups of debt as provided for by the State Bank". That is, the credit institution may classify it as a standard debt (see category 1 under Decision 493 in C.3 below) and does not have to classify it as an overdue debt.

3. Risk provisioning

Loan loss reserves are now regulated by Decision 493-2005-QD-NHNN of the State Bank dated 22 April 2005, effective 5 May 2005, which replaced Decision 488-2000-QD-NHNN5 of the State Bank dated 27 November 2000 and Official Letter 354-CV-CNH dated 10 July 2002.

Under Decision 493, debts are grouped into 5 categories to which different risk-weighted percentages are applied, as follows:

- Category 1: undue debt
- Category 2: debts requiring attention (overdue debts < 90 days)
- Category 3: under qualified debt (overdue debts > 90 and < 180 days)
- Category 4: doubtful debt (overdue debts >181 and < 360)
- Category 5: bad debt (overdue debts >360)

Alternatively, the State Bank may approve an internal qualitative credit rating system if the credit institution satisfies specific criteria listed in Decision 493. Consequently, rather than grouping debts based on the

number of days they are overdue (as listed above), a credit institution may group debts into the 5 categories above based on its own assessment and criteria.

The ratios of reserves to be established for the above 5 categories are 0%, 5%, 20%, 50% and 100% respectively. Foreign bank branches may use the risk provisioning issued by their parent banks, with specific approval by the State Bank. Credit institutions must establish a general reserve equal to 0.75% of the total debts of categories 1 to 4 by 15 May 2010. Credit institutions must also establish a specific reserve based on the value of debts minus the value of secured assets.

Credit institutions must issue an internal credit rating system to support the classification of debts and management of credit quality in accordance with their operations by 15 May 2008.

4. Deposits reserves

Under Decision 796-2004-QD-NHNN of the State Bank dated 28 June 2004, the compulsory reserve ratios for deposits are:

- For Vietnamese dong deposits on call and less than 12 months: 5%[1]
- For Vietnamese dong deposits between 12 and 24 months: 2%
- For foreign currency deposits on call and less than 12 months: 8%
- For foreign currency dong deposits between 12 and 24 months: 2%

From 5 August 2004, the interest rate on the compulsory reserves at the State Bank is 1.2% for compulsory reserves in VND and 0% for foreign currency deposits. The interest rates on surplus above the compulsory reserve level is 1% (Decision 923-2004-QD-NHNN of the State Bank dated 20 July 2004).

5. Deposit insurance

Deposit insurance was introduced in Vietnam under Decree 89-1999-ND-CP of the Government dated 1 September 1999 in order to protect the lawful rights and interests of individual depositors, contribute to the stability of credit institutions and ensure the secure and healthy development of banking activities. Decree 109-2005-ND-CP of the Government dated 24 August 2005 amends Decree 89. Decree 109 is expected to become effective as of the end of September 2005.

Participation in deposit insurance remains compulsory for credit institutions and any other institutions which are permitted to carry on the banking activity of receiving VND deposits from individuals. Deposit premiums remain payable at the rate of 0.15% per annum of the average deposit balance of individuals at the institution participating in deposit insurance. All institutions participating in deposit insurance must still display publicly notification of their deposit insurance at their head offices and transaction places. If an institution participating in deposit insurance is in danger of insolvency, but not to the extent of being put under special control, Vietnam Deposit Insurance may assist it by providing loans to support payment of the insured deposits, by providing guarantees for special loans to fund payment of the insured deposits, or by purchasing debts in cases where such debts are secured by property.

Reforms introduced under Decree 109 include:

- The maximum amount of insurance proceeds payable for all deposits (including principal and interest) of any one individual at any one institution participating in deposit insurance has been increased to VND50 million (from VND30 million under Decree 89).
- If an institution participating in deposit insurance is required to terminate operations pursuant to a decision of a competent State body in order to commence liquidation procedures or pursuant to a decision of a court on commencement of liquidation procedures, there is now a time-limit for payment

[1] A lower percentage applies to the Bank for Agricultural and Rural Development (4%), rural commercial shareholding banks, the Central People's Credit Fund and co-operative banks (2%).

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of deposit insurance proceeds to depositors. The time-limit is 60 days from the date of any such decision.

6. Money laundering

For the first time in Vietnam, Decree 74-2005-ND-CP of the Government dated 7 June 2005 Against Money Laundering introduces as of 1 August 2005 an anti-monetary laundering regime, imposing obligations on individuals and organisations involved in monetary transactions, such as credit institutions, insurance companies, real estate companies and lawyers (transacting bodies). Decree 74 also applies to foreign individuals and organisations operating in Vietnam.

Under Decree 74, transacting bodies are required to identify and report to the Anti-Money Laundering Centre under the State Bank the following transactions:

- One or more cash transactions conducted by an individual/organisation that in one day has a value of more than VND200 million (approx USD12,615) or in the case of saving account transactions more than VND500million (approx USD31,500).
- Other suspicious transactions (listed in Decree 74, to be supplemented from time to time by the State Bank).

The State Bank is understood to be finalizing guidelines for implementation for Decree 74. As yet, personnel and infrastructure for the Anti-Money Laundering Centre has not yet been arranged.

>>> See Vietnam Legal Update June 2005 on www.vietnamlaws.com for more on anti-money laundering.

7. Reporting obligations

Under Decision 1407-2004-QD-NHNN of the State Bank dated 1 November 2004, joint stock commercial banks must now publish audited financial reports to shareholders and customers on a quarterly (optional) and annual basis. The annual financial report must be certified by independent auditors. The information in the annual finance statements must be disclosed at the offices of the joint stock commercial bank and in 3 consecutive issues of central and local newspapers within 120 days after the end of a fiscal year.

PART D: LEGISLATIVE PIPELINE

1. Foreign currency regulation

Foreign currency is currently regulated under various decisions and implementing documents issued by the State Bank. An Ordinance on Foreign Exchange was scheduled to be drafted (only) in 2005. Now, in order to expedite promulgation of legislation necessary for WTO accession, the Ordinance (which is waiting in draft form) will be promulgated by the National Assembly's Standing Committee in October 2005 (not in 2006 as previously expected).

2. Law on Bills of Exchange

The Law on Bills of Exchange (previously titled the Law on Negotiable Instruments) is designed to create a legal framework for securing financial and banking transactions relating to credit bills, debit bills and cheques. The draft law is scheduled to be approved by the National Assembly in its October/November session this year, and is expected to be effective from 1 July 2006.

3. Land use rights as collateral for offshore loans

Legislative reforms to allow foreign invested enterprises to use land use rights as collateral for loans provided by offshore banks have been deferred indefinitely. A proposal to introduce this reform was submitted by the State Bank to the Government early in 2003 and was reportedly supported by the Government. It was widely anticipated that the revised land law would introduce this reform. The Ministry of Planning and Investment had also planned to provide for this reform in the foreign investment laws. However, the 2003 Law on Land failed to provide for the use of land user rights as collateral for offshore loans. Reportedly, the Government is considering allowing the introduction of this fundamental reform on a trial basis, but no legal instrument enabling a trial has been issued as yet.

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