SECTOR ASSESSMENT (SUMMARY): FINANCE[1]

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Viet Nam's average gross domestic product (GDP) growth rate reached nearly 8% per annum during 2001–2007, but fell below 6% during 2008–2012 in the wake of the global financial crisis. The economy stabilized after the government tightened monetary and fiscal policy in response to a sharp increase in inflation in 2011. However, the crisis exposed financial sector vulnerabilities and showed the need for structural reforms and more effective monetary and fiscal policy tools. For instance, the effectiveness of the State Bank of Viet Nam (SBV) would benefit from having the independence and mandate to implement a more advanced and effective monetary policy framework to maintain price stability. Money and capital markets also need to be further developed to maintain macroeconomic stability and sustain high growth rates. Further, deepening of financial inclusion is essential to ensure resilience in low-income households.

2. **Intermediation overly reliant on weakened banking sector.** Bank intermediation is inadequate to compensate for the limited size of the nonbanking sector and is constrained by undercapitalization, low profitability, nonperforming loans, and limited operational scale.[2] Liquidity risk also remains elevated as virtually all long-term credit needs of the commercial sector are provided through funding with short-term bank deposits. State-owned commercial banks dominate the banking sector and often provide subsidized credit to select industries.[3]

3. **Small debt markets show positive trends.** Viet Nam's total local currency bonds outstanding grew 53.3% year-on-year to reach $30.2 billion in March 2013. This represents an accelerated expansion from the 20.1% year-on-year increase in March 2012. In fact, Viet Nam was the fastest growing local currency bond market in emerging East Asia in the first quarter of 2013, due exclusively to government issuance. A program has been launched by the government to introduce primary dealers and market makers. Nevertheless, the bond market remains thin and illiquid. The local currency bond market amounted to only 20.5% of GDP in the first quarter of 2013, well below the overall average of 54.8% for emerging East Asia.[4] Corporate local currency bonds outstanding contracted to $0.9 billion (0.5% of GDP) in June 2013 from $1.8 billion (1.4% of GDP) in June 2012, continuing a declining that began in March 2011.

4. **The money market remains small and fragmented.** A deep and well-functioning money market enables: (i) matching short-term assets and liabilities by financial institutions, (ii) smoothing out working capital needs of corporations, (iii) effective monetary policy, and (iv) the provision of transparent short-term benchmark rates. Moreover, securities dealers are reliant on money markets to finance their inventories and to make two-way markets. Although the larger state-owned commercial banks are keen to deploy excess liquidity, several barriers may need to

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[1] Based on Bezemer, M. and Schuster, S., 2013. *Southeast Asia Regional Department Sector Assessment, Strategy and Road Map. Viet Nam: Financial Sector*. Manila. Available on request.

[2] Fitch Ratings estimated system-wide nonperforming loans to be three to four times higher than the 4.9% reported by banks in September 2012. This would by far exceed the 6.0% estimate of the SBV in February 2013. Given the pivotal role of the banking sector in the Vietnamese economy, nonperforming loans must be brought down to more natural levels. In July 2013, the Viet Nam Asset Management Company was set up to resolve bad debts and stimulate credit growth. However, concerns have been expressed over its limited capital of D500 billion, lack of independence, and intention to purchase bad debt at book value.

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

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

be lifted before the money market can perform its key functions. For example, lingering doubts on the creditworthiness of possible counterparties are exacerbated by poor transparency that impedes qualitative credit assessments. The Viet Nam Interbank Offered Rate also does not reflect actual market conditions and thus cannot be used as a reference rate. Further, there is a lack of standardized agreements, and the legal framework does not provide an adequate enabling environment. Moreover, settlement netting of treasury bills has only recently been formally recognized and established.

5. **Equity markets are slowly emerging.** 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. However, while most regional equity markets recovered quickly after the global financial crisis, market capitalization in Viet Nam has yet to reach 2007 levels again. The relatively low capitalization of 23% of GDP in 2012 illustrates the nascent state of Viet Nam's stock market as well as its 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. **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. While at times such interventions in the financial sector may be justified by external shocks or the need for proper sequencing, they could have repercussions in other parts of the economy. For instance, a rigid mechanism was introduced in 2009 to manage basic dong-denominated interest rates. 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. 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 as potential investors were unable to obtain adequate returns for the risk assumed.[5] In addition, it had a negative impact on the credit discipline mechanism as rates paid by less creditworthy institutions in the interbank money markets tended to bunch at the ceiling rate. Fortunately, gradual liberalization of the ceiling began in 2012 for deposits exceeding 6 months. This decision has been supported by falling market rates, but would be tested if the market were to rise again.

7. **Contractual savings present an emerging opportunity.** Development of the nonbank financial sector is needed to mitigate risks posed by overreliance on a bank-dominated financial sector. Contractual savings can provide stable and sophisticated institutional demand for long-term asset classes and strengthen the economy's resilience to shocks. The commercial insurance market, which is evolving rapidly in terms of premiums, products, and diversity, could play an important role. While the sophistication of the largely foreign-owned life insurance market is increasing, performance of the nonlife sector remains relatively lackluster. There is a need to adopt and enforce international financial reporting standards for all insurance companies, and to increase the effectiveness of compulsory insurance products. The Insurance Supervisory Agency (ISA) requires greater autonomy and more needs to be done to strengthen the agency's capacity to support a shift towards principles-based supervision. Overly optimistic accounting practices and significant conflicts of interest at the commercial end of the market require attention as well.[6] 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.

[5] 77% of interbank turnover in 2012 was undertaken for tenors of 1 week or less, largely unchanged from March 2009.
[6] Insured entities and insurance companies are often both owned or controlled by the government.

8. **Previous development efforts lacked coordination.** The financial sector has developed along product lines given an apparent preference of authorities to develop formal systems and trading models for every product, creating a patchwork of markets. Laws and regulations are supported and issued by various regulatory bodies in a layered patchwork fashion without sufficient coordination or collaboration, and specific capital market infrastructure supports unique functions with limited cohesion. Cooperation even within single regulatory bodies is weak. Repurchase agreements are subject to multiple layers of supervision. Reporting of bond transactions is executed through an equity-style trading platform that relies on brokers acting as put through agents. Experience in emerging markets shows that such equity based transaction systems tend to inhibit bond market liquidity. The debt market contained over 400 small issues, a large part of which is not traded.

9. **Investor and consumer protection is lacking.** There is a general lack of capacity, which impacts financial sector development. Understanding of economic, financial, and legal principles is generally low, which contributes to a disregard of regulations and standards by companies. This problem has remained largely unchecked as regulatory agencies, such as the State Securities Commission (SSC) and the Insurance Supervisory Agency, have limited enforcement capabilities and are insufficiently independent. Regulatory response times are slow, and professional organizations intended to be self-regulatory are too few and require additional training to supplement the regulatory process. The market surveillance and monitoring capability of the SSC needs strengthening, with expanding and clarified roles for self-regulatory organizations. Consumer protection also needs to be enhanced in the rapidly expanding insurance and microfinance subsectors in terms of new regulations and accounting standards, risk-based regulatory oversight, and strengthened information exchange.

10. **Overall quality of basic financial infrastructure is poor.** International Accounting Standards are not fully embraced, which presents difficulties for financial market development. For example, the Law of Accounting requires cost-based valuations rather than fair or market value. Key incentives that encourage discipline through risk management and the development of technical skills will therefore be lacking. Moreover, restrictive presentation rules for financial statements are not in accord with those stated in International Financial Reporting Standards. The Ministry of Finance (MOF) is required to guide the application of management accounting suitable to each field of activity, which diverts scarce resources and runs counter to the purpose of having an international standard. In the securities market, there is a lack of certainty regarding settlement finality and netting as there is no precedent as to how a defaulting broker or bank would be administered. Moreover, the settlement process and Viet Nam Securities Depository (VSD) face a number of legal and operational challenges. For example, the cash leg of securities settlement relies on a commercial bank, and emergency funds to support the settlement process are inadequate in size but are used almost constantly to force delivery versus payment. While operations have been strengthened, a money market survey identified settlement issues, transaction costs, and collateral management as major constraints to developing a repo market.

2. Government’s Sector Strategy

11. From 2000 to 2010, the government laid the foundations of capital market development. Measures were implemented to begin harmonizing the legal and regulatory framework with international standards. A program of “equitization” of state-owned enterprises, including banks, was initiated to raise capital and provide listings for the fledgling stock market. To set the foundation of the stock market and strengthen oversight and supervision of the market, the government promulgated and amended a Securities Law supported by regulation that strengthened corporate disclosure requirements and the supervisory, investigatory, surveillance,

and enforcement mechanisms of the SSC. The two stock exchanges, the VSD, and settlement systems were established in this period as well. Other important 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.

12. **Strategy for 2011 to 2020.** As part of its Socio-Economic Development Plan, the government developed a detailed sector road map for strategic development of the Vietnamese capital market to address a wide range of market infrastructure bottlenecks that impede capital market growth. The government will continue to support growth in the stock market through its equitization program, but equal focus will be applied to the money markets, debt markets, and insurance subsector.[7] Immediate priorities include (i) deepening the government bond market; (ii) building a risk-free yield curve that can be used to price corporate bonds and other financial instruments; (iii) strengthening the capacity of regulators, market participants, and self-regulatory organizations; (iv) amending the accounting law; and (v) enhancing coordination between regulators and government agencies. The VSD will be upgraded to a central clearing house, combined with the stock markets under a holding company with diversified ownership.

3. ADB Sector Experience and Assistance Program

13. The Financial Sector Program Loan (Phase I) supported the introduction and adoption of basic concepts and systems integral to a market-based financial system and economy.[8] Phase II supported the development of a more diversified, competitive, and resilient finance sector.[9] Phase III systematically built capacity for finance sector development.[10] ADB's most recent country assistance program evaluation recommended continuing financial and technical support for finance sector reform.[11]

14. ADB now proposes to narrow its focus to achieve more targeted and catalytic results. Policy-based assistance will improve the efficiency of the money market, deepen the nonbank financial market, and improve the capacity of public and private institutions in the financial sector. Support to execution of the money market development master plan and strengthening the required legal and operational framework will ultimately allow the government to better manage inflation through monetary intervention. Deeper bond markets will be supported through measures that improve the predictability and operation of the issuance process, develop a risk-free yield curve, increase transparency and information disclosure, and enhance the regulatory and supervisory framework. When successful, these measures will enable the channeling of more long-term funding to much-needed infrastructure projects. Ancillary support will be focused on reducing operational risk in the securities settlement process and promoting insurance. Capacity development will be focused on developing in-house debt sustainability analysis within the MOF; bringing insurance law, accounting standards, and public disclosures in line with international sound practice; and developing human resources at the SSC and SBV.

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[7] The principal activities of the insurance industry road map are to i) improve the legal system; ii) enhance the effectiveness, competitiveness, and soundness of insurance enterprises; iii) develop and diversify insurance products; iv) diversify distribution channels; v) strengthen management within the industry; and vi) accelerate international integration and cooperation.

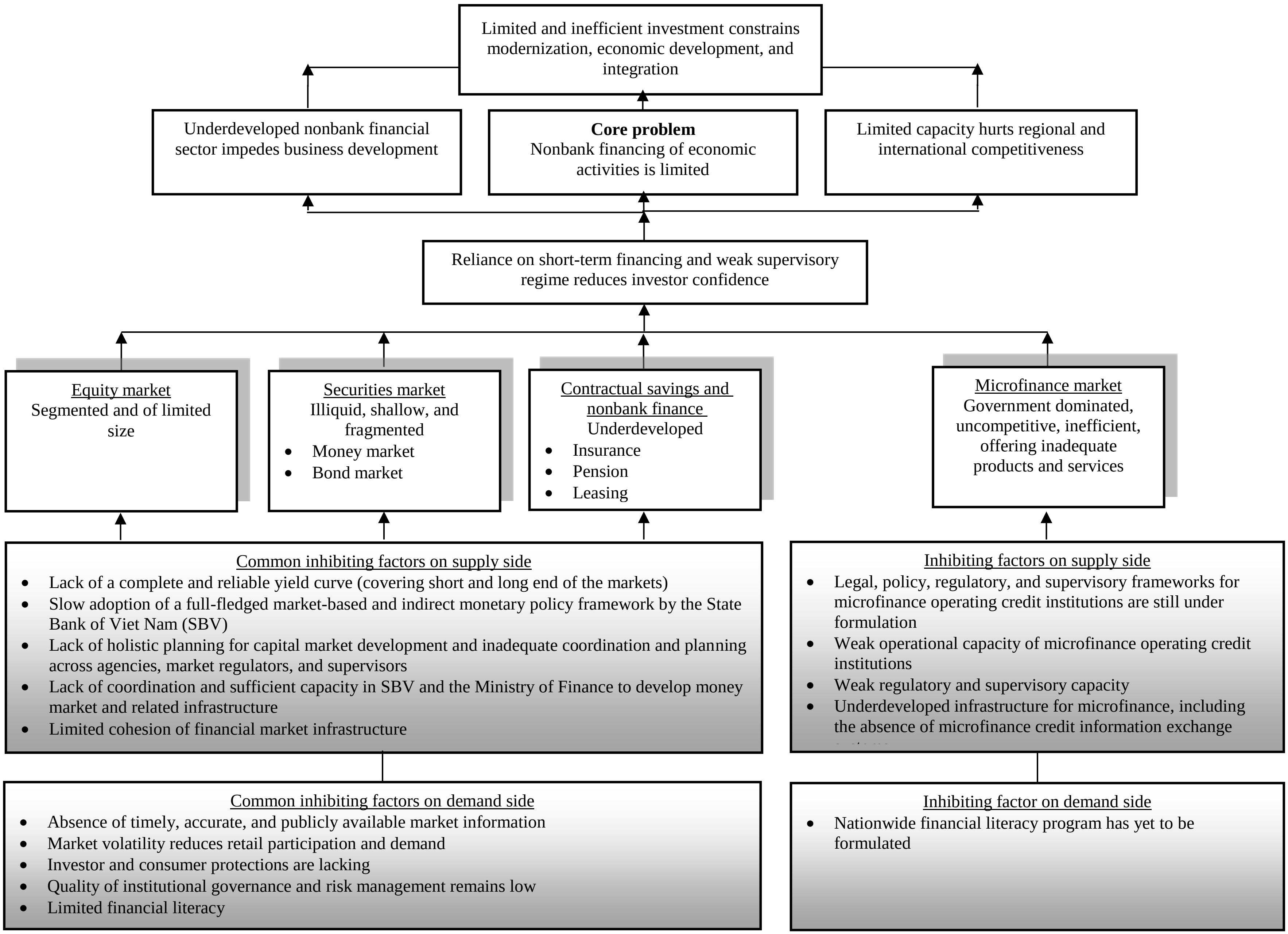
[8] ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan to the Socialist Republic of Viet Nam for the Financial Sector Program Loan.* Manila.

[9] ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan Cluster to the Socialist Republic of Viet Nam for the Financial Sector Program Loan II.* Manila.

[10] ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan Cluster to the Socialist Republic of Viet Nam for the Financial Sector Program Loan III.* Manila.

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

Problem Tree for the Financial Sector



Sector Results Framework (Finance, 2012–2015)

Viet Nam Sector Outcomes		Viet Nam Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**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 financial 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 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).	**(i) Planned key activity areas** Enhanced capital market size and liquidity, increased insurance coverage and old-age protection, strengthened institutional framework, and better staff capacity. **(ii) Pipeline projects** A well-functioning money market, deeper and more liquid financial market, and improved institutional capacity.
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.	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).	Microfinance Development Strategy and road map approved, increased number of licensed microfinance institutions and cooperative banks, reporting 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

ADB = Asian Development Bank, ADF = Asian Development Fund, CIC = Credit Information Center, 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, VBSP = Vietnam Bank for Social Policies.
Source: Asian Development Bank.