Financial Leasing Activities in Vietnam

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Since 1990, the economy of Vietnam has grown quite rapidly and steadily compared with those of other Southeast Asian countries. One of important factors contributing to this achievement is the new policy on economic development and investment, which allows chances for enterprises to invest in and extend their business. Apart from foreign investment of official and private sources (ODA, WB, ADB, FDI, etc.) tens of thousands of billions Vietnam dongs (VND) are invested by domestic financial and banking institutions for the purpose of business investment and extension. However, financial and banking institutions lending capital for renewing machinery, equipment and technology encountered many difficulties and drawbacks. Hence, enterprises found it quite difficult either to invest in machinery and equipment that can bring products and compete with imported goods in respect of quantity, quality and price, or to reach international markets.

Financial leasing activity is an important long/medium-term capital funding channel for enterprises to equip or renew equipment and manufacturing technology. Therefore, since 1993, the International Financial Corporation (IFC) has been consulting the State Bank of Vietnam (SBV) on the study and preparation of regulations on financial lease in order to bring this technology into Vietnam.

I. THE LEGAL FRAMEWORK FOR FINANCIAL LEASE

1. Legal regulations

a. Stage 1 (from 1995 to 1998):

In this period, banking institutions were subject to the "Ordinance of the State Bank" and "Ordinance of Banks, Credit Co-operatives and Finance Companies" issued by the President of Vietnam.

On Oct. 9, 1995, the Government issued Decree No.64/CP on "Temporary regulations on the organization and operation of the financial leasing company in Vietnam" and on Feb. 9, 1996, the SBV issued Circular No.03/TT-NH5 providing guidance on implementing Decree No.64/CP. These documents are the basis for the establishment and operation of the financial leasing company (FLC) in Vietnam.

b. Stage 2 (from1998 to date):

- Financial leasing activities are regulated in Articles 61, 62, 63 of the Banking Institutions Law, which came into effect on Oct. 1, 1998.

- After more than three years since the effective date of the Banking Institutions Law, on May 2, 2001, the Government issued Decree No. 16/2001/NĐ-CP on the organization and operation of FLC. On Sep. 9, 2001, the SBV issued Circular No. 08/2001/TT-NHNN providing guidance for implementing Decree 16/CP.

2. The concept of financial lease in Vietnam

As by the Banking Institutions Law: Financial lease is a long/medium - term credit activity, which bases on an asset leasing contract between the lessor (the banking institution) and the lessee (the end user). When the leasing period is over, the lessee can buy the asset or continue to lease the asset as agreed in the leasing contract's articles. During the leasing period, neither party can unilaterally annul the contract.

Financial lease to enterprises and individuals are done by financial leasing companies.

3. Types of FLCs

According to Decree 16/CP, five types of FLC have been allowed to be founded and to operate in Vietnam. They are:

a. State-owned FLC: the type of FLC that is invested, established and managed by the State.

b. Joint stock FLC: the type of FLC that is established in the form of joint-stock companies, in which organizations and individuals contribute their stock as regulated by law.

c. FLC belonging to banking institutions: the type of FLC that has independent accounting systems, possesses legal entity status, is founded by a banking institution by its ownership capital and owned by the entity as regulated by law.

d. Joint-venture FLC: the type of FLC established by joint-capital based on joint-venture contracts between a Vietnamese party including one or more banking institution, enterprises and a foreign party including one or more foreign banking institution.

e. Foreign-invested FLC: the type of FLC that is established from the capital of one or more foreign banking institution as regulated by the Vietnamese law.

4. Operating scope and content of FLCs

Current legal rules of the State allow FLCs to operate all over the Vietnamese territory. All the above five types of FLCs have equal operational content, which are:

a. Capital for operation:

- Owners' capital: legal capital and supplementary funds.
- Mobilized capital: this kind of capital is gained from receiving deposits with terms of more than one year, issuing bonds, deposit certificates and other valuable papers with terms of more than one year, borrowing from domestic and foreign finance/banking institutions.
- Other capital that can be received as regulated by the SBV.

b. Financial leasing activities:

- Financial leasing;
- Buying and releasing assets;
- Financial leasing co-funding.

c. Other activities:

- Other professional activities regulated by current law:

+ Consulting clients on issues related to financial lease;

+ Providing entrust services, asset control and other services that are related to financial lease;

- Other activities allowed by the SBV:

+ Foreign exchange activities: The foreign exchange activity license will regulate which activities the company is allowed to undertake, depending on the nature of its operation.

+ Other activities.

II. FINANCIAL LEASING RESULTS IN VIETNAM UP TO 2002

1. Performance of FLCs

a. Network and organization:

By the end of 2002, there were nine FLCs established and granted operation licenses in Vietnam. They include two foreign-invested companies, two joint-venture companies between Vietnam commercial banks and foreign partners, five domestic companies belonging to four state-owned commercial banks. However, one joint-venture company has merged into a domestic company, so there are in fact 8 FLCs in Vietnam currently. The total number of staff working in these companies is around 350 persons.

b. Capital:

FLCs' capital sources by the end of 2002 are as follow:

Table 1:Sources of capital of FLCs (VND million)

Target	2001		2002	
	Balance	% of total	Balance	% of total
I. Owner capital:	688,416	35	793,543	25
1. Legal capital	667,466		752,051	
2. Funds	11,858		40,048	
3. Gross profit	9,092		1,444	
II. Loan capital from banking institutions	944,876	48	1,723,842	55
III. Mobilized capital	87,000	4	240,665	8
- Deposits	0		145,165	
- Valuable papers	87,000		95,500	
VI. Provision for risk	32,152	2	54,854	2
V. Income before tax	43,248	2	45,645	1
VI. Other capital	167,659	9	262,722	9
Total	**1,963,351**	**100**	**3,122,538**	**100**

The total legal capital of FLCs at the time of establishment is VND914 billion (US$30 million and VND452 billion- the exchange rate at that time is US$1/VND 15,000). These FLCs are allowed to mobilize 20 times as much as their owners' capital to lease to enterprises. Therefore, with the current legal capital, FLCs are allowed to mobilize and lease approximately VND20,000 billion. The proportion of owners' capital in the total capital of FLCs tends to decrease. The figure was 25% in 2002.

- Loan capital: Due to the fact that FLCs have not undertaken foreign exchange activities, their loan capital is mainly in VND from commercial banks and other banking institutions. Up to the end of 2002, this type of capital amounted to VND1,723 billion, accounting for 55% of the total capital. This type of capital tends to drastically increase as companies have promoted leasing activities but have not yet mobilized more capital.

- Mobilized capital: as regulated by current law, FLCs are only allowed to receive deposits with terms of more than one year and are allowed to issue valuable papers when permitted by the SBV. Up to the end 2002, FLCs only mobilized some VND240.6 billion, which accounts for 8% of their total capital.

- Other capital: During their operation, FLCs have formed various funds to engage in leasing activities, such as lessees' security deposits, and other payables which account for nearly 9% of their total capital.

FLCs also formed provision for risks of nearly VND55 billion to deal with unexpected risks.

c. Use of Capital

Financial leasing activities:

The main operation of FLCs is to lease to small and medium sized enterprises. Up to 2002, the balance from financial lease was VND2,544 billion and from investment in leasing assets was VND225 billion; thus, capital invested in financial lease consisted of 89% of the total assets. This debt balance made up 50% of the total debt balance of all non-banking institutions in Vietnam. However, this number is still modest compared with the entire capital investment of all banking institutions in the economy.

Up to the end of 2002, the total overdue debt balance of FLCs was VND75

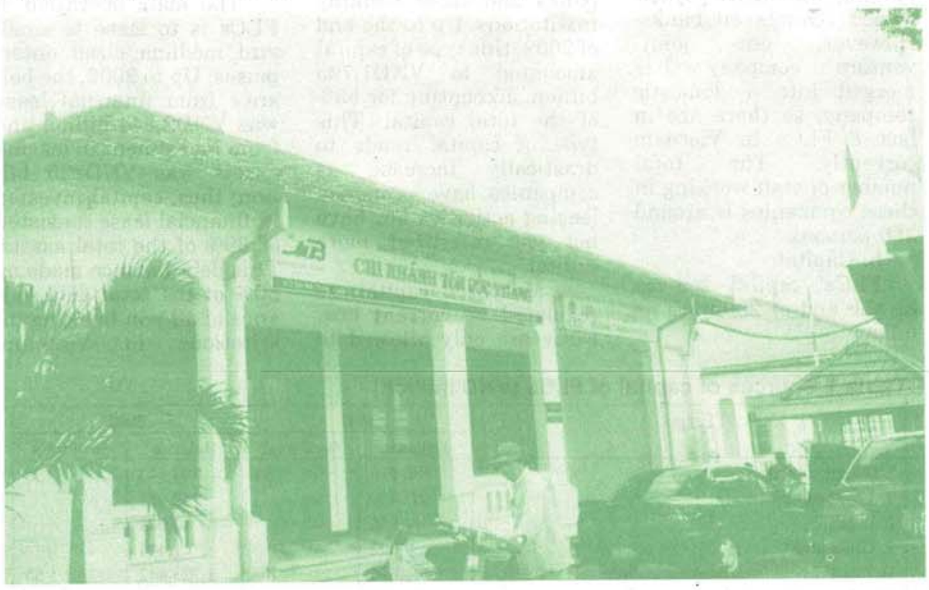
Table 2: Capital utility by FLCs at the end 2002 (VND million)

Target	2001		2002	
	Balance	% of total	Balance	% of total
I. Leasing assets	1,535,418	78	2,544,473	82
II. Investing in leased assets	122,324	6	225,728	7
III. Using other capitals	305,609	16	352,337	11
Total	**1,963,351**	**100**	**3,122,538**	**100**

billion, making up 3% of the total debt balance. However, many contracts where the lessees could not pay on time have renewed. These leasing debts will be potential risks for FLCs.

2. Business outcome

Despite of time limitation and small-scale operation, most FLCs in Vietnam have gradually stabilized operations and have started to make profits. The total profits before tax up to the end of 2002 was VND45.6 billion. Of eight FLCs, six showed profits and two companies were still in the red.



III. ADVANTAGES AND DISADVANTAGES OF FINANCIAL LEASE

The fundamental reason for the continuing growth of financial leasing activities is that it meets the needs of so many companies of all shapes and sizes. For example, mature, profitable companies may lease equipment to keep bank credit lines open for other purposes. Young, start-up companies lease to conserve cash, and firms requiring state-of-the-art technology lease equipment to avoid technological obsolescence and preserve the ability to update. Financial leasing meets the different needs of each company. Large companies that want to leave managers free to acquire small, non-capital budget items of equipment; mid-sized companies that cannot tap the stock or bond markets; and small companies that like the convenience of financial leasing all utilized this creative financing alternative.

1. Advantages

Financial leasing has addressed an unmet demand from new, small- and medium-sized firms and attracted borrowers away from traditional bank loans. It offers advantages to all parties.

a. For the economy

Every country needs a certain capital source to operate their economy. Countries that are on the way to economic development and worldwide integration have a great demand for capital for industrialization and modernization. To this end, the countries have to innovate in their technology, facilities, machinery and so on. At present, many businesses still employ outdated and faulty machines, which results in low productivity, high cost and bad quality. In order to survive well in a competitive market, businesses must be re-equipped with modern facilities to increase output, quality and export and import value.

Financial leasing has a close link with machine and technology innovation and production expansion, especially for small- and medium-sized businesses in the private sector. Thanks to the variety and diversity of leased assets, financial leasing can satisfy different demands of businesses for facility innovation and production expansion. Particularly, finance lease is an effective way to raise a huge capital source through middle or long-term capital mobilization and joint ventures so that it can create an outside capital channel for the economy.

Financial leasing helps equipment suppliers, both domestic and foreign ones, to sell their equipment to companies that didn't have enough money to purchase new capital goods.

In addition, many governments have promoted leasing as a way for encouraging new investment. Financial leasing helps accelerate technological development, diversify finance institutions, provide the economy with medium- and long-term capital and it lays a foundation for the establishment of a solid capital market. Financial leasing also offers other benefits: it broadens competition in financial services and introduces businesses and financiers to innovations such as cash-flow-based credit analysis.

b. For the FLCs

Financial leasing is considered a safer way for funding than other methods for the following reasons:

- Ownership of the asset gives the lessor strong security. In countries where weak collateral laws (like Vietnam, for example) hinder bank lending, leasing offers the advantage of (often) not requiring collateral beyond the security of the leased asset itself, and of simpler repossession procedures, because ownership of the asset already lies with the lessor. Therefore, the lessor also has the right to take back possession of their assets in case the lessee violates the financial lease contract and the two sides cannot reach an agreement. In case the lessee falls into bankruptcy, the leased assets will not be put on sale and are still under the ownership of the lessor.
- The risks linked with asset ownership are transferred to the lessee. The lessee has the responsibility for preserving and taking care of the leased asset and paying for the damage or loss of the asset.
- The lessor has the right to ask for a physical insurance from the lessee during the lease term and the lessor is entitled to this benefit. If the loss happens accidentally, the contract is broken and the lessee cannot afford the compensation, insurance companies will pay losses for the lessor.
- Dedicated use of funds: Because the lessor purchases the equipment directly from the supplier there is no opportunity for

the lessee to use the funds for other purposes. In this way, the lessor will not have to face impediment in controlling the usage of asset.

- Relatively simple documentation keeps transaction costs down, allowing leasing companies to achieve high leasing volumes efficiently.

c. For the lessees

Financial leasing is an important source of long- and medium-term capital for companies in many countries, regardless of their size and production profile, allowing them to increase production and grow their fixed assets. Although financial leasing is a high-spread business, it offers potential advantages to the lessee:

- Financial leasing, as an alternative financing mechanism, can play a major role in renewing fixed assets of industrial companies, allowing them to grow and increase their productivity. The small business sector has been identified as a potential source of increased economic growth. Financial leasing is an effective mechanism for financing this sector, which the banking sector has traditionally passed over.

- Simpler security arrangements and the less strict requirements for historical balance sheets mean that the lessee can access lease finance more easily than bank loans.

- Availability: In developing countries, leasing may be one of the few forms of medium- to long-term finance available for purchasing equipment.

- Convenience: Financial leasing can be arranged more quickly and simply than conventional loan financing because outside security often does not need to be established. Therefore, the leasing procedure is much simpler, more flexible and less time- consuming than borrowing from banks. The lessee has a free choice of the machines, facilities, producer, suppliers, technical characteristics, means and time of transaction, installation and insurance, and price.

- Little cash required: The lessors have to purchase the assets directly under the demand of the lessee and pay the total value of the assets. So, they can finance a higher percentage of the capital cost of equipment than bank borrowing, often with little down-payment; and even support the whole value of the assets wanted by the lessees.

- Flexibility: Financial leasing contracts can be structured to meet the cash flow needs of the lessee. In case the lessees use their equity capital or short-term capital source to buy machines and facilities and do not have enough working capital to buy materials and services for production and business, they can sell and lease back their assets. Therefore, lessees have both assets and working capital to operate.

- Tax incentives: In many countries lessees can offset their full lease payments against income before tax, compared to just the interest on bank loans. Furthermore, lessors may pass on tax benefits associated with their depreciation to lessees via reduced financing costs. Governments grant tax incentives to leasing because they recognize that it enables new and small firms to access financing for investment.

Current regulations in Vietnam allow businesses to reduce the time of accelerated depreciation to fixed assets by 60% of the time regulated by the Ministry of Finance. Businesses, especially those who are flourishing, have a chance to readjust the benefits and income tax at their own disposal even when they are in debt. After businesses pay the total lease costs, the ownership of assets will be transferred or purchased at a nominal price. In theory, the assets have a low value and were fully depreciated but in fact, the real value and use value of the assets still remains rather high, both businesses and the government can earn real revenues due to low cost for asset depreciation and low price of products. Moreover, accelerated depreciation also helps save the leased assets from physical wear and tear and obsolescence, minimizing the risks of assets becoming outdated, and upgrading assets with more advanced technology before the lease ends.

2. Disadvantages

- Lessees are not the owners of the assets so they cannot mortgage the assets even after paying the most part of their finance lease.

- Lessees do not have an active role in using the leased assets. Regulation stipulates that without the agreement of lessors, lessees can not readjust the position, structure and form of the machines to make them conform to the present production line.

- Financial lease is usually more expensive than medium and long-term loans because lessees have to pay for arrangement fees, asset valuation and interest for lessors.

- Leased assets relate to technical and technological equipment, so that it can meet many potential risks that might affect the effectiveness of financial lease.

Financial leasing activity is, without doubt, the creative financing alternative of so many enterprises in the world generally, and in Vietnam today in particular. It is an imposing industry in terms of scope, size and potential, as more and more of the world's equipment needs are met through this form of financing. Financial leasing offers many benefits to all parties in the transaction, including low payments and off balance sheet financing to lessee, and financing income to the lessor. The range of equipment being leased is vast. Leasing truly has something to offer everyone.

Although financial leasing has just been established in Vietnam, this financing activity has been developing steadily and is getting good results. Financial leasing is to become one of the most important sources of long- and medium-term funds for companies, encouraging them to expand their production and to integrate into the international markets.■