ASYMMETRIC INFORMATION AND THE NEED FOR FINANCIAL REGULATION

CASE OF THE VIETNAMESE BANKING SYSTEM

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Bank failures around the world in recent years, especially the financial crisis in East Asia in the late 1990s, have pushed us into reconsidering the efficiency of the existing financial regulations and supervision. Although many "laissez-faire" academic economists attribute these crises to the side-effect of regulatory efforts, it's acknowledged that more attention should be paid to the reinforcement of financial regulations.

I. NATURE OF ASYMMETRIC INFORMATION

In most developing countries, open markets for stocks, bonds, mortgages and commercial papers are of no great importance. It is this missing which makes private financial savings constrained only by claims on the banking sector; and thus creates more risks in this bank-based capital market. Asymmetric information is a typical characteristic of the credit market between borrowers and savers. The borrowers know more in detail and evaluate more accurately their projects than the lenders do. When the banking services are non-homogeneous, this information becomes essential to banks. The homogeneity may be understood in the sense whether the buyers (borrowers) regard the products (loans) of all sellers (banks) as identical and whether the sellers have certain preferences as to the buyers. Nevertheless, because different borrowers involve different risks, banks need to construct an efficient portfolio which requires adequate information to distinguish between different borrowers.

II. MEASURES TO DEAL WITH IMPERFECT INFORMATION

1. Monitoring process in the banking system

According to Charles Goodhart (1998), there are four main reasons that prudential regulation and supervision are required to be applied to the banking system:

(i) the pivotal role of banks in the financial system,

(ii) the potential systematic crisis in the banking system,

(iii) the nature of bank contracts, and

(iv) adverse selection and moral hazard that may incur during the bank's performance as the lender of last resort and the supplier of other safety net.

Banks play a pivotal role in the financial system because they have financial relation with a large number of borrowers and they take the main part in clearing and payments systems. While a normal firm's failure has limited influence over other entities, a jeopardy of a certain bank may cause chain- reaction damage in the economy, especially in the people's confidence which will threaten the whole banking system eventually. This is a result of the much tighter interconnectedness of banks in the clearing and payment systems than that in most other industries.

Banks need to make optimum effort to reduce the risk of their lending thanks to information from institutions recording the overall net exposure of each borrower (Cosci 1993). This advantage is attained thanks to economies of scale in banking activities. Moreover, banks also can take advantage of scale economics by reducing agency costs of monitoring and controlling borrowers. Specialization in information production about firms may help banks sort out a good from a bad risk, and thus make more profit which in turn encourages information supplying activities. As a result, asymmetric information will reduce gradually. Given these advantages, banks may have much expertise in monitoring the implementation of the financed project. As a lender, banks may also try to intervene when something wrong is recognized. In order to make use of these advantages, banks need to apply a strategy of extending small and short-term loans if necessary, so that direct control and sanctions from banks become easier, and thus the risk is smaller.

On the customer's side, how is the monitoring process performed? Financial market is considered special because its services are contracted and paid at different points of time, especially in investment contracts which are usually of long terms, the existence of risk is natural. Unlike the value of normal goods, a financial contract's value to the customer is often determined by the financial institutions after the service is purchased. Therefore, customers find it difficult to exit the contract at low cost. To protect customers as well as improve efficiency of the financial institution's operation, continuous monitoring is required. Then, the question is raised here: who will undertake it?

In case the customer does it by himself, he should spend some time, money and energy investigating operation of firms supplying financial services. In the economy as a whole, two sets of costs are involved: (i) substantial duplication of the monitoring process by each individual, this results in excessive social cost; and (ii) inability to exploit economies of scale in monitoring. Besides, in the absence of a specialist agency conducting the monitoring process, "free-rider" problem may occur among customers.

Disadvantages of individual monitoring account for the need for a specialist agency responsible for performing regulations and supervision over the whole financial system.

2. Other measures

Besides prudential regulations and supervision, banking theory also points out some other measures to deal with the imperfect information. Although this is not the focus of this paper, it sounds helpful to take an eye on them.

Asymmetric information makes banks face the problem of selection or the repayment risk. To cover this risk, banks can decide to raise the lending rate. Nevertheless, an increase in the interest rate may lead to (i) an adverse selection effect by dropping out safe borrowers with projects of less risk and less return and attracting riskier borrowers who are ready to accept the costly loan offer, and (ii) an incentive effect by implicitly encouraging borrowers to plunge into projects that are expected to be more profitable and thus riskier. Both effects may damage banks, especially in case they outweigh the beneficial effect when the bank gets a bigger income from projects financed by the bank.

Although the repayment risk can be covered by a higher interest rate, theoretical and empirical studies have proved that lenders prefer credit rationing to different classes of borrowers (Vos 1995). One reason may lie in the fact that banks can't charge different lending rates to different borrowers according to risk degree. Further, honesty and risk aversion are different among borrowers, so a widespread increase in the lending rate may encourage borrowers to choose riskier projects which are expected to produce larger return once they are completed successfully. If their projects fail, borrowers don't encounter a bigger loss. In this case, there is no coincidence of the lenders' and borrowers' interests, and the former can't control the latter's behavior. In other words, the "moral hazard" will happen. Hence, the adverse selection and incentive effect in the environment of costly and imperfect information make banks unable to assess and monitor borrowers effectively. As a result, they decide to practice credit rationing, consider borrower's balance sheet carefully and demand collateral in order to ensure their income.

Borrowers can be required to offer collateral which can guarantee banks to run no risk when lending at the market interest rate. This measure increases the own stake of the borrower in the project and reduces risks for the lender. Nevertheless, this clearly works against small and potential enterprises whose collateral is limited.

Banks are also recommended to make efforts to establish long-lasting relations with borrowers. This is expected to make banks' monitoring easier and better. Borrowers in their turn have an incentive not to cheat or default, hoping to maintain a good relation with banks. As such, if intermediaries always keep a stable relation with their customers (the firms), they can successfully overcome the problem of information imperfection. Then they will become more efficient and dynamic in monitoring the borrowers. After capturing this available information disclosed by the borrowers, these intermediaries easily exploit this monopoly power and attain an informational advantage over their competitors. This eventually leads to inefficiency in resource allocation, especially in an underdeveloped financial mechanism common among developing countries.

The final measure to deal with asymmetric information is the establishment of interlocking ownership. The "in-house" lending between banks and firms in the same economic group clearly escapes from the influence of asymmetric information between borrowers and lenders. However, financial intermediaries existing in these economic groups usually operate just for their own objectives, regardless of the interests of the creditors and depositors outside the groups. This, as a result, leads to an ineffective allocation of resources in the economy as a whole.

III. FINANCIAL REGULATION IN THE VIETNAMESE BANKING SYSTEM

Under the centrally-planned mechanism, the Vietnamese government imposed almost no effective regulations or supervision on the banking sector because of the absence of competition in the financial system. When the financial system was deregulated, the imperfect competition led easily to moral hazard that deteriorated the efficiency of the whole financial system as well as the banking sector. Hence, an effective framework of banking supervision and prudential regulations is actually an important instrument to attain an optimal efficiency of banking activities.

The first prudential regulation applied in Vietnam was the minimum capital requirement. The banking institution must guarantee a minimum 5% capital-to-asset ratio and not mobilize deposits exceeding 20 times bigger than its capital and reserves. This requirement serves as a protection against doubtful debts and apparently takes the repayment risk into account as a potential cost. But this cost isn't considered as a tax deductible expense. Further, the simple ration of capital to asset doesn't reflect fully all risks associated with different types of banking activities. Thus, these prudential regulations sound inappropriate and raise little interest from banks. Second, lending limits, in an effort to disperse risks, require that loan to a single customer not to exceed 10% of the bank's capital and reserves, and to the top ten borrowers not to exceed 30% of the total loan. However, this regulation sounds infeasible because there is no rule stipulating how loans are to be combined under these lending limits. Finally, it is not allowed to let investment in equity participation exceed 10% of the capital of all participants, or total investment in equity participation exceed 50% of the bank's capital and reserves. Additionally, the total amount of loan to insiders and connected parties mustn't pass an upper limit of 5% of the bank's capital. These regulations which aim at maintaining the discipline among banking institutions and alleviate repayment risk are rather ineffective when political pressures prevail and a suitable policy on bank collateral is still lacking.

To manage the banking system better, the SBV conducts on-site inspection every three years and off-site examination every month. The recent collapse of many big companies, such as Tamexco, Minh Phụng and Epco, however, was attributed to weak banking supervision which resulted from the close linkage between bank officials; enterprises and political pressures; and inept and badly-trained supervisors. In addition, the banking supervision performed at the moment looks like internal audit rather than bank inspection.

Furthermore, off-site examination was less reliable because of the bad quality of reported data which resulted from rudimentary information used for internal management at many banks, untimely-mannered compilation of information, incomplete regulations on debt classification and weaknesses in definitions or application of prudential regulations. For example, the calculation of overdue debts including only delinquent payments and the inclusion of state companies' debts in the bank's current investment portfolio obviously understated the amount of overdue loans by the banking system.

So far, ineffectiveness of existing prudential and supervisory framework has become an impediment to the financial system's stability and development when the supply of bank credit is on the increase. Therefore, an immediate improvement in the banking supervision and prudential regulations is a prerequisite for the healthy development of the banking system.

IV. EFFECTIVE FRAMEWORK OF PRUDENTIAL REGULATIONS AND SUPERVISION

Commercial banks in Vietnam, especially private joint stock ones with small capital, find it difficult not only to solve existing non-performing loans but also to maintain operation and development in the future, especially when Vietnam integrates fully into the world market. Therefore, to increase their capital is the essential measure for banks to improve their financial standing, competitiveness and immunity to market fluctuations.

To enhance the supervisory function of the SBV, the Government may establish an institute alarming and countermeasuring any potential risk, and adopt a policy to get rid of badly-managed banks without causing instability. Further, special annual audits of banks are urgently required not only to maintain public confidence in the banking system but also to deal with any emerging problem. This program of portfolio audits is also a basis for the SBV's tasks of determining banks' asset quality and establishing minimum capital requirement.

In addition to the supervisory function, the self-supervision needs to be encouraged. Annually, banks should undertake reassessment of lending to each borrower as well as general evaluation of the remaining lending. Improvement in information collection and distribution among banks also helps enhance the effectiveness of the existing supervisory framework.

In Vietnam and other developing countries with fragile financial institutions, the urgent issues are to make the tradition financial regulations more effective, to levy a proper ratio control on capital, to hinder connected lending, and to minimize political influence on management decisions.

In this stage of development, many foreign banks enter the Vietnamese market and vice versa, Vietnamese banks are expanding their operation abroad. This globalization trend in the banking business sharpens the need for strict financial regulations. Our banks' credit standing will be threatened if our regulatory requirements fail to reach international standards. Although there is no formal request for banks to do so, the common recognition that sound experience underlies international requirements and that these requirements are worth adopting has pushed our banking system into making financial regulations appropriate to international counterparts.■

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