



# IDENTIFYING RISKS INVOLVED IN LENDING FROM COMMERCIAL BANKS TO INVESTORS IN STOCK

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**T**he stock market in Vietnam has experienced many wide fluctuations. After gaining a growth rate of 20% or higher for four successive years, the VN-Index in 2008 lost 66% of its value. Many factors have affected it, such as the global financial crisis, income tax on investments in stock, anti-inflation policies, etc. but this paper only aims at analyzing risks involved in lending by commercial banks to investors in stock, which has been considered as both cause and consequence of fall in the stock exchange.

## 1. Before Directive 03/2007/ CT-NHNN

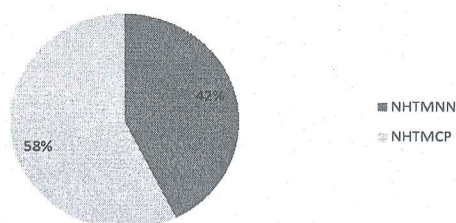
There were many factors in this period affecting operations of commercial banks. Rises in the stock prices reduced the demand for long- and medium-term loans, and at the same time, made it difficult for them to attract idle money because depositors withdrew their money to buy shares. The surge in demand for share is an important dynamic and favorable condition for privatization of state-owned commercial banks and issues of new shares by banks to increase their chartered capital and improve their public images. This situation encouraged many commercial banks to increase continuously their chartered capital with a view to gaining profit (as shares of commercial banks get much dearer) without paying much attention to their services and operations. And as a result, their business performance got poorer and they were forced to improve it, which made them less cautious about their business, especially lending. Quick developments of the stock market made

many investors discover sources of big profit from financial investments. In 2006-07, the bank lending rate varied between 12% and 14% a year while the profitability ratio of investments in stock was much higher than that of other investments (in gold, real estate, or bank deposits), which made most investors to move to the stock market. Particularly, idle money of small savers, which used to be put in saving accounts, was also turned into investments in shares.

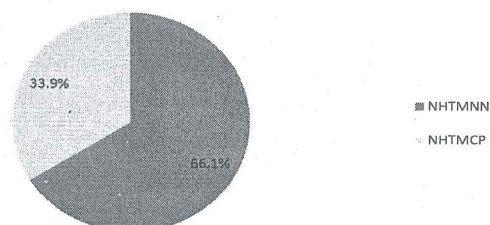
Turning bank loans into investment in securities became a common trend during the upsurge of financial investments. To secure bank loans, many investors have mortgaged their other assets (real estate and movable property) to banks. In most banks, the disposable capital is abundant and they were ready to supply loans at low interest rate and favorable conditions. In addition, many commercial banks also cooperated with securities firms to trade securities in large quantity, and supply short-term collateral loans, with the result that the outstanding loan to investors in securities skyrocketed, representing some 10% of the total loan in some major banks; and up to 40% in some newly established banks.

We can see that the source of loans from commercial banks supplied to the stock market has made the market hotter in the past few years. This source made securities have high liquidity but also produce a huge "virtual demand" with short-term transactions by day traders equipped with loan capital.

**Figure 1: Loans supplied to investors in securities by state-owned and joint stock banks in 2007 (%)**



**Figure 2: Total loan by state-owned and joint stock banks in 2007 (%)**



NHTMNN: State-owned banks

NHTMCP: Joint stock banks

Source: Financial statements by commercial banks in 2007 and author's calculations

Although the total loan by joint stock banks represented only 33.9% of the grand total loan of VND880,426 billion of the banking system, compared with the figure of 66.1% by state-owned banks, the outstanding loan to investors in securities by joint stock banks accounted for 58%, compared with 42% by state-owned banks, of this class of loan from the whole banking system.

## 2. After Directive 03/2007/CT – NHNN

This Directive from the SBV Governor on a stricter control over loans to investors in the stock exchange aims at curbing the inflation and promoting the economic growth. It requires banks to prevent risks when discounting negotiable instruments or supplying loans to such investors, and keep such loans at a level lower than 3% of the total loan. In addition, the supply of collateral loans or discount of negotiable instruments or commercial papers for investors in the stock exchange should observe strictly banking regulations. As for banking institutions where total loan of this kind is higher than 3% of the total outstanding loan, they had to collect repayment and reduce the total loan with a view to ensuring the

standard percentage before Dec. 31, 2007.

When the Directive came into effect, the total loan to investors in the stock exchange by all finance companies and commercial banks has exceeded the 3% limit. To avoid violation of banking regulations set by the Directive 03, many banks introduced various practices, such as:

- Increasing the supply of loans to investors in the realty market and other classes of customers in order to reduce the proportion of loan to investors in the stock exchange to the total loan.

- Transferring loans to investors in the stock exchange to brokerage firms acting as subsidiaries of the banks. Securities can be traded between the holding banks and their brokerage firms through repos, which help the brokerage firms keep on doing their business.

After the Directive 03, the Decision 03 by the SBV was made on Feb. 1, 2008 stipulating that commercial banks couldn't use more than 20% of their chartered capital to supply loan to, or discount commercial papers for, investors in the stock exchange.

After the Directive 03 and Decision 03, the lending rate offered by commercial banks started to increase while a tight- money policy was adopted by the SBV, the stock exchange showed a downward tendency, experienced wide fluctuations and various adjustments carried out by all parties, which affected badly many IPO plans and flows of indirect investment when foreign investors worried about prolonged fluctuations in the stock market.

From trying their best to secure loans, investors started selling out their securities making the stock market fall drastically. Facing such a situation, commercial banks and brokerage firms tried to retrieve loans. When many investors became default, what should happen happened: commercial banks and brokerage firms sold out securities they held as collateral to get some repayment. These reactions made the stock exchange develop unstably and unsustainably in the past few years.

Thus, the lending by banks for investors in the stock market has its double effects:

- The supply of bank loans to investors in the stock market helps improve the liquidity of the market and stimulate the trading activities. It is

a positive measure to encourage investment in the stock market but it makes risk degree of the bank lending higher.

- The supply of loans to securities investors produces an army of day traders and speculators. Their excessive activities led to virtual demand for securities and made the stock exchange less safe and more vulnerable to external effects.

### 3. After 2008

With drastic falls in late 2007, the stock market kept breaking its price-floor in 2008: its index fell to 600, and 500, and 400, and in 2009 it was below the 300-point mark. The global economic recession and poor activities in stock exchanges all over the world discouraged all investors and none of them thought of securing bank loans to buy securities. Although the supply of loan to securities investors was only limited, not cut, commercial banks could not attract any investors in spite of a controversy about whether the supply of such loan should be encouraged or not. In fact, however, the supply of bank loan is still necessary for the stock exchange when it needs stimulation.

To make the supply of bank loan a dynamic for the stock market, various measures should be taken by the SBV, commercial banks and investors employing the bank loans, and they should not pay too much attention without caring about possible risks. A look back on shortcomings and cause of falls in the supply of loan to securities investors by commercial banks is useful for minimizing risks to the banking system, the stock market and investors as well, and for working out basic solutions to the supply of loans to securities investors.

### 4. Shortcomings and causes of falls

In the stock exchanges in Vietnam, individual investors represent 90% of the investing community. These investors lack experience and necessary knowledge of the stock exchange, tend to follow any trend, get influenced by herd instinct and become day traders or speculators, and get vulnerable to fluctuations in market prices. On the other hand, organized investors have necessary experience and knowledge, make investments based on careful analyses and keep calm when facing fluctuations in prices. In principle, these organized investors plan a very important role in transactions of securities and operation of broker-

age firms because their activities set the pace in the market. In Vietnam, however, the organized investors failed to play such a role while commercial banks paid too much attention to individual investors instead of organized ones with the result that investment based on herd instinct became widespread and caused harm for the stock market. The supply of loans to securities investors by commercial banks was not controlled strictly and risks were not prevented properly. Many commercial banks ignored warnings against risks in trade in securities from the SBV and failed to observe banking regulations. The following are some facts:

- Official Letter 7318/NHNN-CSTT issued by the SBV on Aug. 25, 2006 requires banking institutions to carry out measures to control the supply of loans to investors in the stock exchange, keep a close watch on changes in the prices in order to forecast and estimate possible risks, and retrieve loan in time, avoid providing loans with bonds they issue as collateral, set credit limit for each borrower, keep the loan used for buying securities below the allowed percentage to the chartered capital and total loan, limit the loan used for buying securities from the OTC market and only provide loans when risks are well under control.

- When the prices on the stock exchange rose quickly, commercial banks increased the supply of loan to securities investors without investigating the creditworthiness of borrowers or kinds of securities used as collateral. Regulations on loans supplied to traders in securities by commercial banks are not in place with the result that securities are not classified, analyzed and evaluated properly, technical practices, such as evaluating borrowing and business plans; creditworthiness of borrowers; and assets used as collateral, etc. are not carried out carefully.

- Commercial banks have no department or expert specializing in analyzing, evaluating and forecasting development of the stock exchanges, market trends, macroeconomic situation, economic policies, fluctuations in prices, and values of securities in order to determine maturity of loans and classes of securities that could be accepted as collateral with the result that the market values of securities were overestimated by most commercial banks, which led to potential risks for their lending.

- Mechanism for managing the risks, supply-

ing the loans, and classifying borrowers of commercial banks is not as perfect and modern as expected. The Directive 03 issued by the SBV in May 2007 that was effective as from July 2007 came as a surprise to most commercial banks, investors, brokerage firms and finance companies because supplying loans to securities investors has long been considered as a service allowed by law, therefore the Directive 03 was partly a cause of continuous falls in the securities prices because it blocked the flow of credits from banks to the stock exchange. This fact proves that the SBV has had no appropriate policy on this service in the first place and has let commercial banks supply loans on easy terms without measures to manage the risks. When the flow of loan swelled too much, the SBV suddenly took measures to block it causing bad effects on participants in the stock market.

When the Directive 03 prevented local investors from getting access to bank loan, many of them had to sell out their securities to repay debts, which provided foreign investors with favorable opportunities to trade in securities. It turned out that the Directive had transferred sources of profit from local and foreign investors. Moreover, setting an inappropriate limit on the total loan to securities investors forced commercial banks to take various measures to ensure the required percentage and retrieve loans, which discouraged investors who traded in long-term securities employing bank loans.

The Decision 03/2008/QĐ-NHNN made by the SBV on Feb. 1, 2008 on the supply of loan and discount of commercial papers as a replacement for the Directive 03 proves to be more reasonable when linking risks with risk management by banks and capital adequacy ratio of international standard. But it is not reasonable when linking the credit limit on loans to securities investors with the bank chartered capital (it requires banks to keep loan to securities investors and discount of commercial papers below 20% of the chartered capital) because it encourages commercial banks more to increase their chartered capital than to improve their risk management.

Examining the Directive 03 and Decision 03 along with some policies adopted by the SBV in the past, we could discover some shortcomings in the SBV implementation of monetary policy:

(1) The SBV lacks a long view and necessary

orientation, and fails to use modern econometric models to analyze and forecast changes in the money market.

(2) The monetary policy is not flexible enough. Decisions are made too quickly and continuously for participants in the market to deal with.

These shortcomings come from the following causes:

+ The monetary policy is not appropriate to economic laws and is like an administrative command.

+ The monetary policy is based on unreliable information and unscientific analyses and predictions.

These analyses show that risks of the supply of loan to securities investors by commercial banks come from shortcomings in the macroeconomic management and making of the policy by the SBV, and in business strategies of commercial banks. We should draw lessons from realities to work out solutions to lending by commercial banks.

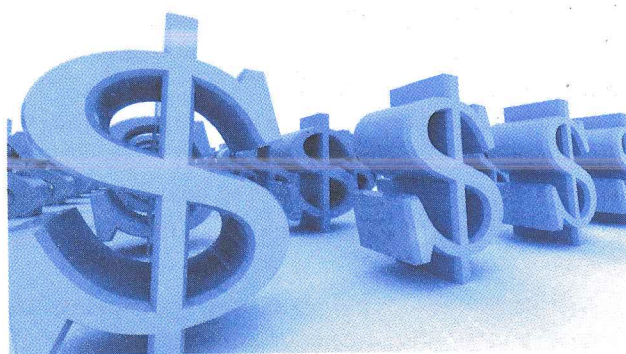
## 5. Solutions

a. For commercial banks:

- Improving the risk management: Banking services always involve risks, therefore the banks should enhance continuously their risk management in order to prevent and limit risks in supplying loans to securities investors under current conditions in Vietnam and at the same time, meet international standards of banking services.

The credit department of commercial banks had better separate its duties and functions and delegate them to divisions: customer relation, credit evaluation, credit risk management, and debt management; improve quality of lending officials; develop internal mechanisms for supplying information and credit rating to classify customers; and work out reasonable customer policies with a view to reducing the risks and improving the banking services.

- Improving the financial strength: A health financial strength is a basic condition for expansion of operations of banks, and improvements in competitiveness and ability to struggle against risks. The banks should keep increasing their chartered capital and assets along with the quality and profitability of these assets; reduce proportion of risky assets in the total assets; handle basically doubtful



debts and improve the balance sheet. In addition, the banks should keep the owner's capital appropriate to the total assets by ensuring that the capital adequacy ratio is equal to 8% in a medium term and 10% in a long term.

- Diversifying services supplied to the stock exchange: Commercial banks, at present, can try their best to develop existing services relating to the trade in securities, such as lending and discounting commercial papers, supplying collateral loans to securities investors, supplying advances to sellers of securities, supplying loans to buyers when their orders to buy are matched, and supplying loans to laborers who want to buy shares when their companies are privatized, etc. In addition, they can cooperate with financial intermediaries and brokerage firms to supply banking products and services in order to provide securities investors with more investment instruments, stimulate the demand for securities, and improve the liquidity of securities, thereby helping the stock market become more stable and sustainable. By supplying more products and services, commercial banks can gain more profit and source of capital for re-investment and business expansion.

- Introduction of margin trading: This transaction implies purchase or sale of securities in which seller or buyer holds only part of money or volume of securities traded and the rest is supplied by brokerage firms or other financial institutions. This transaction means that the institution provides investors with money to help them complete the transaction. There are two ways of margin trading: margin purchase and short sale. In margin purchase, the investors pay part of the sum for the lot of securities and the financial institutions cover the rest and keep the lot as collateral. In short sale, the investors can sell the lot of securities they don't hold at the transaction time. To do so,

they borrow securities from the brokerage firm of financial institution and deliver on the transaction day. The short sale can increase the price of securities to a certain extent because the investor has to buy another lot of securities to pay back to the institution.

The margin trading contributes something to the development of the stock exchange when the investors can use securities as collateral for another margin purchase, thereby enhancing liquidity of the payment system. The SBV had better introduce this practice and work out regulations on this trading according to international practices and standards.

b. For the SBV:

The SBV must play well its role in supporting commercial banks in their efforts to improve their risk management and prevention. The following measures may be useful.

- Improving the SBV ability to develop and implement the monetary policy.
- Enhancing its ability to conduct investigation and supervision.

The SBV should cooperate with other governmental agencies, especially the Ministry of Finance, in making the master plan for the banking system and controlling the credit supply in order to ensure credit quality and growth. Particularly, it should create a consistent legal infrastructure for the stock market.

At present, the VN-Index was below the 300-point mark, we hope that the SBV will adopt active and strong measures to help commercial banks control their supply of loans to securities investors more effectively and reasonably, thereby recovering the stock market in the near future■

## Reference:

- SBV (2007) Chỉ thị 03 về kiểm soát qui mô, chất lượng tín dụng và cho vay đầu tư, kinh doanh chứng khoán nhằm kiểm soát lạm phát, thúc đẩy tăng trưởng kinh tế (Directive 03 on control over size, credit quality and loans to investors in the stock market to curb the inflation and facilitate the economic growth).
- SBV (2008), Quyết định 03 về việc cho vay chiết khấu giấy tờ có giá về đầu tư và kinh doanh chứng khoán (Decision 03 on supply of loans and discount of commercial papers for securities investors).
- Information from the SBV Website.