Restructuring of Vietnam's Banking System: Problems and Recommendations

VÕ THỊ THÚY ANH

Doctor of Philosophy, Đà Nẵng University of Economics

Email: vothuyanh@yahoo.com

ABSTRACT

The paper analyzes the current situation of the Vietnam's banking system and figured out four primary difficulties facing it namely high ratio of bad debts, low owner's equity, unsustainable liquidity, and unfair competition. This fact poses serious problems for Vietnam's government and the SBV in their effort to restructure the national banking system. The author recommends four groups of solutions to these problems, that is, (i) classifying and restructuring banks, (ii) enhancing the bank's immunity by means of bank's owner's equity, (iii) disposing of bad debts and preventing newly-arising ones; and (iv) creating a healthy environment for banking sector and orienting banking activities towards international standards

Keywords: restructuring, banks, solution

1. RATIONALE

In order to resolve difficulties and inadequacies facing Vietnam's economy, the Vietnamese government has introduced a comprehensive project on economic restructuring and alternation of growth model with a view to enhancing the performance and competitiveness of the national economy. This project was presented to the Vietnam's National Assembly on April 17, 2012. Its kernel is the restructuring of banking organizations. Moreover, the Vietnamese Prime Minister issued Decision 254/QĐ-TTg dated March 1, 2012 concerning the restructuring of Vietnam's banking organizations in the period 2011-2015. This expresses the sheer determination of Vietnam's government in restructuring the national banking system.

This paper analyzes the current situation of Vietnam's banking system and sheds light on the necessity for a restructuring as well as problems facing the government and the whole banking system while implementing the restructuring. Some recommendations to the restructuring of the banking system are also set forth in the paper.

2. THEORETICAL BACKGROUND ON RESTRUCTURING OF BANKING SYSTEM

In order to prevent a banking crisis (which is supposed to be the onset of a fierce financial crisis), as Hoelscher and Ingves (2006) state, it is necessary to implement synchronously many remedies, especially those related to the restructuring of the banking system. Based on empirical researches, Hoelscher and Ingves (2006) recommended the followings:

- The kernel of banking system restructuring is to restore the profitability and liquidity of individual banks and the whole banking system as well. Related strategies must aim to improve the competence of banks and the climate for banking services, and dispose of those with bad performance. The restructuring of banking system is often a long-term issue which requires amendments to or reform in the laws and institutions; development of strategies of liquidation, merger, or capital restructuring; change and recovery of bank's assets; and renovation of operation and procedures.

- The restructuring of banking system must start with recognition of financial losses of each bank. A bank is supposed to survive only if: (i) it remains profitable and competitive in the medium term; and/or (ii) stockholders commit themselves to and are capable of supporting its operation. Banks can be asked to submit business plan by their inspectors. Ordinarily, there are three types of bank, that is, (i) those that can survive and meet the capital adequacy ratio (CAR) as well as other stipulations of the central bank; (ii) those that cannot survive; and (iii) those that can survive yet lack capital. For the third type, additional evaluations are necessary to determine whether existing stockholders can restructure the bank's capital or call for the government's financial relief.

Banks that are becoming insolvent and may not survive must be removed. The protection for depositors will enable the government to purify the banking system without suffering from the chain effect of bank runs.

There are two groups of remedies for bank restructuring in the private sector and the public one respectively.

- For the private sector:

Stockholders are responsible for restructuring their bank's capital and operation. If the bank's capital cannot be restructured at once yet the bank is considered able to survive, it can invite other banks which are solvent yet destitute of capital to join the business under certain terms and conditions. Bank's capital restructuring can be carried out step by step with strict requirements and supervision (including the temporary cessation of dividend distribution until the required amount of capital is ensured). If existing stockholders cannot restructure the bank's capital, it is advised to seek for new ones.

- For the public sector:

When solutions to restructuring of banks in private sector fail and many banks become insolvent yet they need not go into liquidation, financial support from the public sector may help them survive. The backups of public sector include: (i) planning the capital restructuring; (ii) utilizing public funds to transfer debts or secure the bank's assets; and (iii) nationalizing insolvent private banks which then can be privatized again when the banking system can run smoothly.

According to Claessens (1999), "bank restructuring process includes: (i) recognizing financial losses; (ii) restructuring financial claims; and (iii) operational restructuring of banks. Recognition of financial losses involves the allocation of existing losses. Losses can be allocated to shareholders by dilution, to depositors and external creditors by reduction of (the present value of) their claims, and the government, that is, the public at large, through increased taxes, expenditures cuts or inflation tax. Restructuring of financial claims can take many forms: rescheduling (extensions of maturities), lower interest rates, debt-for-equity swaps, debt forgiveness, indexing interest payments to earnings, and so on. Operational restructuring, an ongoing process, includes improvements in efficiency and management, reductions in staff and wages, asset sales (for example, reduction in the number of bank branches), enhanced marketing efforts, and so on, with the expectation of increased profitability and cash flow."

Dziobek (1998) recommends using market-based instruments to restructure the banking system as follows:

Table 1: Banking Restructuring Instruments

Types of instrument	Instances
Financial instruments - Immediately finance banks	Liquidity supports from the central bank The government's support Capital injection via private stocks and bonds
Operational instruments - Improve the management and performance of banks	Increase bank's capital Renovate the mode of management Enhance the professionalism of staff Collaborate with other banks Facilitate the participation of prestigious foreign-run banks
Structural instruments - Restore the bank's competitiveness	Shut down Merge/detach; and reduce the scale Manage assets; restructure debts Privatize Restructure enterprises

Based on the current situation of 25 countries facing the banking system crisis during 2007-2009, Laeven and Valencia (2010) showed that these countries employed three out of the following six remedies: supporting emergency liquidity (with about 5% of bank deposit and liabilities of non-residents), restructuring banks with the minimum cost of 3% of GDP, nationalizing private banks, the governmental guarantee for the banking system, acquiring bank assets (at least 5% of GDP), ceasing receiving deposits and closing banks.

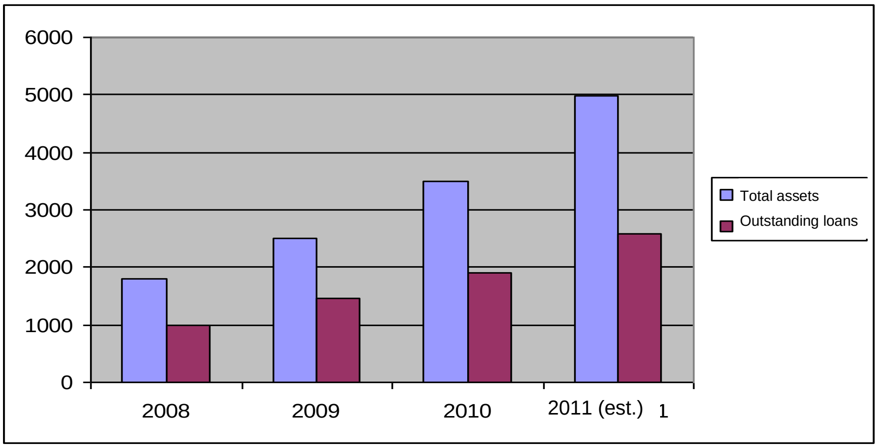
As Knapp (2012) put it, five crucial factors deciding the successful restructuring of Chinese banking system in the late 1990s are: (i) resolving bad debts and subprime loans, most of which fall into state-owned enterprises; (ii) enhancing the banking administration in terms of management and personnel; (iii) attracting strategic investors; (iv) enabling locally-listed banks to be listed in foreign markets in the hope of helping them attract more capital and simultaneously forcing them to attempt to observe international standards; and (v) utilizing newly mobilized capital to invest in new technologies and risk management, thereby improving the performance of the banking system.

In brief, the restructuring of banking system is extremely vital to the effort to overcome banking crises; and it is a complicated process which can last for many years. Restructuring must be executed in each individual bank and requires supports from stockholders, the government and the central bank. In the remainder of the paper, some solutions to restructuring of Vietnam's banking system will be put forth.

3. THE NECESSITY OF RESTRUCTURING VIETNAM'S BANKING SYSTEM

In past years, Vietnam's banking system has witnessed strong growth in terms of both capital size and number of banks. The gross asset value of the entire system, up to the end of March 2011, reached around VND4.84 quadrillion (some US$240 billion). Yet, majority of Vietnam's banks are small-sized and scattered; and there is no major banks that can act as pillars for the system. Alongside the surge in capital size, Vietnam's banking system is at present facing four risks namely high ratio of bad debts, a sharp decline in the owner's equity caused by huge bad debts, unsustainable liquidity, and unfair competition. These four issues are interwoven with each other, and there is a causal relationship among them.

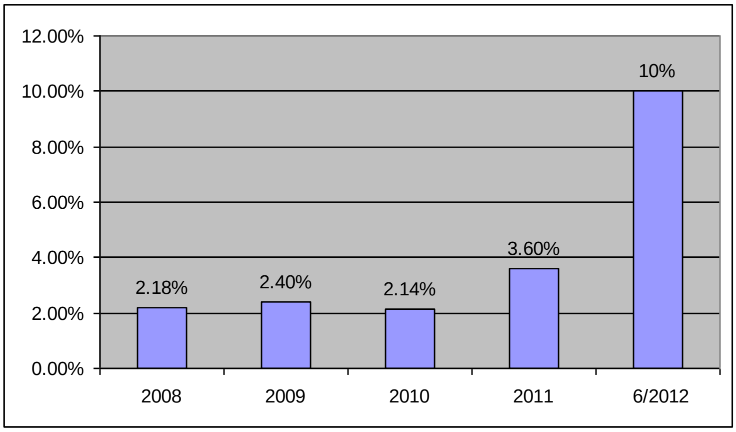
In the past four years, the credit growth of the banking system has exceeded the growth of GDP to reach around 30% per annum (see Figure 1). This fact is also an outcome of a rapid growth in the number of commercial banks in late years of the previous decade, which, despite enhancing the supply of banking products, is merely a growth in terms of quantity but not quality. Commercial banks have mobilized a large volume of capital, continuously raising the credit growth ratio while many newly established banks lacked modern banking technologies, competent staff and managerial skills. The capital supply is abundant, so high inflation is inevitable.



Source: Stoxplus

Figure 1: Total Assets and Outstanding Loans in Vietnam's Banking System (VND thousand billion)

The consequence of a high credit growth and bad investments has caused the ratio of bad debts in the banking system to surge. According to the SBV, the bad debt ratio reaches 3.6% by the end of the first quarter of 2012. This percentage even ranges between 12% and 13% as estimated by Fitch Ratings. Most recently in June 2012, the SBV officially publicized a new bad debt ratio of 10%, which is equivalent to VND250 thousand billion. In the event that one third of bad debts is irrecoverable, the ratio of owner's equity will reduce by a quarter. Alarmingly, difficulties facing enterprises and successive bankruptcies can increase the bad debt ratio. As evaluated by foreign organizations, this ratio is indeed much higher. Therefore, the high ratio of bad debts in the national banking system has been a serious nuisance and can result in a decline in the owner's equity of commercial banks in the near future.



Source: SBV

Figure 2: The Average Ratio of Bad Debts in the Vietnam's Banking System as of 2008

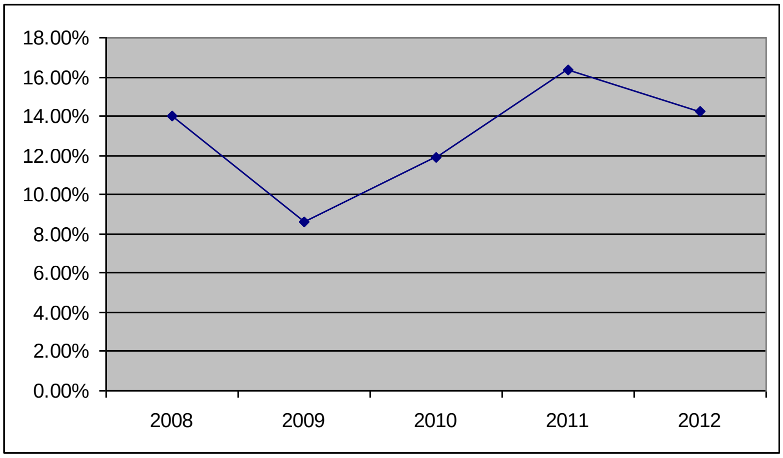
The liquidity of commercial banks is often evaluated on the basis of owner's equity (which is supposed to be an effective shield of banks against risks, a guarantee of the bank liquidity and interests of depositors), CAR, ratio of medium and long-term loans to the current capital, and credit growth. The bad liquidity is often manifested by an upsurge in the bank rate and the interest rate race among commercial banks.

At present, the liquidity of commercial banks seems to be improved thanks to a decline in the deposit rate (see Figure 3). The average CARs of the whole banking system in late 2010 and 2011 respectively reached 11.56% and 11.62%; and many commercial banks gained a satisfactory CAR of 9% as required by the SBV.

After many efforts in both administrative commands and new monetary policies, the short-term borrowing rate for commercial banks was reduced to 9% as from June 11, 2012. This result allowed the SBV to think of some improvement in liquidity of commercial banks. However, liquidity of most banks is not sustainable and liquidity risk is still looming large.

Although the inflation rate has fallen, economic fluctuations in the past and possibility of a high inflation rate in the near future make the public prefer short-term deposits while most commercial banks have turned much more than 30% (a limit set by the SBV) of their short-term deposit into long- and medium-term loans. This situation led to shortage of liquidity especially when commercial banks are facing great difficulties in attracting deposits.

High bad debt and consequences of hot credit growth in the past few years and difficulties facing enterprises as debtors may reduce CAR in banks. In the years 2008-2011 the credit growth always exceeded 30%, much higher than the GDP growth rate of 6% on average (Figure 1). Additionally, when short-term borrowing rate (for loans with maturity of under 12 months) was reduced from 11% to 9% and the rate for long-term loans (longer than 12 months) was allowed to float, many banks raised the borrowing rate on 13-month deposit to 13% or 14%. This move revealed their shortage of liquidity.



Source: Vietnam's state bank

Figure 3: The Average Deposit Rate of Commercial Banks

SBV statistics up to June 2012 show that there were five state-owned commercial banks and 37 joint-stock ones in Vietnam. After the merger of Sacombank, Đệ Nhất, and Tín Nghĩa, the total number of commercial banks in Vietnam would be 40. Furthermore, there are also five foreign-owned banks, five joint-ventures, and 53 representative offices of foreign banks in Vietnam. This number of commercial banks in a country with the GDP of some US$110 billion like Vietnam is too high. The increase in this number in past years has led to a fierce competition in the banking sector. As Figure 1 shows, the total assets of Vietnam's commercial banks increased from VND1,850 billion in 2008 to VND5,000 billion in 2011 (i.e. equaling a rise of 119.4% p.a.).

Unfair competition among commercial banks is also a serious nuisance. Small-sized joint-stock banks, due to poor management and difficulties in mobilizing capital, usually employ interest rate to attract customers; yet to maintain the profitable threshold at the same time, they must raise the lending rate. Those who resort to these banks to take out a loan are often customers with bad credits. Once their customers go bankrupt, serious capital difficulties are unavoidable. In addition, many other banks, to survive the fierce competition, ceaselessly attempt to attract customers at any cost. Typically, many of them seek ways to dodge the ceiling rate.

All recent financial crises in the world are related to major banking issues (i.e. high ratio of bad debts, decline in bank's capital, unsustainable liquidity, and unhealthy operations of the banking system). Hence, Vietnam needs bold solutions to the restructuring of the national banking system, especially for four aforementioned issues.

4. PROBLEMS TO THE RESTRUCTURING OF VIETNAM'S BANKING SYSTEM AND SOME SOLUTIONS

Primary difficulties facing Vietnam's banking system force the government and each bank to attempt to dispose of bad debts, enhance the immunity of commercial banks by increasing the owners' equity, and improve the liquidity. The difficulties include:

- Restructuring should be implemented not only in each bank but also in the whole system as well.

- The banking climate should be improved.

- Every bank and the whole banking system must settle bad debts, improve their balance sheets, and improve the immunity.

- A bank with poor performance and decreased financial strength can be merged with a better one, no matter how large its size is.

- The banking practice should be oriented towards and observe international standards.

In order to deal with the stated problems, it is needed to carry out the following groups of solutions.

a. Group 1: Classifying and restructuring banks

As presented in section 2, the first and foremost task to be tackled is to evaluate and classify banks. Although the SBV has started to do this, standards are quite ambiguous and unpublished. Classification must be based on the quality of assets, CAR, business performance (which is reflected by ROA), ratio of bad debts, profitability, medium and long-term competitiveness, and bank's capital adequacy. Banks can be divided into three classes. Banks of class 1 are those that are highly profitable and able to recover and improve their competitiveness in the medium run, and assure CAR. Class 2 includes banks that satisfy features of the class 1 yet cannot assure CAR. Class 3 comprises banks with poor performance, low competitiveness and inadequacy of capital.

Banks of class 1 may not need support from the public sector. Yet, they must renovate their own way of management in compliance with the development of the finance market, improve the risk management, and strictly observe banking regulations.

Banks of classes 2 and 3 are subjected to restructuring. At the systemic level, the SBV needs to strictly manipulate the operation of banks of class 2 and requires them to draw up a capital-raising plan in order to assure CAR; and requests banks of class 3 to either shut down or undergo restructuring after considering their ability to recover. At present however, when the public's trust in the banking system is spoiled, the closure of a bank requires careful consideration; and the SBV should take measure to protect depositors, which can help avoid the bank run that may cause harm for the whole banking system.

Banks of class 2 should aim at capital restructuring. Those of class 3, besides capital restructuring, should renovate their operation and administration with a view to enhancing the profitability and restoring competitiveness. Solutions to capital restructuring will be included in the Group 2.

When undergoing an operational restructuring, it is necessary to thoroughly reconsider current operations to eliminate inefficient or risky ones, define and focus on major operations and strengths of the bank, reduce the lending dependency and increase non-lending services, and appoint employees to suitable positions according to their skills and qualification.

Regarding the restructuring of banking administration, it is advised to recruit and appoint competent managers to keynote positions, observe norms and standards in banking operations; publicize information about bank services and performance, and build a risk management paradigm on the basis of Basel standards.

b. Group 2: Enhancing the bank's immunity by increasing owner's equity

First of all, banks should evaluate its actual owner's equity after provisioning against subprime loans and depreciating assets. To do so, they need to precisely evaluate bad debts and at the same time re-check available assets. The SBV should request all commercial banks to estimate their owner's equity and strictly supervise this process. Any bank that does not own a minimum owner's equity as stipulated by the SBV or whose owner's equity is on a downward trend must be made known to the public. Such banks, then, must draw up a capital-raising plan to ensure their competitiveness and improve the immunity. The SBV shall directly assess the feasibility of the plan. Some measures to increase the owner's equity are as follows:

To raise capital, banks can consider the following remedies which are presented in order of importance, that is: retain the profit to increase the bank's capital (i.e. no dividend is paid to stockholders); call for a capital raise from existing stockholders; issue long-term bonds, especially convertible ones; and/or ask for backups from the SBV. However, issuance of more stocks or mobilization of long-term capital from the bond market is only feasible when investors are confident on the recovery and sustainable development of the bank; and thus banks of class 3 can hardly carry out this solution without SBV help.

The government can take the following measures to support commercial banks:

- The government can provide guarantees for the operation of commercial banks. This can help improve the confidence of investors and shareholders; and the bank itself can increase its capital by issuance of stocks.

- The government can act as an underwriter for issues of long-term bonds by banks.

- The government can inject capital into commercial banks by nationalizing them (i.e. acquiring majority of their shares). This solution has also been recently employed in the USA, China, and the U.K. Once banks can recover their health, the government can enable such banks to re-acquire their stocks.

- The government can support commercial banks' capital raise through reciprocal funds. Accordingly, the government will commit to acquire a certain percentage of the bank's shares. In so doing can the government consolidate the trust of investors in the banks. Once the bank can run effectively again, these stocks will be floated in the market.

- The government can promote the merger of commercial banks in order to boost their size and competitiveness.

c. Group 3: Disposing of bad debts and preventing newly-arising ones

It is necessary to reevaluate the recoverability of bad debts. For recoverable loans, just quickly recoup them. Those that can be restructured should be examined. Yet, bad debts restructuring is extremely risky if the bank evaluates imprecisely **customers' recoverability**. Irrecoverable bad debts should be written off by freezing or selling debts. This may result in considerable financial losses due to a fact that bad debts are often discounted with a high interest rate. However, the thorough handling of bad debts can enable banks to concentrate on their primary businesses and recoup the financial health without worrying about bad debts. Falls in owners' equity caused by handling of bad debts can be compensated by taking aforementioned measures of Group 2 to increase the owner's equity.

In addition to rooting out bad debts, commercial banks should improve their administration mechanism and risk management, and observe local and international standards for banking services. In so doing can the bank perform within the safety boundary and keep the bad debt ratio under control.

d. Group 4: Creating a healthy environment for banking operations and orienting the banking system toward international standards.

In order to create a healthy environment for local banking operations, the SBV should employ actively and flexibly such instruments as monetary policy, interest rate, and exchange rate according to laws of market economy to guarantee the safe and sound operation of the banking system; reduce risks; curb inflation; stabilize the interest rate, exchange rate, and the macroeconomic environment; and promote economic growth.

To orient banking services toward international standards, the SBV should review and update banking rules and regulations. Specifically, the state bank can (i) set up CAR standards on the basis of Basel II and Basel III for the period 2015-2020; (ii) impose regulations on full disclosure of current financial situation and assets on commercial banks; and (iii) amend and modify existing accounting standards vis-à-vis international ones.

The SBV should strictly monitor commercial banks' compliance with banking regulations, and impose penalties in order to step by step inch the ratio of bad debts down under 3% as required by international standards.

5. CONCLUSION

In the paper, the author has evaluated the current situation of Vietnam's banking system and identified some difficulties facing it (i.e. high ratio of bad debts, decline in owners' equity, unstable liquidity, and unfair competition). These problems, without being thoroughly resolved, can result in a banking crisis. The author also recommends four groups of solutions to these problems, namely (1) classifying and restructuring banks, (2) improving the bank's immunity by its own capital sources, (3) disposing of bad debts and preventing newly-arising ones, and (4) creating a healthy environment for banking services and orienting them towards international standards.

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