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# TAKING STOCK

## AN UPDATE ON VIETNAM'S RECENT ECONOMIC DEVELOPMENTS

**December 2014**

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# ACKNOWLEDGEMENT

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# ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| **ASEAN** | Association of Southeast Asian Nations |
| **CDS** | Credit Default Swap |
| **CIT** | Corporate Income Tax |
| **CPI** | Consumer Price Index |
| **DB** | Doing Business Report |
| **EAP** | East Asia and Pacific |
| **FDI** | Foreign Direct Investment |
| **GDP** | Gross Domestic Product |
| **GDC** | General Department of Customs |
| **GSO** | General Statistics Office |
| **IMF** | International Monetary Fund |
| **IRRs** | Intellectual Property Rights |
| **MOF** | Ministry of Finance |
| **MPI** | Ministry of Planning and Investment |
| **NSCERD** | National Steering Committee of Enterprise Reform and Development |
| **ODA** | Official Development Assistance |
| **OOG** | Office of Government |
| **PIT** | Personal Income Tax |
| **PMI** | Purchasing Manager Index |
| **SBV** | State Bank of Vietnam |
| **SOEs** | State-owned Enterprises |
| **SEGs** | State Economic Groups |
| **SGC** | State General Corporations |
| **TPP** | Trans Pacific Partnership |
| **VAMC** | Vietnam Asset Management Company |
| **VAT** | Value Added Tax |
| **WB** | World Bank |

**OFFICIAL INTERBANK EXCHANGE RATE: US$ = VND 21,246**

Government Fiscal Year: January 1 to December 31

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# EXECUTIVE SUMMARY

## Recent Economic Developments

**The global economy is showing signs of recovery, but at an uneven pace; global growth is expected to rise modestly to 2.6 percent in 2014, and an average 3.3 percent in 2015–17.** GDP in the United States and the Euro Areas expanded in the second and third quarters, with significantly stronger performance in the former. In the US, output rebounded strongly – with 4.6 percent (seasonally adjusted and annualized) growth in the second quarter of 2014 followed by 3.9 percent in the third quarter – supported by still accommodative monetary policy, easing fiscal consolidation, and rising employment, investment growth, and confidence. Growth in the US is projected at about 2 percent in 2014, rising to 3 percent in 2015. In the Euro Area, the recovery continues to be impaired by weak domestic demand and credit growth, and subdued investment prospects. Japan's GDP contracted at an annualized rate of 1.6 in Q3, following the downwardly revised 7.6 percent contraction in Q2. In both the Euro Area and Japan, growth is projected at about 1 percent in 2014, rising slowly thereafter.

**The gradual strengthening of activity in the Euro Area and especially the US will boost demand for exports from developing East Asia and Pacific (EAP), helping the region sustain its growth performance.** Growth in developing EAP will moderate gradually from 7.2 percent in 2013 to 6.9 percent in 2014–15. However, the capacity to benefit from the global recovery will vary significantly across countries, reflecting structural constraints to investment and export competitiveness, and weak export prices for commodity producers. There is also a window of opportunity for EAP economies to enact critical—and in some cases overdue—reforms; the short-term priority is to address the vulnerabilities and inefficiencies that have been created by an extended period of loose financial conditions and fiscal stimulus. Over the longer term, the focus is needed on infrastructure investment, logistics, and the liberalization of services and FDI, including in the context of regional integration.

**There are early signs of firming up of economic recovery in Vietnam.** GDP growth picked up to a relatively brisk 6.2 percent (y-o-y) in the third quarter of 2014, contributing to an overall growth rate of 5.6 percent for the first nine months of the year. Each of the major sectors barring services recorded faster growth in 9M-2014 compared to the same period last year. Based on this uptick, we project GDP growth to pick up slightly from 5.4 percent in 2013 to 5.6 percent in 2014. Relatively flat domestic demand has kept a check on even faster recovery in growth.

**Continued macroeconomic stability has been an important underpinning of growth in Vietnam.** Headline inflation (year-on-year) fell from a peak of 23 percent in August 2011 to about 2.6 percent in November 2014 – the lowest level since October 2009 – as a result of ample supply of food, weak energy price, and soft domestic demand. The exchange rate remains stable since the one-percent devaluation of the dong in June 2014. Stronger current account balances enabled foreign exchange reserves to build up to an import cover of about 3.1 months in June 2014, up from 2.4 months in December 2013. These positive macroeconomic developments contributed to improved sovereign

risk ratings and allowed Vietnam to successfully issue government bonds on international capital markets to raise US$1 billion at an annual coupon of 4.8 percent.

**Government revenue collections have increased in the first 9M-2014.** Total revenue collection was estimated at nearly 81 percent of the 2014 State Budget, increasing by around 17 percent in nominal terms compared to the same period last year. At the same time, total expenditure also rose by 11.5 percent, due largely to recurrent spending. The 2014 State Budget has a targeted deficit of 5.3 percent of GDP (by Government's definition). The last joint IMF-World Bank Debt Sustainability Analysis (DSA, June 2014) assesses Vietnam at low risk of debt distress, but overall debt levels are becoming an increasing concern. Medium-term fiscal policy should aim for consolidation in light of tightening fiscal space, and take account of contingent liability risks. This process can be facilitated by improving tax revenue collection (by broadening the tax base, phasing out exemptions), slower expenditure growth, improving efficiency of public investment and scaling up the existing medium-term budget framework piloted in various line ministries to the national level. It would, however, be important to protect social safety nets as Vietnam transitions further to a market economy.

**Credit growth continues to come in below target, hampering the State Bank of Vietnam's efforts to carry out credit expansion to support economic growth.** Growth in lending was constrained by banks' impaired balance sheets, concerns over the financial health of borrowers, a sagging property market, and weak demand for credit on account of low consumer and investor confidence. At the same time, banking sector deposits continued to grow at a healthy rate, thereby ensuring adequate liquidity on bank balance sheets. Easing monetary policy further in such an environment is unlikely to have much effect on credit growth.

**Underlying the broad patterns of recovery, the performances of foreign-invested and domestic firms remain dichotomous.** The foreign-invested sector continues to be a significant source of growth. Business sentiment within the FDI sector has improved in the past one year. Reflecting the relative optimism of foreign investors, the seasonally-adjusted Purchasing Managers' Index (PMI) of the manufacturing sector posted a reading of 51 in October, signaling continued expansion in the sector. At the same time, a rising number of domestically-owned businesses have been closing or suspending operations. Domestic private firms are clearly being impacted by the constrained access to finance, subdued domestic consumer demand, and an uneven playing field vis-à-vis state-owned enterprises.

**The Government has taken some important measures in 2014 to improve business conditions which are expected to bear fruit from 2015 onward.** The Government issued Resolution 19 (March 18, 2014) which prioritizes shortening the time for processing and completion of administrative procedures, reducing administrative costs, and strengthening transparency and accountability of state administrative agencies. The revised Law on Bankruptcy, passed in July 2014, was another effort to improve the legal framework for businesses. The Enterprise Law and the Investment Law, expected to improve corporate governance in enterprises and SOEs in particular, were approved by the National Assembly in November 2014.

**Despite a pick up in momentum, SOE reforms are lagging behind planned targets.** The Government has articulated a clear policy vision on SOE reforms, but more consistent implementation will be the key. 74 SOEs were equitized in 2013 (thrice the number in 2011 and 2012), and the momentum continued in 2014. But the Government's aim to equitize 200 SOEs in 2014 is unlikely to be realized.

Some progress has been made against Decree 71, requiring all non-bank SOEs to fully divest from 5 non-core risky areas by 2015, though, again, the pace is slower than anticipated. Future progress will require strengthened information disclosure, performance monitoring, corporate governance reform, transparency of the divestment process, and clearer lines of accountability in SOE oversight. The legal framework for SOE reform has been further strengthened with the issuance of Resolution 15, containing a comprehensive action plan to step up SOE divestment. Two related laws — the Law on Management and Use of State Capital Invested in Production and Business and the Enterprise Law —were approved by the National Assembly in November 2014.

**Accelerating banking sector reforms remain a priority.** Liquidity injections have brought some relief to the banking sector, although the pace on the more important structural reforms needs to pick up. Resolution of bad debts in the system remains a key issue of concern. As of October 2014, the Vietnam Asset Management Company (VAMC) had absorbed about VND90 trillion or about US$4.2 billion of bad debt but it is yet to articulate a clear strategy to actually resolve the bad debts. Its efforts in this regard have also been hampered by the absence of an enabling legal framework for insolvency and asset titling, and for protecting VAMC and commercial bank staffs against possible lawsuits. The actual size of NPLs itself is still unclear. In this regard, the issuance of Circular 02 on loan loss classification and provisioning is a step in the right direction, but its full enforcement has been delayed till April 2015. The State Bank of Vietnam (SBV) has targeted 6-7 M&As in the banking sector in 2014, and a 50-percent reduction in the number of commercial banks in the next 3 years, but no new M&As have taken place in the year. The good sign is that none of the past M&As have been reported to result in major disorders to the system performance thus far, and that should be given the benefit of doubt.

**Medium term projections reflect continued modest GDP growth and further consolidation of macroeconomic stability.** GDP growth in the base case scenario is forecast at 5.6 percent for 2014, supported by expansion in the manufacturing sector, trade and steady performance of foreign-invested sector. Inflationary pressures are expected to remain subdued and the trade and current accounts in surplus in 2014. The Government's continued commitment to fiscal consolidation and debt reduction is reassuring, for which improved revenue collection, better controls on recurrent expenditures, and improving the efficiency of public investment are critical. This outlook is subject to the following macroeconomic risks: (i) relatively slow progress on restructuring the state-owned enterprises and the banking sector could adversely impact the macro-financial situation, undermine growth prospects and create large public sector liabilities; (ii) the high export orientation of the Vietnamese economy exposes it to adverse turn of events in the global economy, especially in the developed world which absorbs much of Vietnam's exports.

## Special Focus: Vietnam Financial Sector Assessment

**The Financial Sector Assessment Program (FSAP) provides a comprehensive framework to identify financial system vulnerabilities and develop appropriate policy responses**. Recognizing its importance, in July 2012 the Government of Vietnam invited the WB and the IMF to initiate an FSAP for Vietnam. An integral part of the FSAP is the Financial Sector Assessment (FSA) report—an indepth look at the stability and development potential of the financial system. The special focus section of this Taking Stock report summarizes the main messages of Vietnam's FSA that was publicly released on August 29, 2014.

**In recent years the Vietnamese economy has shown signs of corporate and financial distress, and slowdown in GDP growth.** Several segments of the corporate sector exhibit poor performance and financial distress, and have affected the health of the banking system. Large state owned enterprises (SOEs) have defaulted on their obligations and several others appear to be overleveraged. The banking system has accumulated a significant amount of non-performing loans (NPLs) and many small banks have experienced more serious liquidity and solvency problems in the same period, leading to interventions by the SBV. The reduced lending capacity of the banking system is one of the factors that have contributed to a sharp slowdown of credit growth mentioned above.

**The weak performance of the financial sector is due to a complex array of institutional and regulatory factors.** These factors have included episodes of interference by central and local authorities on the investment and credit decisions of state owned enterprises (SOEs) and state owned commercial banks (SCOBs); inadequate governance structure and risk management capacity in these institutions; connected lending in several joint-stock banks (JSBs); weaknesses in financial infrastructure, including poor financial reporting standards; and deficiencies in financial regulation and supervision. In this context, credit growth has often been excessive and credit allocation poor. Increased macroeconomic volatility in the last five years has compounded these problems and led to further deterioration in the quality of loan portfolios.

**The government has announced a comprehensive reform program designed to address the problems faced by the financial and corporate sectors.** The reform program was officially documented in the Socio-Economic Development Plan (SEDP) for the period 2011–2015, approved by the National Assembly in November 2011. It includes three basic components: banking restructuring, SOE restructuring, and public investment reform. Since then, the government and the SBV have been making efforts to elaborate further the design of these three programs, and in March 2012 issued a decision approving the banking restructuring component. More recently, the Government and the SBV introduced a new asset management company (the VAMC) to handle NPLs. The banking reform program is comprehensive, but important reform issues must be further developed and the program must be consistently implemented to ensure the full recovery of the financial sector.

**The FSAP provides a broad set of policy recommendations that can be used to operationalize the SEDP and the banking restructuring program.** The recommendations fall into three groups: (i) a plan to work out the large stock of existing NPLs; (ii) measures to ensure sound new flows of finance and prevent the accumulation of additional NPLs; and (iii) a set of policy steps designed to protect the financial sector during the envisaged reform period. For each group of measures, the plan identifies pre-conditions (first phase) and sub-sets of measures that needs to be implemented in the short run (second phase) as well as those that can be phased in over the medium term (third phase).

**The recommendations include recapitalization plans, the workout of NPLs, regulatory and other reforms, and the temporary extension of the safety net.** Special financial audits of banks would provide accurate assessments of NPLs, the related recapitalization needs, and key information for the design of debt resolution schemes. Operational audits would provide the basis for restructuring plans in the SOCBs. An identification of the main patterns of interconnectedness across banks and borrowers would allow the monitoring of systemic risk during the reform period. In a second phase, banks would be recapitalized and SOCBs and SOEs would divest their shares in other banks. This phase would also entail the preparation of a reform of the regulatory and supervisory systems. A well-articulated NPL workout program would be

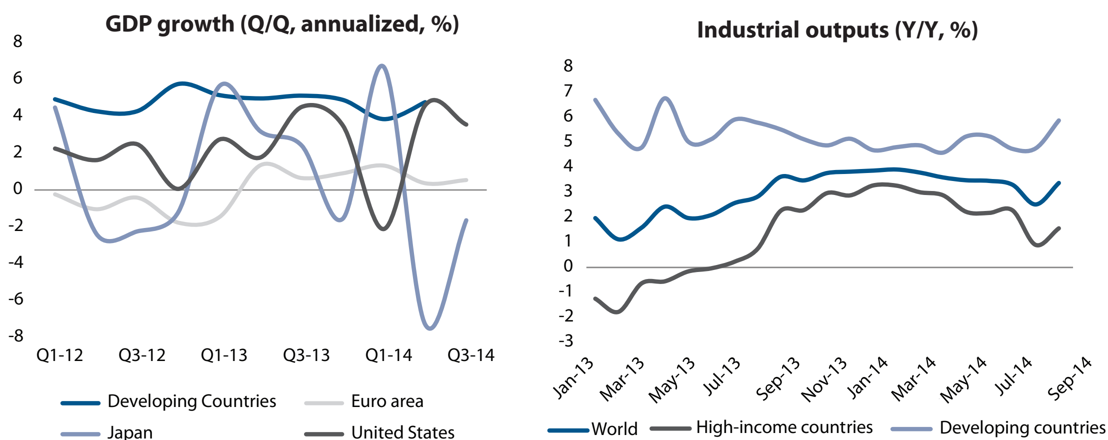
prepared in the second phase and fully launched in the third phase. It would proceed in four tracks, one led by the banks, one led by a centralized AMC, and two additional tracks to deal with large and complex SOEs. Simultaneously, a set of measures to relieve the SOCBs from policy mandates would be adopted. The implementation of the capital markets agenda and the reform of financial infrastructure and financial regulation would be deepened in this final phase.

# SECTION I
## RECENT ECONOMIC DEVELOPMENTS

### I.1. External Economic Environment

1. **The global economy is showing signs of recovery, but at an uneven pace; global growth is expected to rise modestly to 2.6 percent in 2014, and an average 3.3 percent in 2015–17.** GDP in the United States and the Euro Areas expanded in the second and third quarters (figure 1.1), with significantly stronger performance in the former. In the US, output rebounded strongly – with 4.6 percent (seasonally adjusted and annualized) growth in the second quarter of 2014 followed by 3.9 percent in the third quarter – supported by still accommodative monetary policy, easing fiscal consolidation, and rising employment, investment growth, and confidence. Growth in the US is projected at about 2 percent in 2014, rising to 3 percent in 2015. In the Euro Area, the recovery continues to be impaired by weak domestic demand and credit growth, and subdued investment prospects. Japan's GDP contracted at an annualized rate of 1.6 in Q3, following the revised 7.6 percent contraction in Q2. In both the Euro Area and Japan, growth is projected at about 1 percent in 2014, rising slowly thereafter.

**Figure 1.1: Growth in Global GDP and Industrial Output**




*Source:* World Bank, October 2014

2. **The gradual strengthening of activity in the Euro Area and especially the US will boost demand for exports from developing East Asia and Pacific (EAP), helping the region sustain its growth performance.** Growth in developing EAP will moderate gradually from 7.2 percent in 2013 to 6.9 percent in 2014–15. In China, growth is expected to moderate also to 7.4 percent in 2014 and 7.1 percent in 2016 (Table 1.1), reflecting intensified policy efforts to address financial vulnerabilities and structural constraints, and place the economy on a more sustainable growth path. In the region excluding China, growth will bottom out at 4.8 percent in 2014, reflecting the slowdown in Indonesia and Thailand, before recovering to 5.3 percent in 2015–16 as exports firm and the impact of domestic adjustment in the large ASEAN countries eases. However, the capacity to benefit from the global recovery will vary significantly across countries, reflecting structural constraints to investment and export competitiveness, and weak export prices for commodity producers. Developing EAP will remain the fastest-growing developing region.

**Table 1.1: East Asia Pacific GDP Growth**

| | 2012 | 2013f | 2014f | 2015f | 2016f |
|---|---|---|---|---|---|
| East Asia | 6.0 | 6.1 | 6.0 | 6.1 | 6.1 |
| Developing East Asia | 7.4 | 7.2 | 6.9 | 6.9 | 6.8 |
| China | 7.7 | 7.7 | 7.4 | 7.2 | 7.1 |
| Indonesia | 6.3 | 5.8 | 5.2 | 5.6 | 5.6 |
| Malaysia | 5.6 | 4.7 | 4.9 | 5.0 | 5.0 |
| Philippines | 6.8 | 7.2 | 6.4 | 6.7 | 6.5 |
| Thailand | 6.5 | 2.9 | 1.5 | 3.5 | 4.0 |
| Vietnam | 5.2 | 5.4 | 5.6 | 5.6 | 5.8 |
| Cambodia | 7.3 | 7.4 | 7.2 | 7.5 | 7.2 |
| Lao PDR | 8.0 | 8.5 | 7.5 | 6.4 | 7.0 |
| Myanmar | 7.3 | 8.3 | 8.5 | 8.5 | 8.2 |
| Developing East Asia excl. China | 6.2 | 5.2 | 4.8 | 5.3 | 5.3 |
| *Assumptions about the external environment:* | | | | | |
| World | 2.5 | 2.4 | 2.6 | 3.2 | 3.3 |
| High-income countries | 1.5 | 1.3 | 1.8 | 2.3 | 2.4 |
| Developing countries | 4.9 | 4.8 | 4.5 | 5.0 | 5.3 |

*Source:* World Bank, October 2014

3. **This assessment of the global and regional economies remains subject to several downside risks.** Significant uncertainties remain about the strength and sustainability of the recovery in high-income economies (exemplified in the Q2 and Q3 contractions in Japan) as well as about the timing of policy actions by central banks in these countries. A key risk to the regional outlook is that the global recovery, and the associated pickup in demand for regional exports, may be slower than anticipated. In addition, global financial conditions are likely to tighten, and financial volatility may also rise, especially if geopolitical tensions escalate; this may create debt-service challenges for some economies. Relatedly, real estate prices in some countries are likely to come under pressure.

4. **In this uncertain global environment, there is still a window of opportunity for EAP economies to enact critical—and in some cases overdue—reforms;** the short-term priority in several countries is to address the vulnerabilities and inefficiencies that have been created by an

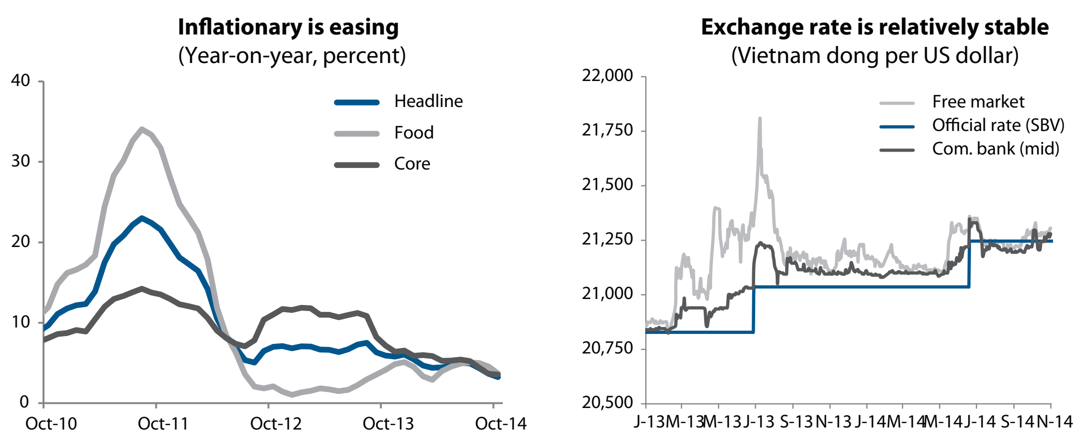
extended period of loose financial conditions and fiscal stimulus. Over the longer term, the focus in most countries must be on implementing the structural reforms needed to enhance their export competitiveness. Such reforms will position them to benefit from the global recovery, as well as from China's continued move up the value chain to less labor-intensive exports. Key reform areas include infrastructure investment, logistics, and the liberalization of services and FDI, including in the context of regional integration.

# I.2. Recent Economic Developments in Vietnam

## I. 2.1. Global Investors Recognize Vietnam's Sustained Macroeconomic Stability

5. **Vietnam continues to maintain macroeconomic stability.** Headline inflation (year-on-year) was down to 2.6 percent in November 2014 (Figure 1.2) – the lowest level since October 2009 – as a result of ample food supplies, weak energy prices, and soft domestic demand. Moreover, output remains below potential, further easing pressures on inflation[1] . The exchange rate remains mostly stable since SBV's one-percent adjustment of the dong reference rate in June 2014, aimed at helping exports, promoting foreign exchange market stability, and ensuring foreign currency liquidity. Stronger external account balances enabled foreign exchange reserves to build up to imports cover of about 3.1 months in June 2014, up from 2.4 months in December 2013. These positive macroeconomic developments contributed to improvements in Vietnam's sovereign risk ratings and allowed the country to raise capital in international markets.[2] On November 7, 2014, Vietnam successfully issued government bonds on international capital markets to raise US$1 billion at an annual coupon of 4.8 percent, or about 2.39 percentage points over similar-maturity U.S. Treasuries.[3]

**Figure 1.2: Stable Macroeconomic Environment**

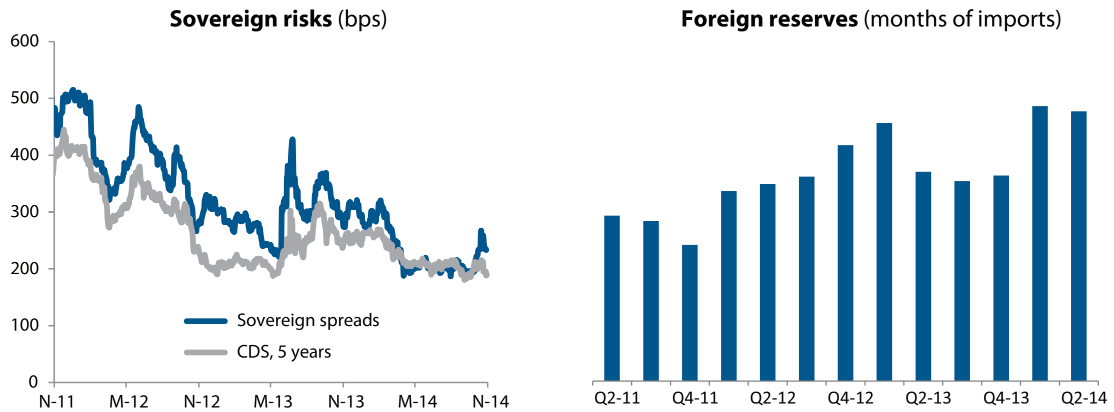



*Source:* World Bank, October 2014

[1] The IMF staff report for the 2014 Article IV Consultation estimates an output gap of 1.5 percent of GDP in 2013, with a close correlation over time between trends in output gap and inflation.

[2] Most recently, in early November 2014, the rating agency Fitch upgraded Vietnam's sovereign ratings by one notch to BB- from B+ (three levels below investment grade). This followed a similar move by Standard & Poor's and Moody's.

[3] Proceeds of the bonds will be used in part for swapping the government's sovereign debts issued in 2005 and 2010.

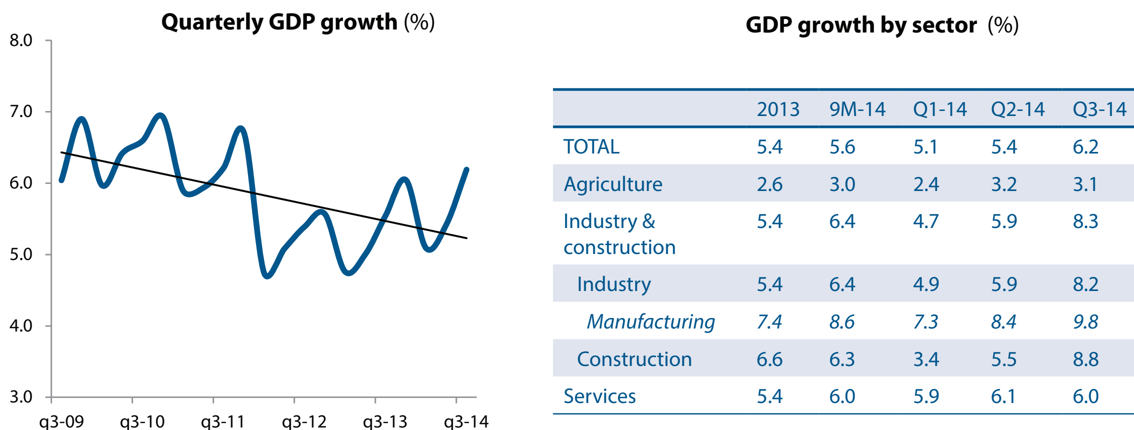



*Source:* World Bank, October 2014

## I. 2.2. Early Signs of Economic Recovery

6. **GDP growth picked up to a relatively brisk 6.2 percent (year-on-year)** in the third quarter of 2014, contributing to an overall growth rate of 5.6 percent for the first nine months of 2014 (Figure 1.3). Based on this uptick, we project GDP growth to pick up slightly, from 5.4 percent in 2013 to 5.6 percent in 2014. Each of the major sectors barring services recorded faster growth in 9M-2014 compared to the same period last year. The Industrial Production Index (IPI) is estimated to have increased by 6.7 percent thanks to strong rebound in the third quarter. The manufacturing sector is expected to continue benefiting from rising foreign investment and growing demand from Vietnam's key trading partners, especially the US. Recovery in construction reflects increased government capital spending. Growth in agriculture, too, has picked up. Vietnam is forecast to produce 45 million tons of paddy rice this year, up almost 800 thousand tons over 2013. Growth in services has remained flat at around 6 percent throughout 2014 thus far.

**Figure 1.3: Gradual Recovery of Economic Growth**



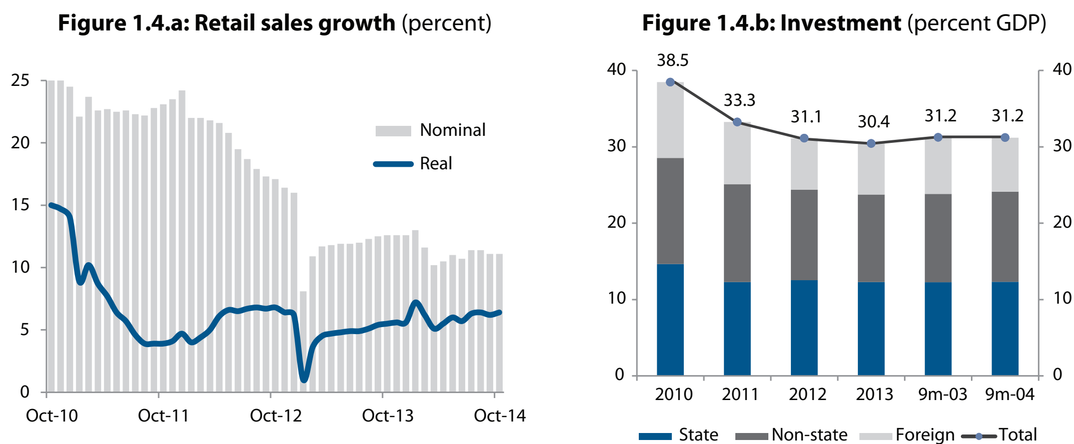

**GDP growth by sector** (%)

| | 2013 | 9M-14 | Q1-14 | Q2-14 | Q3-14 |
|---|---|---|---|---|---|
| TOTAL | 5.4 | 5.6 | 5.1 | 5.4 | 6.2 |
| Agriculture | 2.6 | 3.0 | 2.4 | 3.2 | 3.1 |
| Industry & construction | 5.4 | 6.4 | 4.7 | 5.9 | 8.3 |
| Industry | 5.4 | 6.4 | 4.9 | 5.9 | 8.2 |
| *Manufacturing* | *7.4* | *8.6* | *7.3* | *8.4* | *9.8* |
| Construction | 6.6 | 6.3 | 3.4 | 5.5 | 8.8 |
| Services | 5.4 | 6.0 | 5.9 | 6.1 | 6.0 |

*Source:* GSO

7. **Relatively flat domestic demand has kept a check on an even faster recovery in growth.** Growth in retail sales – a proxy for private consumption – improved to 6.1 percent (in real terms) in the first 10M of 2014, up from 4.6 percent in the same period of the previous year but considerably lower than in 2010. Total investment in 9M-2014 amounted to about 31.2 percent of GDP, the same level as in 9M-2013 – but significantly lower than the investment rate in 2010 (Figure 1.4). By contrast, an improved trade balance implies that the net exports continue to make a positive contribution to GDP growth for the third consecutive year.

**Figure 1.4: Weak Domestic Demand**

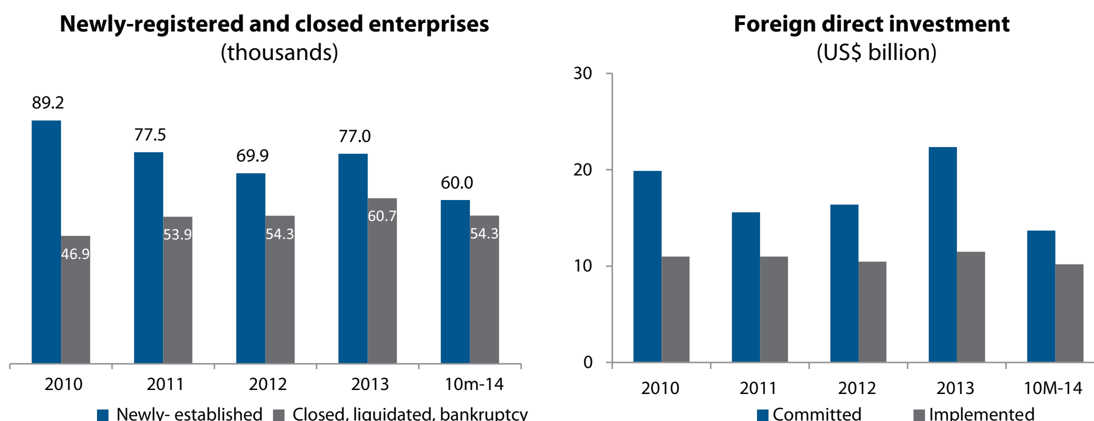



*Source:* GSO

## I.2.3. Performances of Domestic and Foreign-Invested firms Remain Dichotomous

8. **A rising number of domestic-owned businesses have been closing or suspending operations.** A total of 61 thousand firms closed or suspended business in 2013 compared to 47 thousand in 2010. A further 54 thousand were added to this category in the first ten months of 2014, about 9 percent increase over the same period last year. At the same time, the number of newly-established businesses decreased by 6.5 percent (Figure 1.5). Domestic private firms appear to be impacted by constrained access to finance, subdued domestic consumer demand, and an uneven playing field vis-à-vis the state-owned enterprise sector.

**Figure 1.5: Private Domestic and Foreign-Invested Investment**




*Source:* MPI

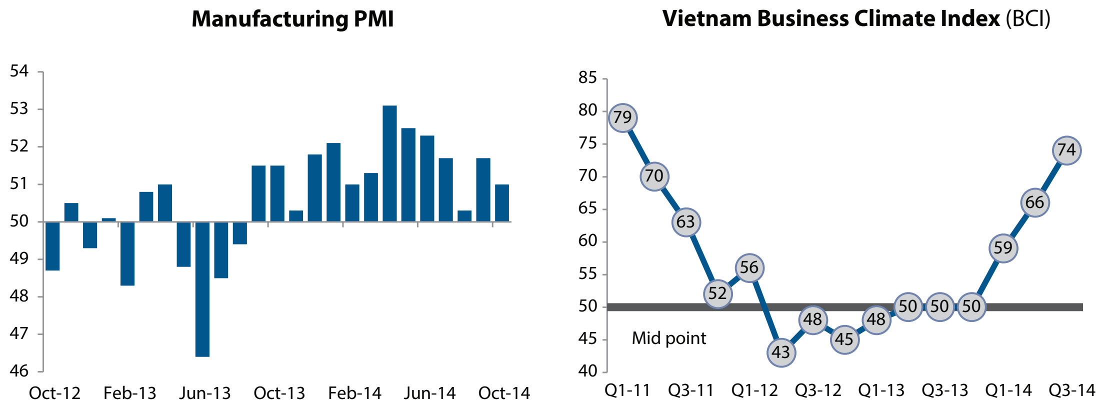
9. **The foreign-invested sector, immune to a large extent from the domestic regulatory burdens, remains a significant source of growth for the Vietnamese economy.** The sector accounts for nearly 20 percent of GDP, 22 percent of total investment, supplies two thirds of merchandise exports and provides a quarter of employment in the enterprise sector. Vietnam's manufacturing sector continues to be the main draw for foreign investors: manufacturing accounts for 70 percent of registered FDI. International investors are attracted by Vietnam's political stability, competitive wages, a relatively skilled (for labor-intensive manufacturing activity) and disciplined workforce, and proximity to the Chinese supply chains.

10. **Business sentiment within the FDI sector has improved in the past one year.** This is illustrated by EuroCham's Business Climate Index (BCI), a regular barometer of business sentiment among European companies operating in Vietnam, which has climbed significantly over the past four quarters. The BCI for the third quarter of 2014 hit a three-year high.[4] Reflecting the relative optimism of foreign investors, the headline seasonally adjusted Purchasing Managers' Index (PMI) of the manufacturing sector posted 51 in October, signaling continued expansion in the sector (Figure 1.6). This was the 14th consecutive month in which the PMI remained above the critical value of 50.[5]

4 European Chamber of Commerce in Vietnam, October 2014

5 HSBC's Markit Economics, Financial Information Services, November 2014

**Figure 1.6: Improved Business Sentiment among Foreign Investors**



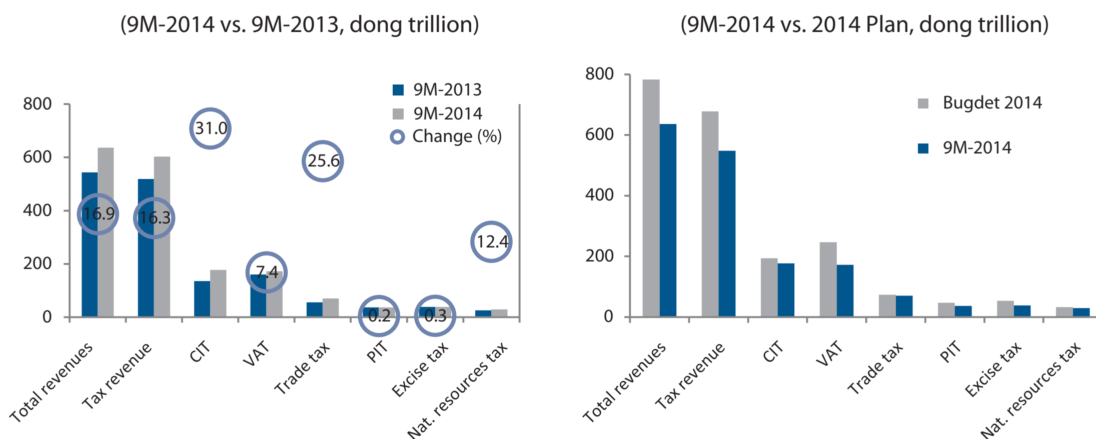

*Source:* HSBC

*Source:* Euro Cham Vietnam

## I.2.4. A Medium-Term Fiscal Consolidation Strategy is Needed

11. **Revenue collections have increased in the first 9M-2014.** Total revenues were estimated at nearly 81 percent of the 2014 State Budget, increasing by around 17 percent in nominal terms compared to the same period last year (Figure 1.7). While oil revenue fell by 4 percent (year-on-year), revenues from key taxes (corporate income tax (CIT), value added tax (VAT), and trade tax) recorded a substantial improvement compared to 2013 thanks to better performance of the corporate sector and improvements in tax revenue administration. In particular, CIT increased thanks to the collection of (i) Retained earnings of 100% state-owned SOEs; (ii) Profit sharing from Russia- Vietnam Oil JV (Vietsopetro); and (iv) Tax payments due in 2013, which were deferred as part of stimulus measures. Dividends payments from state capital invested in enterprises have also increased.

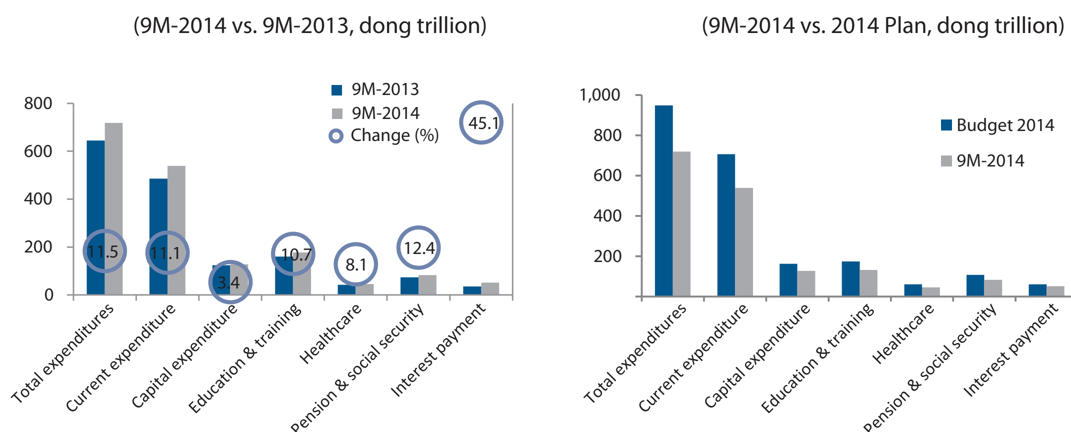
**Figure 1.7: State Budget Revenues**




*Source:* MOF

12. **Total expenditure rose 11.5 percent in 9M-2014, contributed mostly by the increase in recurrent spending which accounted for 70 percent of total expenditure** (Figure 1.8). Capital spending increased at a moderate pace of 3.4 percent. The overall fiscal deficit was estimated at 4.9 percent of GDP (by government definition) in the first 9M-2014 and was financed primarily by domestic debt. In the first 9 months of 2014, the State Treasury issued 210 trillion dong of Treasury bonds, increasing 45 percent year-on-year, and further contributing to a build-up of domestic debt.

**Figure 1.8: State Budget Expenditures**




*Source:* MOF

13. **The 2014 State Budget has a targeted deficit of 5.3 percent of GDP** (government accounting standards). The government has reported to the National Assembly that the budget deficit is among 2 of 15 high level targets set in the Socio-Economic Development Plan (2011-2015) that are off-track. Given this context, medium-term fiscal policy should aim for more consolidation. This process can be facilitated by improving tax revenue collection (by broadening the tax base and phasing out exemptions), slowing expenditure growth, improving efficiency of public investment and scaling up the existing medium-term budget framework piloted in various line ministries to the national level. Although levels of current spending are also high, and will have to be rationalized, it would be important to protect social safety nets as Vietnam transitions further to a market economy.

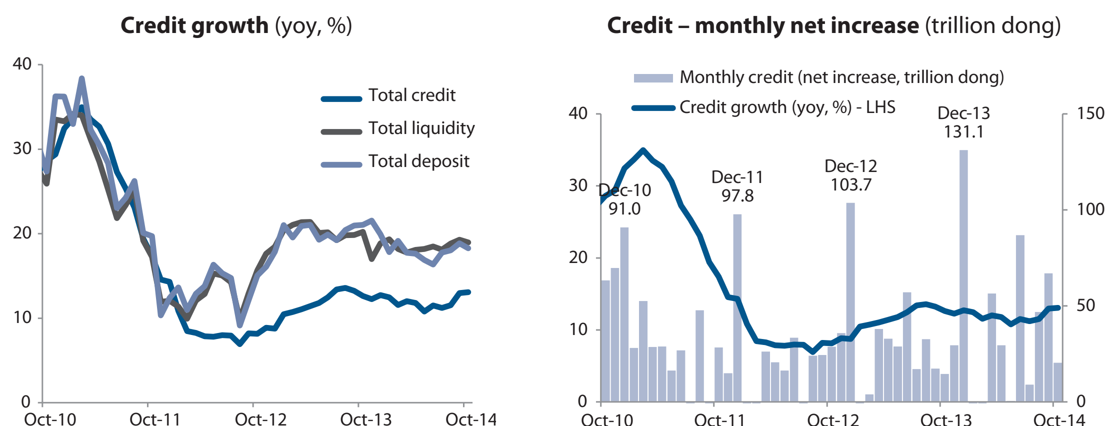
14. **The last joint IMF-World Bank Debt Sustainability Analysis (DSA, June 2014) assesses Vietnam at low risk of debt distress, but overall debt levels are becoming an increasing concern.** Total public and publicly- guaranteed debt (domestic and external) rose from an estimated 46.7 percent of GDP (by GFS standard) in 2011 to around 51.6 percent in 2013 and to a projected 55 percent in 2014. Most of this came from higher domestic borrowing, which increased from 18.4 percent of GDP in 2011 to 25.2 percent in 2013. Public debt indicators are significantly higher than in the previous DSA, and are projected to increase in the medium-term before beginning to decline. The public and publicly- guaranteed debt ratio is expected to rise to around 60 percent of GDP in 2017 before falling to around 48 percent of GDP at the end of the projection period. Public debt is rising and approaching levels that limit fiscal space for critical expenditures and potential costs of banking and SOE reforms. The ratio of debt service to revenue is also projected to rise as the level of concessional

debt in Vietnam's external debt portfolio is projected to decline. A medium-term fiscal strategy must be anchored in public debt sustainability, and should take account of contingent liability risks.

## I.2.5. Credit Growth Remains below Expectation

15. **Credit growth continues to come in below target, hampering the State Bank of Vietnam's efforts to carry out credit expansion to support growth**. Credit growth came in at around 8.6 percent (year-to-date) in October 2014 compared to the annual target of 12-14 percent (Figure 1.9). Growth in lending was constrained by banks' impaired balance sheets, concerns over the financial health of borrowers, a sagging property market, and weak demand for credit on account of low consumer and investor confidence. At the same time, banking sector deposits continued to grow at a healthy rate, thereby ensuring adequate liquidity on bank balance sheets. Easing monetary policy further in such an environment is unlikely to have much effect on credit growth.

**Figure 1.9: Credit Growth Picks Up Slowly**



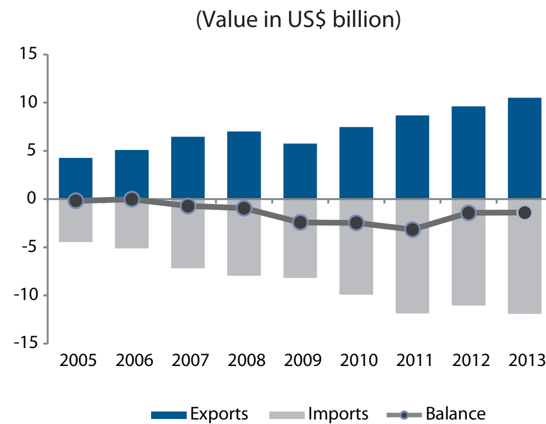

*Source:* State Bank of Vietnam

## I.2.6. Strong External Trade Performance Continues

### *I.2.6.1. Merchandise Trade*

16. **Vietnam's merchandise trade continues to perform strongly, benefiting from the dynamism of the foreign-investment sector.** The value of merchandise exports from Vietnam increased 13.4 percent (year-on-year) to reach US$ 123 billion in the first 10 months of 2014, while its merchandise imports rose by 11.2 percent to US$ 121 billion (Figure 1.10). While earnings from commodity exports are recovering gradually, Vietnam's traditional labor-intensive manufacturing exports such as garments, footwear and furniture continue to sustain rapid growth. Noteworthy additions to the export basket have been hi-tech and higher value addition products (e.g., cell phones and parts, computers, electronics and accessories, automobile parts). These have emerged as Vietnam's largest exports.

**Figure 1.10: Total Merchandise Trade**




*Source:* GSO

17. **Strong growth in exports reflects in part a welcome pick up in recent months in exports by domestic firms.** Export performance of the domestic sector continues to improve – increasing by 12.7 percent (year-on-year) in Q3 and 13.1 percent in 10M-2014 after sluggish growth in the past two years (Table 1.2).

**Table 1.2: Merchandise Exports**

| | Share of total (%) | | | Growth (%) | | |
|---|---|---|---|---|---|---|
| | 2012 | 2013 | 10M-14 | 2012 | 2013 | 10M-14 |
| Total export value | 100.0 | 100.0 | 100.0 | 18.1 | 15.4 | 13.4 |
| Crude oil | 7.2 | 5.5 | 5.1 | 13.6 | -11.6 | 5.4 |
| Non-oil | 92.8 | 94.5 | 94.9 | 18.5 | 17.5 | 13.9 |
| Agriculture and fishery | 18.3 | 15.0 | 14.3 | 6.0 | -5.5 | 12.6 |
| Rice | 3.2 | 2.2 | 2.1 | 0.4 | -20.4 | -0.1 |
| Low value manufacturing | 23.6 | 24.2 | 25.1 | 13.9 | 18.2 | 19.3 |
| Garment | 13.2 | 13.6 | 14.3 | 14.2 | 18.9 | 19.3 |
| High value manufacturing | 18.0 | 24.1 | 22.6 | 85.7 | 54.9 | 4.6 |
| Phones and parts | 11.1 | 16.1 | 15.6 | 98.8 | 67.1 | 6.9 |
| Others | 32.9 | 31.2 | 31.9 | 7.4 | 9.4 | 17.7 |
| | | | | | | |
| *Domestic sector* | 36.9 | 33.3 | 33.0 | 1.1 | 4.0 | 13.1 |
| *Foreign invested sector* | 63.1 | 66.7 | 67.0 | 31.1 | 22.0 | 13.6 |
| *Foreign invested sector (excl. phones) | 52.0 | 50.7 | 51.4 | 22.3 | 12.4 | 14.3 |

*Source:* GSO

18. **In terms of geographical destinations, overall, Vietnam's merchandise exports have been fairly diversified.** Among trading partners, the United States continues to remain Vietnam's largest, accounting for 19 percent of Vietnam's total exports. This is followed by the EU, ASEAN, Japan and China. However, Vietnam's merchandise imports are quite concentrated (Figures 1.11 and 1.12). The top 10 partners account for 80 percent or more of imports. China remains the largest source of Vietnamese imports, accounting for 29 percent of total import value. Trade between Vietnam and China has remained largely unaffected by recent territorial tensions. Vietnam's exports to China increased 16.8 percent from January to September compared to the same period last year and made up 10 percent of Vietnam's total export turnover.

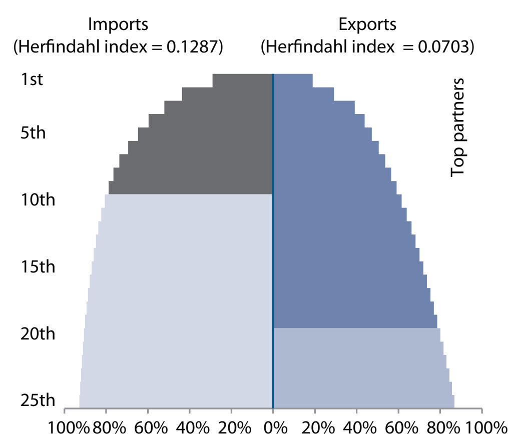
### Figure 1.11: Vietnam's Trade Concentration

**Vietnam trade by partners** (% of total)

| | Exports by destinations | | |
|---|---|---|---|
| | 2012 | 2013 | 9M-14 |
| China | 10.8 | 10.0 | 10.1 |
| Japan | 11.4 | 10.3 | 10.0 |
| The US | 17.2 | 18.1 | 19.0 |
| EU | 17.7 | 18.7 | 18.3 |
| ASEAN | 15.1 | 13.7 | 12.6 |
| North East Asia | 9.9 | 9.8 | 9.4 |
| Others | 17.9 | 19.3 | 20.5 |
| | **Imports by sources** | | |
| | 2012 | 2013 | 9M-14 |
| China | 25.3 | 28.0 | 29.1 |
| Japan | 10.2 | 8.8 | 8.5 |
| The US | 4.2 | 4.0 | 4.3 |
| EU | 7.7 | 7.1 | 6.1 |
| ASEAN | 17.7 | 15.6 | 15.8 |
| North East Asia | 22.0 | 23.6 | 22.8 |
| Others | 12.9 | 12.9 | 13.4 |

*Source:* GSO

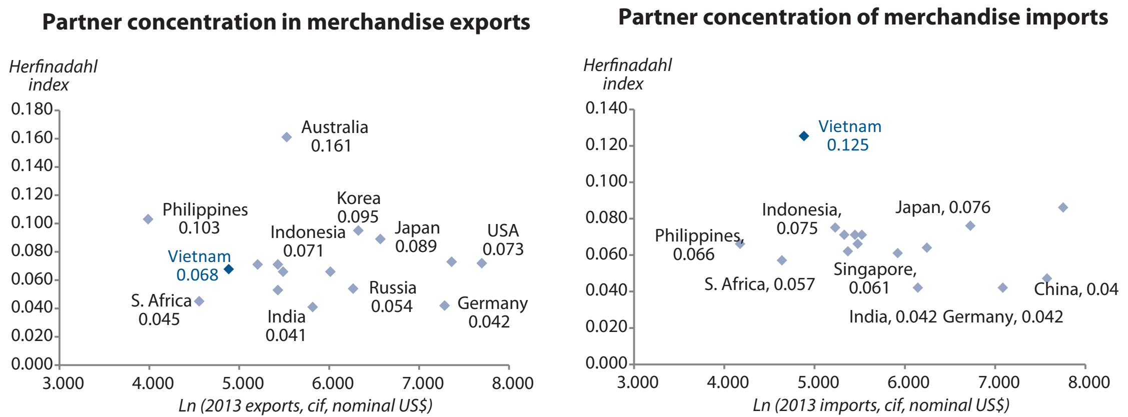
**Partner concentration in merchandise trade**[6]




*Source:* Staff estimates based on data of 9M-2014

6 ***Herfindahl index:*** This indicator is a measure of the dispersion of trade value across trading partners. A higher index indicates that trade (imports and exports) are concentrated in fewer markets, whereas a country trading equally with all partners will have an index close to 0.

**Figure 1.12: Vietnam's Trade Concentration Comparison**

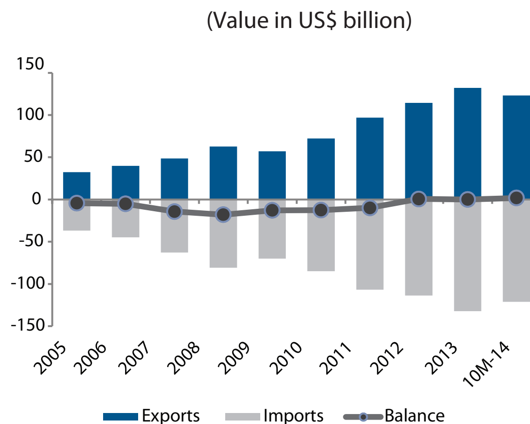



*Source:* Staff estimates based on COMTRADE 2013 data

### *I.2.6.2. Merchandise Trade Trade in Services Shows Potential despite Small Base*

19. **Trade in services remains a minor component of Vietnam's foreign trade:** in 2013, exports (receipts) of commercial services represented about 7.4 percent of total exports of goods and services; and imports (payments) of commercial services accounted for 8.3 percent of total imports of goods and services (Figure 1.13).

**Figure 1.13: Total Services Trade**

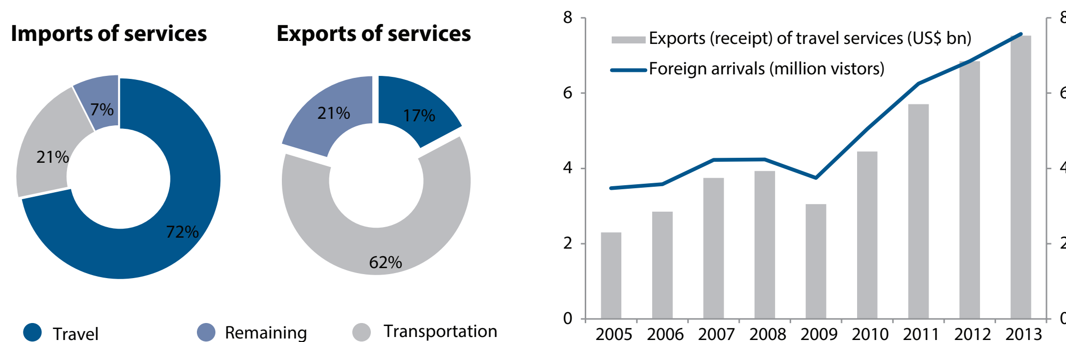



*Source:* GSO

20. **Receipts from travel services account for 72 percent of total Vietnamese service exports whilst transportation and shipping of imported goods account for 62 percent of service imports.** Vietnam welcomed 7.6 million international arrivals in 2013 and 6.6 million in the first ten months of 2014, marking a year-on-year increase of 8 percent (Figure 1.14). Tourists from

China, Korea, Japan, Cambodia, Taiwan (China) and Russia accounted for nearly 60 percent of total foreign visitors to Vietnam so far in 2014. Vietnam has great potential to attract more visitors given its enormous potential in tourism sector. But this will require further strengthening the quality of service provision. If this can be realized, services exports could represent a stronger part of Vietnam's overall exports in the years to come.

**Figure 1.14: Foreign Visitors And Receipts From Travel Services**




*Source:* GSO

# I.3. Structural Reform Agenda

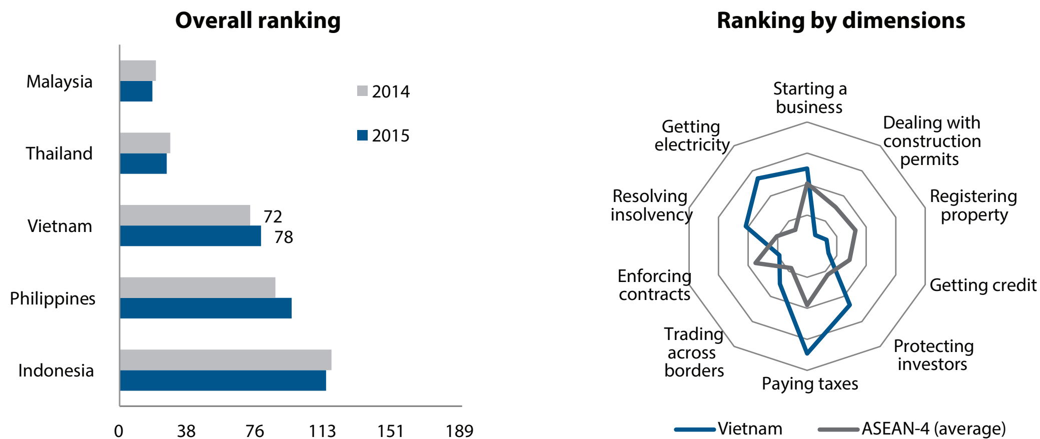
## I. 3.1. Reforms to Address Ongoing Business Environment Challenges

21. **Cross-country competitiveness assessments show that Vietnam is falling behind comparator economies.** Vietnam's ranking on the Doing Business survey has fallen from 72nd position in DB2014 to 78th in DB2015 [7] among 189 economies. [8] Vietnam's national competitiveness is ranked below the average among ASEAN-4 countries, with slow improvements in the institutional framework, infrastructure and business environment (Figure 1.15). This is highlighted by the problems with starting a business, tax payment time, protection mechanism for investors, access to electricity and dealing with business insolvency.

[7] Beginning in this year's Doing Business report (DB2015), the ranking is based on the distance to frontier score rather than on the percentile rank.

[8] Vietnam's score rose modestly from 64.1 in DB 2014 to 64.4 in DB 2015.

**Figure 1.15: Ease of Doing Business Ranking**




*Source:* World Bank 2015. ASEAN-4 includes Indonesia, Malaysia, Philippines and Thailand

22. **The government has, however, taken some important measures in 2014 to improve business conditions, which do not get reflected in the latest Doing Business rankings.** The Government issued Resolution 19 (March 18, 2014) which prioritizes shortening the time for processing and completion of administrative procedures, reducing administrative costs, and strengthening transparency and accountability of state administrative agencies (Box 1). The revised Law on Bankruptcy, passed in July 2014, was another effort to improve the legal framework for businesses. The law incorporated international good practices, including the introduction of professional insolvency practitioners. Two other important laws, the Enterprise Law and the Investment Law, have been revised and are scheduled to be approved by the National Assembly in November 2014. These two laws are expected to improve corporate governance in enterprises and SOEs in particular, further reduce licensing and administrative burdens as well as provide clarity on criteria for conditional businesses and open up more business opportunities for the private sector (Box 1).

**Box 1: Measures to improve business environment and enhance national competitiveness**

The Resolution 19 of Vietnamese Government sets specific targets as follows:

- To streamline procedures and shorten the time required to start new businesses
- To further reform file processing practices and tax payment procedures and reduce the time required of businesses to complete tax payment procedures
- To reduce the time required of businesses and investment projects to get access to electricity
- To improve rules of protection of IPRs and investors towards protecting property rights, investors and minority shareholders in line with international standards;
- To facilitate and ensure equality, openness and transparency in market-based access to credit among enterprises, organizations and individuals of all economic sectors;
- To streamline processes, to simplify record-related requirements, export and import procedures and customs formalities, and to reduce the time for import and export clearance
- To reduce the time to deal with business insolvency;
- To engage in publicizing, with greater transparency, information about business performance and financial standing in accordance with law and in line international best practices.

Following the Government's instructions to cut down the time of paying tax to ASEAN-average of about by 2015, the MOF issued Circular 119 (August 25, 2014) amending a number of current regulations in order to reform and simplify the tax administrative procedures:

- Tax administration: Amending Circular 156 on Tax administration to simplify and rationalize tax declaration forms
- Personal Income Tax (PIT): Amending Circular 111 on PIT
  - ✓ For individuals from a tax treaty country with Vietnam and being Vietnam tax residents, their PIT obligations shall be calculated from the month first arriving in Vietnam instead of from January of that year as previously regulated.
- Value Added Tax (VAT): Amending Circular 219 on VAT:
  - ✓ VAT will not be imposed on imported goods being goods returned overseas parties
  - ✓ Goods and services provided for internal use for business purposes is exempt from VAT
  - ✓ It is no longer required to issue invoice and declare VAT on machine, equipment, materials and inventory being on loan or returned of loan
  - ✓ A new business is no longer required to invest one billion VND in assets to be able to adopt VAT credit method. In addition, at the end of the first calendar year, even when it fails to earn one billion VND in revenue it can continue to adopt the credit method if it has a full accounting and invoice regime in place
  - ✓ It is no longer required to specify the period of deferred payment in the list of purchased goods or services
  - ✓ The purchaser does not need to register or notify the tax authorities on loan accounts at credit institutions used for payment to the suppliers
- Invoices: Amending Circular 39 on invoices for goods and services:
  - ✓ Where a company uses accounting software in line with that of its parent company which is a multinational organization, the "unit" item can be in English. For services, this "unit" item is no longer required
  - ✓ New companies may report the use of invoices on a quarterly basis, not monthly as previously required.
- Corporate Income Tax (CIT): Amending Circular 78 on CIT:
  - ✓ Goods and services used internally for the purposes of ongoing production of a business shall be excluded from taxable revenue

*Source:* Government, MOF and KPMG

## I.3.2. . Despite Greater Momentum, State Owned Enterprise Reforms Lag Behind Targets

23. **SOE equitization has picked up momentum.** The government equitized 74 SOEs in 2013 (thrice the number in 2011 and 2012), and the momentum continued in 2014. By the end of September 2014, 71 enterprises were equitized, 35 of which completed initial public offering (IPO) of shares through the stock markets. Recent equitization has increasingly involved large SOEs such as Vietnam Airlines, Petro Vietnam and Vietnam Textiles & Garments (Vinatex). The government aims to equitize 200 SOEs in 2014 and 232 in 2015. This ambitous target may be hard to achive due to the complexity of the to-be-equitised SOEs and slow economic recovery.

24. **The planned divestment of SOEs from 5 non-core "risky areas" has taken off, though the pace is slower than anticipated.** Some progress has been made against Decree 71, requiring all non-bank SOEs to fully divest from 5 non-core risky areas by 2015. By the end of September 2014, 4.5 trillion dong of state capital was divested from non-core businesses, accounting for about 21 percent of the plan. Future progress will require strengthened information disclosure, performance monitoring, corporate governance reform, transparency of the divestment process, and clearer lines of accountability in SOE oversight.

25. **The legal framework for SOE reform has been further strengthened.** The recently-issued Resolution 15 contains a comprehensive action plan to step up SOE divestment. Two related laws — the Law on Management and Use of State Capital Invested in Production and Business and the Enterprise Law were approved by the National Assembly in November 2014. The Law on Management and Use of State Capital Invested in Production and Business is expected to improve the focus, transparency, and accountability in the investment and management of state capital in production and business, and the level of oversight of SOEs' performance by the National Assembly and other stakeholders. The Law is designed to regulate both the investment in, and the management of, the state's capital in production and businesses. The Enterprise Law (revised) aims to motivate entrepreneurship, create a more transparent business climate and level the playing field for all types of enterprises.

26. **An important element of SOE governance is increased transparency and disclosure of enterprise finances and operations.** In this regard, the government continues to pursue implementation of several newly adopted legal documents, including Decree 61/2013, Decree 69/2014 and Prime Minister's Decision 36/2014. Decree 61 requires more detailed reporting by SOEs to their parent ministries or departments twice a year (four times for larger SOEs), and MOF has to report to the National Assembly every year on the overall operational and financial performance of all SOEs. Enterprises with state capital investment are also required to disclose financial, business and corporate governance performance information. Decision 36 and Decree 69 extend the disclosure coverage to non-financial information such as strategy and long-term development plans of SOEs or regular corporate governance information. All mentioned regulations require public disclosure of information, including on the enterprise websites. Preliminary indications are that there is progress in terms of internal reporting by SOEs to parent ministries and the Ministry of Finance. However, progress on public disclosure requirements has been more limited.

27. **The government has articulated a clear policy vision on SOE reforms, but more consistent implementation will be the key.** The equitization targets need to be distilled into concrete, implementable, and time-bound plans. This implies significant technical background work as well as resolute efforts at prioritization. Also, the decision making process on SOE equitization remains time-consuming (Box 2) and must be streamlined so that decisive actions can be implemented with speed and certainty.

**Box 2: Why Equitization of an SOE Takes So Long?**
***The legal process for an SOE equitization***

| *No.* | *Specific steps* | *Timing (month)* |
|---|---|---|
| 1. | Issuing a decision by Ministry on equitization of the SOE | T |
| 2. | Issuing a decision by Ministry on the establishment of equitization steering committee | T |
| 3. | Issuing a decision by Ministry on approval of SOE value | T+9 |
| 4. | Holding the extraordinary employee meeting to pass the equitization plan | T+10 |
| 5. | Issuing a decision by Prime Minister on approving the equitization plan | T+12 |
| 6. | Issuing a decision by Ministry on approving the initial price for IPO and/or the selection of strategic investors | T+12 |
| 7. | Announcing the organization of IPO | T+14 |
| 8. | Announcing a decision by Ministry to approve price of shares sold to strategic shareholders | T+14 |
| 9. | Contact signing between company and strategic investors | T+14 |
| 10. | Organizing the IPO at the Stock Exchanges (Hanoi or Ho Chi Minh city) | T+15 |
| 11. | Conducting the first general meeting of shareholders | T+16 |
| 12. | Obtaining an enterprise registration certificate for a new enterprise | T+17 |

*Source:* Stoxplus

## I.3.3. Greater Urgency is needed on Implementing Banking Sector Reforms

28. **Liquidity injections have brought some relief to the banking sector, although the pace on the more important structural reforms needs to pick up.** Deposit grew strongly at 12 percent (y-o-y) by the end of October reflecting both stable public confidence in the banking sector and limited investment options for depositors amidst hazy recovery in the real estate and securities markets. During the year, the average lending rate has dropped 1-1.5 percentage points as the SBV further lowered the cap on interest rates for deposits of less than 6 months to 6 percent and maintaining the cap of 0.75 percent on US Dollar deposits. For the first 9 months, the Treasury sold as much as VND210 trillion (approximately USD10 billion), or 1.45 times higher than that of the same period in 2013.

29. **Resolution of bad debts in the system remains a key issue of concern despite the multi-pronged debt resolution approach.** In September 2014, the SBV Governor reported that VND249 trillion of bad debts were being dealt with compared to VND464 trillion as of September 2012. Since

its establishment in July 2013, the Vietnam Asset Management Company (VAMC) has absorbed a growing share of bad assets (about VND90 trillion or about 4.2 billion of US dollars) as of October 2014. But it has not yet articulated a clear strategy to actually resolve the bad debts. Moreover, its efforts in this regard have been hampered by the absence of an enabling legal framework for insolvency and asset titling, and for protecting VAMC and commercial bank staffs against possible lawsuits arising from potential losses to the State in case a fair market price mechanism cannot be established. The question on the actual size of NPLs remains unanswered although issuance of Circular 02 and Circular 09 on loan loss classification and provisioning is a step in the right direction. Full enforcement of Circular 02 however has been delayed till April 2015.

30. **The pace of banking sector restructuring is slower than expected, especially with regard to the banking sector consolidation.** Though the cap for total foreign holdings remains unchanged at 30 percent (consistent with Vietnam's WTO commitments), Decree 01, issued in January 2014, now allows higher ownership in special cases subject to Prime Ministerial approval. The SBV has targeted 6-7 M&As in the banking sector in 2014, and a 50-percent reduction in the number of commercial banks in the next 3 years, but no new M&As have taken place in the year. The good sign is that none of the past M&As have been reported to result in major disorders to the system performance thus far, and that should be given the benefit of doubt. The Government issued Decision 51/2014/QD-TTg on September 15, 2014 in an effort to deal with SOE divestment and listings on the stock market. One of the priorities of the Decision was to provide more options to SOEs for divestments from the banking sector.

31. **Disclosure and transparency of the system have been improved, but remain relatively weak compared with Vietnam's peers in the region.** The SBV has shown its intention to move forward in this regard when considering some upgrading of Circular 35/2011/TT-NHNN on data disclosure by the SBV. Additionally, in a bid to have a better knowledge of the performance of the commercial banks, the Banking Supervision Agency earlier in the year started a special audit which targets portfolio performance, ownership structure of a dozen of commercial banks. However, the audit is still based on the to-be-replaced loan classification (Decision 493) and local standards that may not bring about fully reliable data in order to benchmark the banking sector performance to those of its peers in the region. The focus section of this report has more detailed assessment of the structural issues in the banking sector.

## I.4. Medium-Term Outlook: Continued Prospects of Moderate Growth and Downside Risks

32. **Medium term projections reflect continued modest GDP growth and further consolidation of macroeconomic stability.** The baseline scenario forecasts assume moderately-paced policy stimulation and further progress on structural reform in the financial and SOE sectors. GDP growth in the base case scenario is forecast at 5.6 percent for 2014, supported by expansion in the manufacturing sector, trade and steady performance of foreign-invested sector. However, growth over the medium to long term will depend upon efforts to improve business environment for the domestic private sector – with emphasis on improving access to finance, leveling the playing field vis-a-vis the SOE sector, lowering the regulatory burden, improving trade infrastructure and logistics, and creating a more skilled workforce.

33. **Inflationary pressures are expected to remain subdued over the medium term.** Although loosening monetary policy and year-end spikes in private consumption could trigger temporary price fluctuations, inflationary expectations remain benign, supported by strong supply and relatively stable international commodity prices. The trade and current accounts are expected to remain in surplus in 2014 though by a smaller amount than in 2013. The Government is committed to fiscal consolidation and debt reduction, for which improved revenue collection, better controls on recurrent expenditures, and improving the efficiency of public investment are critical.

**Table 1.3: Selected Shot-term Economic Indicators**

| | 2012 | 2013e | 9M-14e | 2014f | 2015f |
|---|---|---|---|---|---|
| Real GDP (% change, y-y ) | 5.3 | 5.4 | 5.6 | 5.6 | 5.6 |
| Consumer price index (%, annual average) | 9.1 | 6.6 | 3.6 | 4.5 | 5.0 |
| Current account balance (% GDP) | 6.0 | 5.6 | 4.5 | 4.1 | 3.3 |
| Fiscal balance (% GDP, GFS definition) | -4.8 | -5.6 | -5.5 | -6.6 | -5.9 |
| Public debt (% GDP, GFS definition) | 48.5 | 51.6 | n/a | 54.8 | 57.1 |

*Source:* GSO, IMF and WB

34. **The medium-term outlook presents the following macroeconomic risks:** (i) relatively slow progress on restructuring the SOEs and the banking sector could adversely impact the macro-financial situation, undermine growth prospects and create large public sector liabilities. By contrast, quick and decisive restructuring and reform of SOEs and the financial sector should help Vietnam return to a more sustainable macroeconomic environment while laying the foundations for greater efficiency and productivity to drive medium and longer term growth; (ii) the high export orientation of the Vietnamese economy exposes it to adverse turn of events in the global economy, especially in the developed world which absorbs much of Vietnam's exports; Finally, an upturn in global interest rates could prove problematic for the Vietnamese economy, given vulnerabilities in the domestic banking sector and high levels of indebtedness in the economy.

# SECTION II

# SPECIAL FOCUS ON VIETNAM'S FINANCIAL SECTOR ASSESSMENT

**The Financial Sector Assessment Program (FSAP) provides a comprehensive framework to identify financial system vulnerabilities and develop appropriate policy responses.** Recognizing its importance, in July 2012 the Government of Vietnam invited the WB and the IMF to initiate an FSAP for Vietnam. An integral part of the FSAP is the Financial Sector Assessment (FSA) report—an indepth look at the stability and development potential of the financial system. The special focus section of this Taking Stock report summarizes the main messages of the FSA that was publicly released on August 29, 2014.

## Financial Sector Assessment[9]

### I. Introduction and Summary of Main Recommendations

1. **Vietnam has achieved remarkable progress since the start of its transition from a centrally planned economy in the mid-1980s.** The Economic Renovation Policy (Đổi Mới) announced in December 1986 marked the transition from a centrally planned economy to a mixed economy with greater reliance on markets and increased participation of private financial and non-financial institutions. These reforms contributed to an impressive performance in the last two decades—since 1990 the annual GDP growth has exceed 7 percent and per capita income has increased more than three-fold.

2. **However, in recent years the Vietnamese economy has shown signs of corporate and financial distress, and weaker growth.** Several segments of the corporate sector exhibit poor

[9] The Financial Sector Assessment report was prepared by a team comprised Roberto Rocha (World Bank) and Javier Hamann (IMF), co-heads, Isaku Endo, Serap Gonulal, Olivier Hassler, William Mako, C. Michael Grist, Yen Mooi, Harish Natarajan,Valeria Salomao Garcia, Martin Vazquez-Suarez, and Niraj Verma (all World Bank), Rina Bhattacharya, Carlos Caceres, Nombulelo Duma, Toshi Kurosawa, Pamela Madrid, Judit Vadasz, and Mamoru Yanase (all IMF), Andrea Corcoran and Vern McKinley (external experts).

performance and financial distress, and have affected the health of the banking system. Large state owned enterprises (SOEs) have defaulted on their obligations and several others appear to be overleveraged. The banking system has accumulated a significant amount of non-performing loans (NPLs), estimated conservatively at 12 percent of total loans at the end of 2012, and many small banks have experienced more serious liquidity and solvency problems in the same period, leading to interventions by the State Bank of Vietnam (SBV). The reduced lending capacity of the banking system is one of the factors that have contributed to a sharp slowdown of credit growth.

3. **The weak performance of the financial sector is due to a complex array of institutional and regulatory factors.** These factors have included episodes of interference by central and local authorities on the investment and credit decisions of state owned enterprises (SOEs) and state owned commercial banks (SCOBs); inadequate governance structures and risk management capacity in these institutions; connected lending in several joint-stock banks (JSBs); weaknesses in financial infrastructure, including poor financial reporting standards; and deficiencies in financial regulation and supervision. In this context, credit growth has often been excessive and credit allocation poor. Increased macroeconomic volatility in the last five years has compounded these problems and led to further deterioration in the quality of loan portfolios.

4. **The government has announced a comprehensive reform program designed to address the problems faced by the financial and corporate sectors.** The reform program was officially documented in the Socio-Economic Development Plan (SEDP) for the period 2011–2015, approved by the National Assembly in November 2011. It includes three basic components: banking restructuring, SOE restructuring, and public investment reform. Since then, the government and the SBV have been making efforts to elaborate further the design of these three programs, and in March 2012 issued a decision approving the banking restructuring component. More recently, the Government and the SBV introduced a new asset management company (the VAMC) to handle NPLs. The banking reform program is comprehensive, but important reform issues must be further developed and the program must be consistently implemented to ensure the full recovery of the financial sector.

5. **This FSAP provides a broad set of policy recommendations that can be used to operationalize the SEDP and the banking restructuring program.** The recommendations fall into three groups: (i) a plan to work out the large stock of existing NPLs; (ii) measures to ensure sound new flows of finance and prevent the accumulation of additional NPLs; and (iii) a set of policy steps designed to protect the financial sector during the envisaged reform period. For each group of measures, the plan identifies pre-conditions (first phase) and sub-sets of measures that needs to be implemented in the short run (second phase) as well as those that can be phased in over the medium term (third phase).

6. **The recommendations include recapitalization plans, the workout of NPLs, regulatory and other reforms, and the temporary extension of the safety net.** Special financial audits of banks would provide accurate assessments of NPLs, the related recapitalization needs, and key information for the design of debt resolution schemes. Operational audits would provide the basis for restructuring plans in the SOCBs. An identification of the main patterns of interconnectedness across banks and borrowers would allow the monitoring of systemic risk during the reform period. In a second phase, banks would be recapitalized and SOCBs and SOEs would divest their shares in other banks. This phase would also entail the preparation of a reform of the regulatory and supervisory systems. A well-articulated NPL workout program would be prepared in the second phase and fully launched in the third phase. It would proceed in four tracks, one led by the banks, one led by a centralized AMC, and two additional

tracks to deal with large and complex SOEs. Simultaneously, a set of measures to relieve the SOCBs from policy mandates would be adopted. The implementation of the capital markets agenda and the reform of financial infrastructure and financial regulation would be deepened in this final phase.

## II. The Structure of the Financial System

7. **The Vietnamese financial system is large for a low middle-income country, with assets of 200 percent of GDP in 2011.** The banking sector dominates the financial system, with its assets amounting to about 183 percent of GDP (including the two policy banks) and 92 percent of financial institutions' assets. The banking sector is large by international comparison, whether measured by deposits or credits. Bank deposits increased significantly in the past decade, reflecting a large savings ratio, rapid economic growth, and slower development of other suitable savings instruments. By 2011 the ratio of bank deposits to GDP exceeded the relevant benchmarks by significant margins[10] . The ratio of credit to GDP also expanded significantly in the same period, particularly from 2007 to 2010, driven by very high investment ratios, and also exceeded the relevant benchmarks by significant margins in the same period.

8. **While the financial system is large by international comparison, its expansion has been volatile in recent years, reflecting the unstable external environment and erratic macroeconomic policies.** The growth of credit has followed an erratic pattern since 2006, with credit spikes followed by sharp credit slowdowns. In 2007, credit grew by 54 percent per annum (the equivalent of 20% of GDP), mainly driven by large inflows following Vietnam's accession to the World Trade Organization (WTO). Credit and economic activity slowed down at the end of 2008 as a result of the global crisis, prompting a corrective response from the authorities. The relaxation of fiscal and monetary policies triggered another credit spike in 2009 and 2010, prompting a round of policy tightening and a strong credit slowdown in 2011. Concerns that tightening was excessive amidst a weakening global environment prompted another aggressive loosening of policies in 2012, including cuts in policy rates and a range of administrative measures. However, credit growth has remained sluggish despite the policy easing, reflecting the deterioration of banks' balance sheets and the need for deleveraging. While the macroeconomic situation appears to have stabilized since 2012, financial vulnerabilities still need to be addressed by a coherent program.

9. **The banking sector is large, but non-banking financial institutions and securities markets remain small.** Non-banking financial institutions (including cooperatives) account for only 17 percent of GDP and 8 percent of financial institution assets. Finance companies provide project and consumer finance and represent the largest class of non-banking financial institution, accounting for 6 percent of GDP and 3 percent of financial institution assets. Insurance companies account for 4 percent of GDP, while mutual funds account for less than one percent of GDP and private pension funds remain negligible. The Social Security Fund (SSF) is the only institutional investor of significant size, managing pension reserves amounting to 6.5 percent of GDP. Equity markets have grown rapidly but are still at an early stage of development. While the number of companies listed in the two exchanges has increased dramatically, primarily due to the "equitization" of SOEs, total equity market capitalization is relatively small at 20 percent of GDP in 2011, reflecting the fact that listed firms in Vietnam are generally small. The fixed income market is of a moderate size and is dominated by government bonds.

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10 The two benchmarks include: (1) the values predicted for Vietnam by a panel regression model that controls for per capita income, population size, population density and demographic profiles; and (2) the average of four East Asian countries (Indonesia, Malaysia, Philippines, and Thailand).

# III. The Structure and Performance of the Banking Sector

10. **State presence in the banking sector is large and involves both direct and indirect ownership links.** At the end of 2011, the five state-owned commercial banks (SOCBs) accounted for almost 40 percent of assets and 48 percent of deposits. The total participation of the State in the commercial banking system is larger, considering the equity participations of the state, SOEs and SCOBs in several of the 34 joint-stock banks (JSBs) – the segment that has grown most rapidly and accounts today for half of total assets. The share of foreign banks in total commercial banking assets has remained small and stable at 10 percent.[11]

11. **The banking system is also characterized by a high degree of cross-ownership between banks and between banks and enterprises.** This includes ownership of JSBs by other banks (both SCOBs and other JSBs) and by economic groups (including SOEs) whose structures are not well-understood. The complex shareholding structure raises serious concerns about conflicts of interest and related/connected party lending to finance questionable projects. These structures have also led to an overstatement of capital through multiple gearing and facilitated the circumvention of prudential regulations, such as credit concentration limits.

12. **The performance of the banking sector has deteriorated in recent years and is probably weaker than reported.** The average ROA of all banks fell from 1.8 percent in 2007 to 0.5 percent in 2012, with the latter figure probably overstated given the low quality of financial data. More generally, the low quality of financial data impairs the accurate measurement of most performance indicators, including ROAs, NPL ratios, and capital ratios. Data weaknesses are due to several factors, including inadequate loan classification and provisioning rules (including the classification of rescheduled loans), unreliable valuation of collateral and questionable classification of certain assets as liquid. In addition, there are concerns about the valuation of the large non-lending assets in banks' balance sheets, especially the inadequate valuation of investments (some of which related to operations designed to under-report NPLs) and lack of transparency over other items such as receivables. As mentioned before, there is also concern about multiple gearing of capital in light of the widespread cross-ownership.

13. **There are severe concerns about the quality of loan portfolios and the levels of capital in a number of banks.** Taking into account data weaknesses discussed above, the reported financial data was adjusted based on assumptions that are not too stringent [12]. These adjustments raised the NPL ratio to 12 percent at the end of 2012 and significantly lowered the capital-adequacy ratios (CARs) of several banks. Stress tests on the adjusted data further reveal that banks are highly exposed to credit and concentration risk. Sensitivity analysis to changes in assumptions shows that the key findings are robust, although the low quality of financial data and the need to rely on assumptions for several calculations mean that the stress test estimates are subject to wide confidence intervals.

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[11] The participation of the State in the banking system is even larger considering the two development banks – the Vietnam Development Bank (VDB) and Vietnam Bank for Social Policies (VBSP).

[12] The adjustments included the reclassification of loans in the top categories, haircuts of the inferred levels of collateral and further adjustments to reflect the likely overvaluation of investments and other assets.

14. **A complementary analysis of the listed corporate sector provided consistent results.** Many economic sectors are performing poorly, with the construction and materials, real estate, basic resources and utilities industries in particular vulnerable to economic shocks. Interestingly, although listed SOEs probably represent the best performing segment of the SOE sector, they still appear to be more distressed than their private listed counterparts. The underlying credit quality of majority state-owned companies is weak, particularly for the large enterprises. These firms could have difficulties in servicing their debts compared to private firms, as they are more indebted, have weaker liquidity positions, and are concentrated in the low-performing industries.

# IV. Capital Market Development

## A. SECURITIES MARKETS

15. **The domestic fixed-income market is of a moderate size and dominated by government bonds.** The outstanding value of fixed-income securities is 15 percent of GDP, with almost 90 percent of the market consisting of government bonds (comprising treasury bonds, government guaranteed bonds and a small share of bonds issued by local authorities). Government bonds are frequently issued with tenors of three and five years, and the average maturity of central government debt is 3.2 years. The corporate fixed-income market has been growing but remains at an embryonic stage.

16. **The MOF has taken important initial steps towards the development of the government debt market, but much needs to be done to build a reliable benchmark yield curve.** Factors limiting bond market development include ineffective primary markets (despite recent commendable initiatives and improvements, there is still an excessive number of issues, no critical mass of issues in the main benchmarks, and the new primary dealer system remains untested); illiquid secondary markets; the absence of a solid institutional investor base (banks hold more than 80 percent of the stock of domestic government debt); and the absence of the necessary infrastructure and market support services.

17. **The government has recently approved a comprehensive roadmap for bond market development and a timeframe for implementation.** The roadmap is based on five pillars, including the policy framework, primary market, secondary market, investor base, infrastructure, and support market services. The government is establishing a committee to implement the roadmap over the remainder of the decade, chaired by the MOF with the participation of the SBV and other relevant stakeholders. The roadmap is focused on the government bond market, but its implementation is a precondition for the sound development of the corporate bond market. These efforts are commendable, given the potential contribution of corporate, infrastructure, and covered bonds for expanding access to long-term finance by corporates, local governments, and banks, while also contributing to the stability of the financial system.

18. **The equity market is characterized by a large number of listed companies with low average capitalization.** The two exchanges, the Ho Chi Minh and Hanoi Stock Exchanges opened trading in 2000 and 2005 respectively, and already have 700 listed companies, an unusually large number for Vietnam's level of income and young capital markets. The rapid increase in listings was

due primarily to the "equitization" of former SOEs through initial public offerings (IPOs). About one-third of the companies listed are majority state-owned. The Ho Chi Minh City Stock Exchange (HSX) is the principal equity market for larger companies and listed 302 companies and 6 closed end funds as of end 2011. The Hanoi Stock Exchange (HNX) is the primary fixed income market, operates an equities market listing 396 companies (typically smaller in size than HSX listed companies) and also hosts the UpCom platform where 135 non-listed public companies are traded. Despite the creation of UpCom, the shares of many public companies continue to be traded outside regulated markets.

19. **While the equity market has so far served as a conduit for "equitization", it has the potential to play a much more meaningful role.** Total market capitalization was about 20% of GDP in 2011, roughly in line with the levels predicted for Vietnam but significantly lower than comparable East Asian markets . The fact that market capitalization is relatively small despite the large number of listings reflects the small size of most listed companies. Many of the SOEs with better prospects have not yet listed and family companies may still be reluctant to commit to enhanced disclosure. The universe and quality of listed firms could be improved by equitizing some of the larger companies with better prospects and seeking strategic investors to improve governance and performance. Market depth, liquidity, and price discovery can also be improved by enforcing the processes that require public offers to be listed on the public market, and building the investor base. The institutional investor base in Vietnam is very thin, and the prevalence of retail investors raises questions about the quality of price discovery. From a customer protection perspective, reliable disclosure, control of related party transactions, protection of customer funds, and the financial integrity of firms handling trading are concerns.

## B. INSTITUTIONAL INVESTORS

20. **The small mutual fund industry shows promising prospects for growth, but it is critical to improve certainty about the legal framework and build market confidence.** Until recently, the industry was restricted to 23 closed-end funds managing assets of only 0.4 percent of GDP in 2011. However, new legislation enacted in December 2011 has already led to the offering of the first two open-ended funds in early 2013. Bond funds and index funds representing the VN30, an index of 30 HSX blue chips, are also in the planning stage. Related regulations appear comprehensive, but the valuation and distribution of units must be carefully monitored. As the funds distribution channel has been expanded beyond securities companies to banks and insurance companies, it is important that disclosures at the point of sale clarify that the investment is not a bank deposit or some type of insurance. Expanded investor education and financial literacy programs should accompany market development efforts. The valuation of fund portfolios should be scrutinized, especially considering the illiquidity of many market segments.

21. **The insurance sector is small and still dominated by the non-life sector.** At the end of 2011, there were 43 active insurance companies, including private and foreign players, but total assets were only 4 percent of GDP and industry premiums only 1.8 per cent of GDP in the same year. Non-life insurance is the largest portion of the insurance market (at 56 percent of premiums), with the main business line being motor insurance, including motor third party liability (MTPL). This segment may need to undergo a major restructuring program. Large numbers of cars and motorbikes are driven without insurance. Premium rates and insurance provisions do not reflect underlying risks and expected costs, as they are not based on the underlying risk characteristics and statistical data.

22. **Given the weight of Motor and MTPLs business, the Insurance Supervision Agency (ISA) should adopt risk based premiums and limit insurance fraud in motor vehicle insurance in general and MTPL in particular.** The introduction of risk-based premiums should be done across the entire insurance sector, starting with Motor and MTPL, while also guaranteeing the adequacy of premiums to ensure the industry's solvency. It is essential to combat fraud in MTPL, ensuring that insurance companies cooperate with police departments to reduce the number of the uninsured and improve driver behavior. Other obstacles in the development of the insurance sector include a weakly regulated and supervised environment, a dearth of actuarial skills and an insufficient volume of suitable instruments to support the long-term liabilities of the life sector.

23. **Bancassurance has started showing some growth, but its distributional advantages have yet to be effectively explored to reach untapped segments of the population.** Banks in Vietnam have extensive distribution networks through which insurance can readily be channeled. Thus, bancassurance provides substantial potential to increase the population's access to insurance products. However, there are also risks associated with giving banks undue levels of power in communities, so careful regulation and supervision is required to ensure the adequate protection of policyholders.

24. **Private pension funds are still negligible, but the Social Security Fund (SSF) has sizable assets and could contribute more effectively to capital market development.** The SSF manages sizable assets of about 6.5 percent of GDP, but does not have a well-articulated investment policy, and its portfolio consists primarily of government bonds, bank deposits, and loans to SOCBs. While it is premature to introduce changes at the moment, given the vulnerabilities in the banking system, the SSF should consider adopting a new approach to the management of its reserves, in line with best international practice, once the banking system is fully restructured. This would include a well-articulated liability-driven investment policy, combined with decentralized asset management

# V. Financial Inclusion

## A. PROGRESS IN EXPANDING ACCESS TO FINANCE

25. **Vietnam has made some progress in expanding access to finance, although there is still ample room for expanding access further.** The World Bank Findex survey data shows that Vietnam has a higher level of credit account penetration for SMEs and individual account holders than comparators, but data from the credit bureau and anecdotal evidence from discussions with market players suggest that the expansion of access could be overstated. In particular, the characterization of the multiple subsidiaries of SOEs and economic groups as SMEs could distort the extent of progress in SME finance. Furthermore, the World Bank-IFC's Enterprise Survey data show that firms characterize access to finance as a major constraint and collateral requirements in SME lending are at 218 percent of collateral-to-loan ratio, which is higher than most comparators. Deposit account penetration also lags comparator countries and the insurance sector is still small despite recent growth. The agriculture insurance program launched by the government remains a pilot. Lastly, the quality, range and depth of all financial services remains limited, with considerable potential for product refinement and development.

26. **Vietnam's approach to financial inclusion has relied prominently on the interventions of policy banks and a few SOCBs.** Policymakers have essentially relied on the two budget-funded policy banks – the Vietnam Bank for Social Policies (VBSP) and to a lesser extent the Vietnam Development Bank (VDB)[13] – but also the Vietnam Bank for Agriculture and Rural Development (VBARD), for promoting the financial inclusion agenda. Price controls have been a prevailing feature, and budgetary support to the VBSP (and the VDB) has enabled the VBSP to offer under-market interest rate products to its low-income clients in line with its mandate. In rural areas, VBSP and VBARD dominate the provision of credit.

27. **Further progress in financial inclusion will require further strengthening of financial infrastructure, institutional reforms and product market development.** Improvements in infrastructure would enhance the incentives for broader participation. The authorities could consider the development of reliable financial reporting standards for SMEs that balance transparency and simplicity. The IFRS for SMEs would provide a good starting point. The CIC should expand coverage of data from PCFs, MFIs and the VBSP. The operationalization of the new credit bureau could enhance competition and improve services for users. The secured lending framework should be strengthened as discussed below. The design of the SME Guarantee Fund of the VDB should be revised to enhance outreach and additionality. Lesser use of price controls[14] would also help to remove market distortions and potential disincentives for broader participation. Weaknesses in several key institutions have to be addressed, including the PCFs (low capital adequacy, weak profitability and liquidity concerns) and the two policy banks. The VBSP should be restructured to reduce reliance on budget support and offer financial products on market-based conditions. Further effort is also required in product market development, in particular savings promotion and agriculture finance

## B. DEVELOPMENTS IN HOUSING FINANCE

28. **Real estate lending reflected significant boom-bust behavior in the past few years, but affordable housing remains short in supply.** Prior to 2010, there was a period of substantial market overheating, and the SBV responded by instructing banks[15] to reduce the growth rate and share of real estate loans. This decision, as well as the subsequent downturn, led to a sharp decline in lending activity. While condominiums, higher-end housing and office spaces are in surplus, affordable housing is in short supply. The Government launched a stimulus program in January 2013 requiring state-owned commercial banks to allocate at least 3 percent of the loan portfolio to lending to low income households and public servants, as well to developers supporting the conversion of higher-end properties to affordable housing.

[13] The VDB receives small postal savings, channeled to project finance.

[14] The literature on financial inclusion indicates that price controls can lead to market distortions and credit rationing, and are ultimately inefficient for the financially underserved segments they were meant to protect.

[15] Commercial banks are the dominant players and have limited product diversification.

29. **The legal infrastructure is not a significant source of concern but the enforcement of mortgage rights is a cumbersome and lengthy judicial process.** The registration system works fairly well, despite some reported problems at the provincial level; transaction costs are reasonable, and a computerization process has been initiated. Enforcement of mortgage rights typically takes two years, and the eviction of defaulting borrowers is difficult in the case of residential properties, although it seems to play a coercive role by facilitating voluntary workout solutions. The banking law allows banks to keep repossessed properties for up to three years, a reasonable time frame for disposal in normal market conditions.

30. **Other sources of vulnerability include the lack of information, certain lending practices for retail housing loans, and liquidity mismatches.** The lack of well-organized data on transactions and no official price index makes it difficult to value real estate collateral. There are also inconsistencies in the reported data – the actual impact of the crisis is not reflected in the reported performance of the banking system, and the sector has probably contributed significantly to the build-up of NPLs. Affordability criteria are lax, and given the variability and historical volatility of interest rates, this translates to a latent credit risk that would materialize in case of new interest rate surges. There are also duration mismatches – mortgage lenders do not have access to long term funding, besides loans provided by the government or SBV.

31. **The government and the SBV should consider several steps to ensure that housing finance develops on a sound basis.** The transparency of the real estate market can be improved by developing price indices, strengthening housing demand analyses, monitoring the supply, and creating indicators of market equilibrium such as on-going and future delivery of new units, vacancy rates, and sales of new developments. Guidelines for appraising underlying assets should also be set, as well as stronger expertise requirements for appraisal. Creating mortgage lending databases would improve critical information to supervisors, enable tracking of new lending by vintages, and the monitoring of loan-to-value (LTV) ratios, debt service-to-income ratios, and NPLs by annual cohorts.

32. **Other measures include strengthening the prudential framework, developing a consumer protection framework and introducing long-term funding instruments.** Prudential rules should be designed for commercial real estate and developer finance. In particular, lending to developers should be linked to the volume of pre-sale contracts, which is an indicator of the adequacy of new developments to demand. Regulators should also prepare a set of counter-cyclical prudential measures by adjusting parameters such as LTV limits, risk weights of differentiated types of loans, or provisioning requirements. Stress tests at origination for floating rate loans should also be required from lenders as well as periodic updates to assess the impact of shocks. Measuring affordability based on initial "teaser" rates should be prohibited. Developing a consumer protection framework would reduce mis-selling and enable households to make better decisions. Finally, introducing long-term funding from capital markets will not only improve the liquidity balance of the banking system but also mitigate the credit risk derived from the interest rate risk borne by borrowers, by offering more fixed-rate solutions.

# VI. Financial Infrastructure

## A. ACCOUNTING AND AUDITING

33. **Financial reporting in Vietnam needs a significant revamp in order to enhance its reliability and usefulness for investment, management, and monitoring purposes.** The accounting framework (Vietnamese Accounting Standards, or VAS) was mainly established in 2003 by the Law on Accounting using as a reference the International Accounting Standard Board (IASB) framework applicable at the time, but substantial differences exist between the two sets of standards. VAS tends to overstate profitability, asset values and the solvency situation of reporting entities. At present only a few foreign institutions, including foreign-owned banks, are presenting their accounts based on IFRS (in addition to VAS-based statements).

34. **The problems embedded in VAS are exacerbated by the incipient nature of accounting and auditing, and the absence of a culture of transparency and accountability.** There is a lack of well-trained accountants to prepare reliable financial statements. In addition, while the recently enacted Independent Audit Law of 2011 could provide the legal basis for the establishment of a reliable auditing profession, its actual implementation will require a strong political commitment that to date remains elusive. There is lack of enforcement of VAS and limited disciplinary action against practitioners who have not implemented VAS or the Vietnamese Standards in Auditing in accordance with the regulation.[16]

35. **Financial statements are generally opaque, especially regarding SOEs, and the quality of financial reporting by financial institutions is also generally poor.** In the case of SOEs, the weaknesses in VAS are aggravated by supplemental MOF accounting rules against "the loss of state capital", that hinder recognition of losses and mask the weak performance of several SOEs. The quality of financial reporting by financial institutions varies widely among types of institutions, but it is generally poor, especially among SCOBs. Moreover, the financial supervision function remains weak (Section VII) and does not contribute effectively to improvements in the quality of financial reporting of the supervised entities.

## B. CREDIT REPORTING

36. **The Credit Information Centre (CIC) plays a relevant role in the flow of credit information, but significant operational and regulatory gaps still exist.** The CIC holds 23 million records on individuals (around 30 percent of the adult population) and 500,000 firms as of 2011. All regulated financial institutions are mandated to report to the CIC. A credit bureau created in 2007 by eleven banks was only issued its license in March 2013. Numerous gaps still hinder the effectiveness of credit reporting. First, financial institutions basing adverse credit decisions on CIC information cannot disclose this fact to potential borrowers. Second, effective enforcement mechanisms are not in place ensuring timely updates and data quality to the CIC. Third, the BSA commendably has real-time

[16] In response to these deficiencies, on September 2013 the Government issued a Decree prescribing sanctions for violations of accounting and auditing rules, but the Decree and its implementation were not assessed by the FSAP.

access to the CIC database, but the CIC no longer provides periodic reports of supervisory value. And fourth, only financial institutions are to date participants in the CIC system. Extending participation to other types of entities with relevant data would broaden and deepen the CIC's database, which would enable SMEs in good standing with non-financial creditors to obtain loans on better terms. Finally there is a need to ensure adequate oversight of the overall credit reporting system (CRS). Therefore, authorities should consider the role of the Central Bank as primary overseer of the CRS supporting the development of efficient, safe and reliable credit bureaus while ensuring the efficiency of the CIC. Also, regulators should encourage the development of the new licensed credit bureau as a complementary and important source of credit information.

## C. CREDITOR RIGHTS AND INSOLVENCY

37. **There are serious gaps in the law and practice of the secured lending framework. The legal framework is fragmented and internally inconsistent.** Foreign entities are unable to effectively take security over land use rights (as Vietnam does not allow foreigners to own land). The land register is beset with problems: it is paper-based and its utility is undermined by many factors, including the difficulty to search the name of registered proprietors, the low quality of publicly available information, and incomplete procedures governing land use certificates, especially in urban areas.[17] The National Registration Agency of Secured Transactions, which registers security interests in movable assets, generally works well, but market participants have raised questions about the system's reliability and security.

38. **The procedures for the enforcement of claims are dysfunctional, and disposal of encumbered assets is lengthy and difficult.** There are problems with both the seizure of the debtor's assets and their disposal. For unsecured claims, creditors are not entitled to unilaterally seize their debtor's assets. As there is no fast-track court procedure for simple debt collection cases, sophisticated debtors use these weaknesses to strategically delay cases. As regards secured claims, the legal entitlement of the creditor to unilaterally seize the secured assets is unclear, and it seems impossible in practical terms to seize a land use right where the relevant property is a residence. Thus, in both cases lenders must resort to the often inefficient court system. While encumbered assets may be sold privately, conducting a private sale without the debtor's cooperation is very difficult. Secured assets may be sold through auction, but this often takes too long and can thus be value-destructive.

39. **The enterprise bankruptcy system is dysfunctional, and many commercial courts do not attract public confidence.** The bankruptcy code is modern and provides for both liquidation and restructuring, but remains ineffective. There are very few bankruptcy cases in practice due to the stigma in the bankruptcy process and lack of confidence in many courts. Stakeholders avoid insolvency proceedings which results in the majority of cases being resolved in an informal way, whereby debtors' assets are subject to multiple transfers, rendering them hard to trace. There are also concerns about political influence, insufficient expertise, significant delays and strategic misuse of the court system. The Supreme People's Court prepared a new bankruptcy law designed to address some of these deficiencies consistently with international best practice, and the law was recently passed by the National Assembly. However, efforts will still need to be made to address how the law is used in practice.

[17] A Circular No. 04/2013/TT-BTNMT issued in April 24, 2013 provides for certain improvements in this area.

## D. PAYMENTS AND SETTLEMENTS SYSTEMS

40. **Over the past decade, the State Bank of Vietnam (SBV) and the State Securities Commission (SSC) have initiated a major reform of the National Payments System (NPS).** Such reform included the launch of new and modern system applications – the Inter Bank Payment System (IBPS) in 2002 which was upgraded in 2008; as well as legal and regulatory reforms. The role of the SBV with regards to payment and settlement systems was revamped, in particular through the adoption of the SBV law in 2010 and various circulars and decisions. For the supervision and regulation of the securities market, the role of the SSC was revamped through the issuance of the 2006 securities markets law (and amendments in 2010). The systemically important financial market infrastructure (FMI) currently operating in Vietnam[18] includes the IBPS, the Vietnam Securities Depository (VSD), SBV Securities Depository and the Vietcom Bank foreign exchange settlement system. In Vietnam there is currently no process for formal designation of specific FMIs as systemically important. The Vietnam Securities Depository operates a delivery-versus-payment securities settlement system for securities traded at the two stock exchanges. The SSC and the VSD have appointed BIDV as the settlement bank for the cash leg of securities transactions. The VSD has established a fund (Compensation Fund) to guarantee the settlement and some clearing members have pre-agreed credit lines with the BIDV.

41. **While the reform efforts are commendable, there is still ample scope for improvements in the general organization of IBPS and the roles of the authorities[19] .** The legal framework has gaps due to which finality and irrevocability of transactions; protection of ownership rights of collateral placed for liquidity support; and recognition and protection of procedures like netting, are addressed at the level of operating rules but not addressed adequately in primary legislation. Although the IBPS has elements of risk management, there is no comprehensive risk management framework, resulting in several issues of concern in the areas of credit risk, liquidity risk, operational risk and risks arising from the tiered membership structure. The current scope and powers of authorities with respect to FMIs are ambiguous, and should be clarified and strengthened. The SBV and SSC's policy objectives with respect to regulation, supervision and oversight of FMIs are not articulated, and their powers not explicitly mentioned in the legal framework. The authorities should start implementing CPSS-IOSCO Principles for Financial Market Infrastructures (PFMIs) and consider undertaking a formal evaluation of the staffing and skills levels with respect to the oversight activities. Lastly, the SBV and the MOF should leverage the existing MoU to develop mechanisms for on-going cooperative oversight. In addition, a number of market-wide recommendations have been identified. The VSD and Vietcombank Foreign Currency Settlement system could also be considered systemically important FMIs and as such the PFMIs should be applied to them as well. The SSC and the SBV should consider conducting a detailed analysis of the costs and benefits of having a CCP as part of their oversight activities. The lack of a direct debit system is a significant gap in the retail payments infrastructure; the SBV in co-ordination with the other stakeholders should address this gap in the medium-term.
he CIC. Third, the BSA commendably has real-time

18 In this FSAP only the IBPS was studied in detailed and assessed against the CPSS-IOSCO PFMIs.

19 Based on the assessment against the CPSS-IOSCO PFMIs.

# VII. The regulatory and supervisory framework

42. The regulatory and supervisory framework needs to be substantially strengthened to ensure a sound path to financial development in the remainder of the decade. The regulatory and supervisory framework, although full-fledged, is divided among multiple agencies. The SBV through its BSA, supervises credit institutions, while the insurance sector and securities markets are supervised by the MOF through the ISA and the SSC. All supervisory agencies suffer from limited operational independence. Moreover, each agency focuses on its sector and does not conduct supervision of financial groups. Furthermore, supervisors have limited tools to identify the time series and cross-sectional dimensions of macro-prudential risk. A "too-interconnected-to-fail" structure is emerging as a result of gaps in the legal framework, inadequate enforcement and weak crisis management. There is no institution responsible for gauging and managing overall risks in the financial system, and no legal framework for macro-prudential policy. While the SBV has functional responsibility for systemic risk oversight, it lacks the database and the capacity to analyze emerging systemic risks.

## A. BANKING REGULATION AND SUPERVISION

43. **Banking regulation and supervision are still under development and face substantial challenges.** The level of compliance with the Basel Core Principles (BCPs) is low. The combination of the prudential supervision function (focused on the safety and soundness of the banking system) and the "general inspectorate" function (focused on policing violations of administrative procedures) has undermined the core prudential supervision function performed by the SBV – on-site inspections of SOCBs by the SBV have not been conducted for several years, partly to avoid overlap with inspectorate visits by the General Inspectorate and State Audit Office. Off-site monitoring is still in its inception. There is very limited financial reporting and disclosure requirements for banks, the quality of information is poor, and non-financial disclosures are practically non-existent. The SBV does not perform consolidated supervision effectively and does not conduct effective oversight over entire banking groups. The regulatory framework contains some provisions related to cross-border banking supervision, but there are still significant supervisory gaps regarding the overseas operations of local banks.

44. **A number of factors inhibit the effective exercise of SBV powers.** The SBV has multiple objectives and its independence is limited, compromising the capacity of the supervisor to exercise the powers that are granted by legislation. On the positive side, Vietnam has an adequate framework regarding permissible activities, providing a base for appropriate coverage of regulatory framework over deposit-taking institutions.

45. **The effectiveness of supervision is also undermined by serious gaps in the regulatory framework.** First, the definition of related parties is overly narrow, hindering the identification and assessment of ultimate beneficiaries, and affecting various aspects of supervision, including licensing, transfer of ownership, acquisitions, large exposures, related party lending, and capital adequacy. Second, the licensing and authorization framework is too prescriptive and does not allow enough room for supervisors to conduct proper screening and assessment. Third, prudential regulations and requirements are still weak. Capital adequacy requirements are still based on Basel I and guidelines on market, operational, and interest rate risks are lacking. Fourth, asset classification and provisioning rules are ineffective.

46. **Laws and regulations give the supervisor broad remedial powers, but these are used sparingly and critical gaps still remain.** Although the legal framework provides broad enforcement powers, operational guidance and procedures for the use and escalation of the powers are lacking. In spite of the presence of several weak institutions, in the past decade no banks have been placed under special control of the SBV, due to concerns that doing so could cause a run. This reflects also the lack of a prompt corrective action framework that would force the supervisor to act in these circumstances. Finally, the SBV does not conduct consolidated supervision. While it has the authority to supervise banks and subsidiaries, it lacks powers to monitor parent and sister companies.

### B. BANK GOVERNANCE

47. **The state plays conflicting roles in the banking system, reducing the incentives for banks to take full responsibility and accountability for their business.** Policy mandates and directed lending, together with a weak regulatory and supervisory framework and low levels of transparency have created a business setting with little or no accountability for bank boards and management. SOCBs also suffer from the lack of well-defined governance structures, and some of the responsibilities normally assumed by a bank board are carried out by the SBV.

48. **The complex shareholding structure of many private banks raises concerns about conflicts of interest, particularly of imprudent channeling of funds to related parties or unrelated speculative ventures.** The financial system lacks a strong risk culture and risk management is underdeveloped across financial institutions. In addition, current laws and regulations focus on detailing the mechanics of each administrative body rather than charging the parties with responsibility to act in the best interests of the public trust and sector stakeholders. Critical pieces of regulation are absent, including a code of bank governance and risk management regulations.

### C. CAPITAL MARKETS REGULATION AND SUPERVISION

49. **The SSC lacks sufficient powers, resources, and independence to be fully effective, and several legal and operational issues impair sound market development.** Commendable first generation reforms have been enacted, but their application has been inconsistent and second generation legislation is needed. The legal and accounting framework should be brought into compliance with international standards and the operational oversight practices should be strengthened. Consistent and predictable enforcement is necessary to increase confidence and foster trading in regulated venues. It is laudable that the cooperation between the banking and securities supervisors is being enhanced in order to address potential system-wide risks; however, it must be tested in practice. Further, as the distribution network for securities is expanded to banks, supervisors should be aware that risks migrate from one sector to another and miss-selling or misuse of customer funds can impair market confidence and development.

### D. INSURANCE REGULATION AND SUPERVISION

50. **The ISA faces significant supervisory challenges, is under-resourced and lacks operational independence.** Supervisory systems are not risk-based and standards in prudential areas, valuation, reinsurance, market conduct and group supervision need to be improved in order to ensure compliance with international standards. Supervisory resources are below the levels seen in comparable markets.

The ISA would need to strengthen its financial resources, build technical capacity, and strengthen its information systems. The ISA is encouraged to implement a supervisory development plan around three pillars: (i) a modern, independent, and self-funded supervision model; (ii) introduction of much stronger governance structures and internal controls; (iii) introduction of a risk-based supervisory approach, along with prudential standards, valuation, reinsurance, market conduct and group supervision.

## E. FINANCIAL SAFETY NET AND NPL RESOLUTION

51. **The DIV has responsibility for standard 'pay-box' duties, but the new law provides for a broader role. The system extends coverage of Vietnamese dong deposits of up to VND50 million (less than US$2,500) although a higher level of coverage is being considered.** Deposit-taking institutions must pay an annual deposit insurance premium equal currently to 0.15 percent of the average insured deposit balance. The number of staff is very large but not used effectively, and the agency expends most of its resources reviewing compliance with provisions of the law.

52. **The DIV has never been used for the resolution of NPLs or troubled banks, and has a weak financial position.** There is resistance to close and liquidate insolvent banks, ostensibly to avoid bank runs. However, should it be necessary to do so, the DIV's financial position is inadequate to assist even in the liquidation of two medium-sized institutions. Currently, the fund balance as a percentage of total deposits stands at approximately 0.8 percent. Also, there are serious risks in the way the DIV's funds are invested. The institution currently places the bulk of its investments with member institutions. This poses risks to the DIV's invested funds, if any of these institutions face a liquidity or solvency crisis.[20]

53. **The preferred method of resolution by the authorities has been the merger of financial institutions to address institutions with liquidity problems.** A primary reason for choosing the merger option is the tight fiscal position and the wish to avoid bank runs. Nevertheless, while mergers have addressed short-run liquidity problems, it is likely that they have not addressed the underlying asset, liquidity, capital and governance problems. Further, the capacity to undertake a purchase and assumption transaction (P&A) is not clear under the Credit Institution Law. A more effective bank resolution regime should be introduced and tested with a small institution.

54. **Since 2003, a centralized asset management company (the DATC) was created to reduce the level of NPLs in the system, but it has had minimal impact.** As of now, it is barely functioning and its remaining assets are concentrated in inventories, receivables and very illiquid investments in subsidiaries and joint ventures. The DATC purchases assets (until now approximately VND10 trillion) primarily from the SOEs. Banks are reluctant to use the DATC due to the reportedly low collection rate (approximately 28 percent of book value, net of expenses). AMCs set up within banks groups have not been very effective either.

[20] The Law on Deposit Insurance enacted of 2012 allows the DIV to invest in government bonds, SBV bills and deposits at the SBV, but the FSAP did not assess the extent to which the DIV's investment policy has changed.

55. **The establishment of a central Vietnam Asset Management Company (VAMC) has so far been the most visible step towards the resolution of the NPL problem.** In May 2013 the Government issued Decree 53 empowering the SBV to establish the VAMC with a charter capital of VND 500 billion (equivalent to US$24 million).[21] The VAMC is expected to buy bad debts from banks at book value (net of provisions) or at market prices. The purchase can be conducted with special zero interest bonds issued by the VAMC. The banks can use the VAMC bonds for refinancing loans through the SBV and are obliged to make annual provisions at a rate of not less than 20 percent of the value of the bond. At the time of the redemption of the special bonds, if the underlying debt has not been resolved the banks will repurchase debts from the VAMC at book value and return the special bonds to the VAMC. If a credit institution with more than 3 percent NPL ratio refuses to sell bad debts to the VAMC, the SBV can carry out an inspection or hire an independent audit to assess the quality and value of assets of those banks.

56. **The effectiveness of this NPL resolution strategy is questionable and a proactive multi-pronged approach may be required.** The resolution of NPLs through the VAMC will depend on its attractiveness to banks as well as its pro-activeness in addressing NPLs. The VAMC design requires banks to provision 20 percent per year against the VAMC bonds without giving them an earning asset (the AMC bonds that will be exchanged for the NPLs have a 0% coupon rate). The access to liquidity using AMC bonds may be of interest to only a handful of banks which are facing more severe liquidity constraints. Furthermore, if the assets are transferred and warehoused, with no active management or disposition, they may actually lose value over time. In any event, only part of the NPL stock will be addressed through the VAMC.

57. **The authorities may want to consider adopting a multi-track restructuring approach that would include four main inter-connected tracks:**

(i) ***Court-supervised insolvency track,*** to address the distressed debt of complex and large groups. However, for this track to be effective, the enterprise bankruptcy regime needs to be overhauled to support formal liquidation and rehabilitation processes.

(ii) ***Bank-led restructuring track***, to be facilitated through primary legislation to establish a creditor-led, accelerated 'pre-packaged' plan negotiation and approval mechanism. The legislation should specify the minimum content of both the applicable negotiating procedure and of the plans to be negotiated, while leaving maximum discretion to the negotiating parties themselves;

(iii) ***Asset Management Company ('VAMC') track***, which would take the lead in resolving non-performing loans/assets, especially in the construction/real estate sectors.

(iv) ***Special administrative restructuring track,*** to be used in limited cases where all or almost all of an SOE's debts are with SOCBs. The Government could pursue an administrative solution for the NPLs, combined with specific SOE restructuring programs.

[21] The VAMC was created after the FSAP was submitted to the authorities on January, 30, 2013.

58. **Legal reforms are needed to support this multi-track approach.** To eliminate obstacles to voluntary workouts and claim enforcement, changes are needed to the Civil Code, Code of Civil Proceedings, Enterprise Law, Land Law, Law on Enforcement of Civil Judgments, the Decrees on Auctions and on Security Transactions, Government Decision 90/2011, the Tax Code, and SBV Decisions.

# VIII. Strengthening the Government Reform Program

59. **The proposed reform agenda aims to address the fundamental challenges in the financial sector in three phases.** The two fundamental challenges include the effective resolution of a large stock of NPLs and ensuring the efficiency of the new flows of finance. Moreover, during the period of reform design and implementation it is essential to preserve the stability of the financial system to ensure the success of the program. The proposed financial reform agenda would be implemented in three main phases. Phase 1 would entail essential diagnostic work (such as special financial audits) preparing the ground for a successful financial reform. In phase 2 the government would launch the priority components of the program (including bank recapitalization) and finalize the design of the other components. In phase 3 the government would deepen and consolidate the implementation of the reform program. Table 3 provides a schematic summary of the three phases.

## A. FIRST PHASE: MEETING THE PRE-CONDITIONS FOR A SUCCESSFUL REFORM

60. **The most urgent reform measure entails special financial audits to measure NPLs accurately and operational audits on SOCBs.** Many successful financial reform programs were built on detailed financial and operational diagnostics. These audits would assess the quality of loan portfolios, the profile of borrowers, the types of collateral and their estimated values, and patterns of interconnectedness across banks and borrowers. The audit results would allow the government and the SBV to identify recapitalization needs and alternative funding sources, e.g. potential need for fiscal support and/or increased participation of strategic private investors in the case of SOCBs. State-owned banks would also be subject to special operational audits, which would include an assessment of governance structures, risk management functions, internal controls, IT systems, and HR policies and procedures. The operational audits would also assess their capacity to lead debt workouts and enterprise restructuring. For the private joint-stock banks, their capacity to lead debt workouts should also be assessed.

61. **The first phase would include temporary measures to protect the stability of the financial system during the reform period.** This should include an extension of deposit guarantees and a well-targeted liquidity support facility.

## B. SECOND PHASE: LAUNCHING THE PRIORITY COMPONENTS OF THE REFORM PROGRAM

62. **The most important policy measure in this phase would entail the recapitalization of the banks deemed viable (based on special audit results) to regulatory minimums, and the orderly exit of unviable banks.** The recapitalization of SOCBs and private joint-stock banks would be accompanied by several additional measures. This includes the divestiture of shares in other banks, or transfer to the VAMC or SCIC for future divestiture, depending on market conditions. For SOCBs, a change in management should be considered, and an international advisor should be selected to

implement the restructuring plan. For private joint-stock banks, this would be an opportunity to divest the shares of SOEs and to clean up the cross-ownerships among banks and with large private economic groups. Smaller and unviable banks could be submitted to an orderly bank resolution regime.

63. **This phase would include the implementation of critical improvements in financial infrastructure and financial regulation, and the preparation of more comprehensive regulatory and supervisory reforms to be implemented in the following phase.** The FSAP and the Detailed Assessments of Observance with International Standards and Codes provide numerous recommendations that could form the basis for a comprehensive reform of the regulatory and supervisory framework. The authorities should also consider programs to build supervisory capacity and IT infrastructure for all three supervisory agencies, with external technical support. Reforms of the tax treatment of loan-loss provisions and debt-write-offs, as well as measures to facilitate out of court enforcement of collateral, would provide the basis for more effective workout arrangements. The government and the SBV could also consider a revision of the debt workout strategy, and in this context, a revision of the legal structure and mandates of the new VAMC.

64. **Finally, the agenda for the development of capital markets and NBFIs could be initiated with the full launching of the Roadmap for Government Debt Development.** The capital market agenda is critical for Vietnam, as it can contribute to both access and stability objectives. During this phase, the government and the SBV could also start preparing key legislation for the introduction of fixed income instruments such as infrastructure bonds and covered bonds.

## C. THIRD PHASE: CONSOLIDATING THE REFORM PROGRAM

65. **The debt workout program would be fully launched in this phase.** The bank-led and VAMC components would be supported by the enactment of enabling legislation, and the VAMC would be properly staffed to perform its functions. By this time, the Government would also have the conditions to deepen the implementation of the special restructuring programs for large Economic Groups.

66. **In this phase, the Government and the SBV should implement measures to relieve the SOCBs from their policy mandates and ensure sound governance for both SOCBs and private banks.** The ownership and supervision functions should be conducted under separate institutional arrangements to ensure the effective exercise of ownership rights and the independence of supervision at the same time. SCOBs should operate with clear mandates, performance targets, and governance structures. Ideally, most policy functions and mandates would be transferred to the policy banks and these banks would also be financially and operationally restructured to play this role effectively. The development of corporate bonds and infrastructure bonds would also contribute to unburdening the SOCBs from policy functions and directed lending, and arguably enhance transparency. The changes to the Law on Credit Institutions and other supporting regulation would also address the key governance agenda, and the SBV would implement requirements ensuring clear separation of the roles of ownership, board oversight, and management; independent and professional boards; and stronger risk management functions.

67. **This phase will also include further deepening of the capital markets agenda and the full implementation of financial infrastructure and regulatory reforms.** This would include substantial progress in implementing the roadmap for the development of government bond markets and possibly introducing new private fixed income instruments, such as infrastructure bonds and covered bonds. Financial regulatory reforms should be accompanied by substantial progress in the implementation of the supervisory development programs.

## Proposed Financial Reform Agenda

| | | FINANCIAL SECTOR REFORM | |
|---|---|---|---|
| | TEMPORARY FINANCIAL SAFEGUARDS | STOCK PROBLEM | FLOW PROBLEM |
| PRE-CONDITIONS | • Assess the extent of safeguards needed throughout the program | • Special financial audits of all large banks, for estimation of NPLs and recapitalization needs, and inputs for the design of workout scheme;<br>• Special operational audits of State commercial and policy banks to guide restructuring program;<br>• Identification of SIFIs.<br>• Identification of interconnections among financial entities and development of contingency plans for addressing common vulnerabilities;<br>• Mapping of the NPL problem for the design of effective workout schemes. | |
| SHORT-TERM MEASURES | • Temporary increase in deposit guarantees. | • Recapitalization of viable banks to regulatory minimums;<br>• Consider enhanced participation of foreign strategic investors in recapitalization;<br>• Orderly exit of small weak banks;<br>• Clean-up of cross-ownership positions;<br>• Finalize design of debt workout scheme;<br>• Finalize legal structure, mandates of AMC, staffing needs.<br>• Finalize draft legal reforms to support implementation of debt workout scheme | • Directive to banks requiring adoption of strict prudential rules on all new loans;<br>• Initiation of operational restructuring of State banks;<br>• Elaboration of supervisory development program for all three supervisory agencies;<br>• Implementation of critical improvements in financial infrastructure and financial regulation for short-term;<br>• Design of comprehensive financial infrastructure and regulatory reforms for next phase;<br>• Launch roadmap for government debt market development |
| MEDIUM-TERM MEASURES | • Replaced by revamped safety net. | • Full implementation of the debt workout scheme, supported by enabling legislation | • Introduction of package to reduce the policy burden of SOCBs<br>o New roles emphasizing commercial orientation<br>o Stronger governance structures, risk management<br>o Shift of policy functions to policy banks<br>o Enhanced participation of foreign minority shareholders<br>o Development of infrastructure and corporate bonds<br>• Development of a properly functioning liquidity management framework.<br>• Deepening of capital market reforms<br>• Implementation of comprehensive financial infrastructure and regulatory reforms |

## Key Technical Recommendations

| Recommendations | Agency | Time-Frame |
|---|---|---|
| *Banking regulation and supervision* | | |
| Strengthen the institutional setup for banking supervision by segregating and enhancing the prudential supervisory function, to be performed by the SBV and focused on safety and soundness, from the inspectorate function, to be performed by the General Inspectorate and State Audit Office and focused on violations of administrative rules. | BSA, SBV | Medium-term |
| Enhance the data collection, analysis, dissemination, and warehousing capabilities of the BSA. | BSA, SBV | Short-term |
| Develop proper monitoring of ultimate beneficiary ownership, as well as economic and banking groups by expanding the definition of related and interconnected parties. | SBV initiate | Medium-term |
| Enact new directives on bank governance, including stronger requirements for risk management; as well as strengthen the supervisory assessment capacity by developing overall and risk-specific risk management guidelines and internal guidance. | SBV | Short-term |
| Strengthen the assessment and monitoring of banks' asset classification and provisioning practices (including valuation of collateral) by developing internal guidance and enhancing capacity of supervisory staff. | SBV | Short-term |
| *Stress testing* | | |
| Revise the definition of liquid assets and short-term liabilities to exclude assets that cannot be sold immediately. | BSA | Medium-term |
| Review the mandatory prudential haircuts and roll-over ratios in the calculation of liquid assets and short-term liabilities. | BSA, SBV | Medium- term |
| *Insurance* | | |
| Develop supervisory/regulatory development plan to set priorities and implement operational challenges. | MOF/ISA | Short-term |
| Move to modern supervisory models along with enriched human resources and strengthened infrastructure. | MOF/ISA | Medium-term |
| Develop and establish standards on insurance corporate governance and internal controls. | MOF/ISA | Medium-term |
| Restructure MTPL insurance and move to risk-based pricing. | MOF/ISA | Medium-term |
| *Securities* | | |
| Strengthen oversight of market intermediaries and customer assets and accelerate the ongoing resolution process of securities firms. | SSC | Short-term |
| Pursue plans for a customer compensation fund. | SSC | Medium-term |
| Strengthen securities markets surveillance and related price reporting regimes. | SSC | Medium-term |
| Enhance settlement infrastructure and related law. | SSC | Long-term |
| Macro prudential issues | | |
| Define in the legal framework a "financial stability" mandate; the agencies in charge of ensuring it; and start exercising the function. | SBV/MOF | Medium-term |

## Key Technical Recommendations (Continued)

| Recommendations | Agency | Time-Frame |
|---|---|---|
| Develop consolidated supervisory framework and enhance inter-agency coordination. | SBV, BSA, MOF, ISA, SSC, DIV | Medium-term |
| Rely less on administrative and more on market-based measures for regulating the financial system. | SBV, MOF | Medium-term |
| *Crisis management and bank resolution framework* | | |
| Implement multi-track restructuring approach with components led respectively by banks, courts, AMC, and high-level administrative processes. | SBV/MOF | Short-term |
| Adopt and implement legislative reform to bankruptcy, enforcement, enterprise, land, and tax laws. | Supreme People's Court, MOJ, SBV, MOL, MOF | Short-term |
| Apply existing crisis management tools more aggressively. | SBV, BSA | Short-term |
| Develop an option under law to undertake a purchase and assumption transaction. | SBV, BSA | Short-term |
| *Financial market infrastructure* | | |
| Develop a new law that would treat all the aspects related to payment and securities settlement systems in a holistic manner. | SBV | Short-term |
| Develop a comprehensive risk management framework for the IBPS, SBV CSD and the linkages of these FMIs with the other FMIs in Vietnam (credit, liquidity, custody and investment, operational risks). | SBV | Short-term |
| Develop oversight policy objectives and strengthen the oversight implementation capacity to effectively implement the PFMIs. | SBV, SSC | Short-term |

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