BAD DEBT SETTLEMENT - CRITICAL ISSUES IN BANK RESTRUCTURING IN VIETNAM

I. Analytical framework overview

1. Theoretical consideration

1.1. Concept

A bad debt or non-performing loan (NPL) can be understood as a loan which the creditor finds difficult or impossible to recover. For banks, bad debt refers to an amount of money given to a borrower, usually firms, which are difficult to recover for a variety of reasons, including business losses or bankruptcy. It is generally agreed that a debt is considered a bad debt for one or both of the following reasons: (i) overdue interest and/or principal; and (ii), the credit institution considers that the borrower does not have the ability to pay the debt. In Vietnam, bad debts are defined to include substandard debts, doubtful debts and uncollectible debts.

1.2. Bad debt classification and provisioning

NPL classification is the process of reviewing loan portfolios and classifying loans to relevant groups based on the similarities and risks of the loans. The regular review and classification of bank loans can help control the quality of the loan portfolio and, where necessary, measures may be taken to handle problems arising. In accounting terms, loans are recognized to be impaired and the setting up of risk provisions are necessary if banks are unable to recover the principal and interest within the contract period. Loan classification and provisioning are difficult both in theory and practice, and countries differ in their selection of NPL classification provisioning.

2. International experience in NPL settlement

2.1. Korea's experience

The impressive economic performance of South Korea during the period from 1980 to early 1990s resulted in excessive investment in business. In the 1988 - 1996 period, investment growth averaged 13.6% per annum. In 1996, 20 out of 30 major corporations experienced that the rate of investment cost was greater than the rate of return. Despite low profitability, business loans did not decrease, partly owing to the Korean government's allocation of credit in the economy. With regard to the banking sector, risks were even greater. The process of liberalization had resulted in a greater level of freedom in the financial system in the absence of a coherent legal framework, leading to more risks in the banking sector. In 1997, the ratio of NPL to the total outstanding debts was 7.4% and this number increased to 8.3% in 1998. The ratio of debt on equity in the 30 largest corporations reached 500% in 1997. To cope with this situation, the Korean government took a series of active interventions to stabilize markets. Measures to handle NPLs were effectively implemented which contributed to tackling bad debts and promoting economic growth. Typical solutions included the mobilization of the Public Fund and reorganization of Korean Asset Management Corporation - KAMCO as well as enhancement of law enforcement agencies to facilitate the process of restructuring of firms and financial sector in accordance with market rules.

2.2. China's experience

The process of handling NPLs in China was directly related to the reform measures to transform the economy from a centrally planned system to a market economy mechanism. This consisted of three main stages: (i) financial restructuring toward reforming the banking system, separating policy lending from commercial loans, classifying debts into 5 groups, instead of the former 4 groups, applying an independent approval of credit with less administrative interference from state bodies; (ii) establishment of Asset Management Companies for execution of the sale or auction, restructuring bad debts, securitization of bad debts, and debt-for-equity swap, etc.; and (iii) restructuring state-owned commercial banks, inviting the participation of selected foreign strategic investors and public listing to increase transparency and improve governance capacity of the four largest state-owned commercial banks.

2.3. Thailand's experience

The Asian financial crisis in 1997 had a severe impact on Thailand's financial system. NPLs increased continuously and reached a record high of 46% of the outstanding loans in late 1997, putting great pressure on the Government to address this problem. The settlement of bad debts in Thailand was implemented though three major solutions, including: (i) direct capital injection; (ii) Asset Management Company (AMC); and (iii) The Corporate Debt Restructuring Committee.

2.4. Lessons learned for Vietnam

The settlement of bad debts in Vietnam may draw on the experiences learned of other countries, taking into account specific conditions of Vietnam. In the current context, the macroeconomic environment is not really stable; lending activity is largely based on real estate as collateral in a situation where the real estate market is unable to recover in the short-to-medium term.

II. Status of Vietnam's bad debts

1. Concept and classification of bad debt in Vietnam

Bank debts in Vietnam include (i) Loans, advances, overdrafts and financial leases; (ii) Discounts, rediscounts of commercial papers and other valuable papers; (iii) Factoring amounts; and (iv) Other forms of credit facilities. Bad debts are defined to include debts that belong to (i) Group 3 - substandard debts; (ii) Group 4 - doubtful debts; and (iii) Group 5 - uncollectible debts as stipulated in Decision 493/2005/QD-NHNN dated 22 April 2005, amended by Decision No.18/2007/QD-NHNN dated 25 April 2007, of the Governor of the State Bank of Vietnam.

Credit institutions must undertake two types of provisioning, including general provisioning and specific provisioning. General provisions are established and maintained at a level equal to 0.75% of the total value of debts from Group 1 to Group 4. The specific provisioning ratio for 5 groups of debts is as follow: Group 1: 0%; Group 2: 5%; Group 3: 20%; Group 4: 50%; and Group 5: 100%.

2. Situation of bad debts in Vietnam

The scale of bad debt: According to State Bank of Vietnam (SBV), as of 30/09/2012, Vietnam's bad debts reached about 255,168 billion dong, accounting for 8.86% of total outstanding loans. As of 28/02/2013, bad debts also accounted for 6% of total outstanding loans, estimated at about 176,208 billion dong. Another noteworthy point is that there are large variations in the rate of bad debts claimed by different organizations: as of 30/09/2012, Fitch Ratings estimated that NPLs accounted for about 15% of total outstanding loans, while Baclays estimated that the percentage was 20%.

Bad debt structure by industries: major outstanding loans are focused on industry (29%), services (27%), and trade (20%). NPLs are concentrated in five major sectors, including: processing and manufacturing (22%); real estate and services (19%); sales and auto and motorcycle repair (19%); transportation and warehousing (11%), and construction (10%).

Bad debt structure by ownership: commercial banks and credit institutions in Vietnam have focused excessively on lending to SOEs, at a time when these economic units have not been operating efficiently. According to SBV, SOEs and the state economic groups accounted for 70% of total NPLs in 2012. The sub-total outstanding loans of other economic sectors accounted for 81-83% of total outstanding loans and their NPLs just accounted for about 30% of total NPLs.

NPLs of some credit institutions: The ratio of NPLs of commercial banks to total outstanding loans is relatively high Typically, SHB has an NPL ratio of 8.53% of total outstanding loans, BaoViet Bank 5.94% and Agribank 5.8%. The NPL ratios of the state-owned commercial banks are not as high - BIDV with 2.7%; Vietcombank 2.26%; Vietinbank 1.46%, and Agribank 5.8%). But the absolute value of the total outstanding loans of the state-owned commercial banks is relatively large. As such, their NPLs account for most of the bad debts of the whole economy.

Status of collateral and risk provisioning for bad debts: About 84% of bad debts accompany collateral; 16% do not. As of the end of May 2012, the amount of provision for credit risks was roughly 67,300 billion dong. As of the end of December 2012, it was 78,600 billion dong, equivalent to more than 50% of bad debts.

3. Reasons for high bad debts in Vietnam

First, incomplete and ineffective legal environment of banking operations: Overall, the system of laws governing banking operations is inconsistent and incomplete. For example, some available rules have not yet been enforced (e.g., regulations relating to foreclosure, the sale of the property, mortgage, land use rights, etc.). Moreover, the enforcement of legislation remained weak, and this has continued to cause high risks for the banking sector in Vietnam.

- Second, internal dynamics of the financial system: Risk management capabilities of commercial banks and credit institutions are weak; Regulations on information disclosure are incomplete and less effective, resulting in a lack of transparency; Credit growth is overheating; The poor reliability of credit information, plus with uncontrolled M&A activities among businesses and cross-ownership of banks have created a vicious circle of cash flow; and banking technology remains insufficient.

- Third, inefficient NPL settlement mechanisms: The process of handling NPLs remains inefficient because the bad debt settlement mechanism is not appropriate to the task and contains many weaknesses. The classification criteria of bad debts do not reflect the true amount of bad debts. A lot of problems remain in the mechanism for handling collateral and the market for buying and selling bad debts remains undeveloped.

- Fourth, unfavorable business environment and business operations: Since late 2008, the economy has suffered a number of the negative impacts of the global financial crisis and economic slowdown, including high inflation, declining economic growth, substantial difficulty in production and business activities of enterprises and a loss of business confidence. This unfavorable business and environment has had a severe impact on banking operations, has reduced credit quality and increased bad debts.

4. Impacts of bad debts

The debt situation has seriously concerned the Government, specialists, credit institutions, and the general public owing to its serious impact on the economy in relation to blocking capital flows, threatening national financial security and causing economic stagnation. It has also adversely affected sustainable development and has created fiscal burdens in the handling of the problem.

III. Some Policy Implications for Vietnam in resolving bad debts and accelerating bank restructuring

1. Policy orientations in managing bad debts

The practical experience of other countries shows that it takes a long time to solve the problem of bad debt in the economy. As such, Vietnam needs to work out a clear strategic roadmap. The government is now on the right track in dealing with the problem of bad debt. However, available solutions remain limited, owing to the lack of a clear strategic roadmap and a clear legal framework for settlement of bad debts. In the future, the Government will need to continue in its determination to handle bad debts through the following orientations: (i) *prevention of increases in bad debts*, in which, it is necessary to improve the institution of the credit system; and at the same time to strictly implement activities of monitoring, inspection, testing, transparency and disclosure of information to prevent development of bad debts; (ii) *dealing with bad debts in a comprehensive manner together with maintaining market discipline and social equity*: the settlement of bad debts must be in line with market discipline. In this aspect, it is noted that uncontrolled money supply increases and credit easing will cause increased inflation, resulting in a costly price for the economy. The use of state budget to rescue the real estate and stock markets will make difficult for the economy to move in equilibrium because of rising bubbles and risk of bad debt; (iii) *handling bad debts in a way that does not cause pressure on public debt*: the Government will not use state budget to deal with bad debts because it will increase public debt in the next period; and (iv) *settlement of bad debts in a way that does not affect monetary policy*: the Government will need to maintain the controlled tight monetary policy and will not loosen credit conditions for businesses with downgraded credit ratings to ensure that the monetary policy is not broken.

2. Some policy recommendations to handle bad debts and accelerate the banking restructuring system

2.1. For government and state bodies

To handle bad debts, the Government will needs to carry out a series of comprehensive solutions, focusing on the following:

- Establish a solid financial infrastructure. Financial infrastructure includes: standards, rules, regulations on accounting, auditing, corporate governance, payment systems, legal frameworks regulating and monitoring the financial markets in particular, etc., aimed at supporting the financial system to fulfill the role of financial intermediary, ensuring the velocity and cost of capital mobility and the ability to transmit and disperse financial risk. A strong financial infrastructure is an important prerequisite to ensure that financial institutions work well and the financial markets operate smoothly. Thus, the financial regulatory and supervising bodies could enjoy a favorable operating environment to play their roles adequately. Accordingly, the Government and the relevant advisory bodies such as SBV and Ministry of Finance, etc., shall assume the role of setting up a strong financial infrastructure;

- Review the classification of debts to apply appropriate measures. For bad debts due to subjective causes of banks, they have to take their own responsibilities to handle. In case of bad debts due to objective causes, the State and the banks are required to share losses together in a way that the State may pay interests under current interest rates, the State may pay part of or whole principal for affected businesses; however, these businesses will need to transfer part of or even entire stake to state ownership;

- Accelerate the process of restructuring the banking system and credit institutions. The settlement of bad debts is the focus of the second phase of restructuring the banking system. The question is how the weak banks are thoroughly treated. If the weak banks cannot find the way to be merged together, the Government will need to gather them together for nationalization to implement the stable monetary policy during the restructuring period. Besides, the Government should allow and encourage M&A between banks. Accordingly, banks with strong financial strength and good corporate governance can be allowed to acquire weak banks. The merger between banks may also be oriented for those having similar fields of activity to ensure the compatibility of business models and organizations;

- Effectively operate the Vietnam Asset Management Company (VAMC). The project of VAMC establishment has been approved by the Government. However, for VAMC to perform well and efficiently, it is necessary to focus on the following measures: (1) VAMC should be given sufficient power. The power of VAMC needs to be accompanied by a specific budget line and time frame to settle serious bad debts;

(2) for facilitation of VAMC to recover purchased debts, it is essential to develop a legal framework for the market for buying and selling of bad assets. This will help avoid legal obstacles in dealing with cases that need to apply a certain policy of debt settlement; and (3) settlement of bad debts must go hand in hand with corporate restructuring, particularly with regard to SOEs;

- Develop the debt trading market. The handling of bad debt in Vietnam should need to combine with the development of the debt trading market for socialization of investment demand in bad debts. For the establishment of the debt trading market, first of all, there is a need to develop companies specializing in buying and selling bad debts and assets of economic sectors. Second, it is necessary to develop the legal framework and macroeconomic mechanisms and policies to create corridors for smooth operation of the debt trading market;

- Enhance the efficiency and effectiveness of banking inspection and supervision so as to ensure credit institutions comply with the rules, especially the rules on credit, loan classification, provisioning and use of risk provisions and regulation. SBV should develop criteria to evaluate the policies and procedures of risk management of commercial banks in accordance with scale and complexity of individual commercial banks; gradually standardize procedures for identification, measurement, testing and control of risks;

- Take advantage of the support of financial institutions and create favorable conditions for domestic and foreign investors to participate in the process of bad debt settlement. In this regard, it is beneficial to consult for experience of big financial institutions during renovation of the financial system and at the same time to take advantage of their financial supports to resolve bad debts;

- Increase monitoring of SOEs' performance. The Government should enact monitoring regulations aimed at monitoring the financial situation and providing warnings to prevent risks and ensure a healthy financial and business performance. At the same time, it is essential to promote the restructuring and overcoming the weaknesses of the SOE system to mitigate the damage that this system could cause the economy; and to reallocate the resources to areas with higher productivity to help dynamic sectors with favorable conditions for optimal development;

- Support the recovery of the real estate market and the stock market to assist the process of handling bad debts. The Government should work out solutions to help recover the real estate market, including supply reduction, no new license, revoking licenses of unqualified investors, stimulus demand in social housing apartments and low-income homebuyers, further improvement of legal procedures, paying special attention to the guarantee property as real estate, and encouraging M & A activities between projects;

- Continue implementation of policies of macroeconomic stability, inflation control and economic restructuring. Facilitate sustainable socio-economic development, thereby reducing the growth of NPLs and improving credit quality; and

- Improve the legal framework to use it as a basis for internal credit rating, addressing the internal constraints of some banks, and monitoring cash flow within the banking system.

2.2. For commercial banks and credit institutions

The Scheme of handling bad debts of credit institutions stipulates that credit institutions needs to actively implement ten specific measures. However, for effective implementation of these measures, it is necessary to carry out the following tasks simultaneously:

- Develop the system of NPL classification to apply appropriate remedial actions for different types of bad debts and affected businesses;

- Enhance the risk provisioning and use of risk provisions to handle bad debts in accordance with the law. The additional provision will facilitate the banks to collect debts, having more time for liquidation of collateral at reasonable price, thus creating income for the following years;

- Securitize doubtful debts. For businesses with a history of good corporate governance, they can be allowed to transfer part of the principal to medium-term bonds to support their liquidity and survival. Transfer bad debts into shares and change the position of the banks as creditors to become major shareholders in case of realizing the businesses' potential of survival and development after corporate restructuring;

- Ensure transparency of information systems. Establishment of independent organizations having roles of mining, verification and control of information from commercial banks. In addition, credit institutions will need to follow the "financial soundness indicators (FSI)" developed by IMF; and

- Credit institutions need to improve their internal administration mechanisms, ensuring that only authorized and responsible people are allowed to make decisions and maintaining close supervision to prevent conflict of interests and vested interests.

2.3. For the borrowers

- Borrowers need to proactively coordinate with credit institutions to develop and implement debt restructuring plans to solve business problems;

- Actively participate in market development for increased goods consumption and boosted exports; and actively participate in programs and business support solutions implemented by the Government, ministries and agencies at different levels; and

- To improve business efficiency, ensure appropriate capital structures, allocate capital properly, ensure efficient use of capital, maintain the cash flow needed for balance of payments, conduct regular assessment of financial status to provide warnings about the financial situation of enterprises.