



**POLICY OPTIONS AND CHALLENGES  
FOR DEVELOPING ASIA—  
PERSPECTIVES FROM THE IMF AND ASIA**  
APRIL 19-20, 2007  
TOKYO



---

**KEY COMMON CHALLENGES  
IN FINANCIAL SECTOR DEVELOPMENT  
IN LOW INCOME ASIAN COUNTRIES—  
THE CASE OF LAO, PDR, MONGOLIA, AND VIET NAM**

**A. NOY SIACKHACHANH**  
ASIAN DEVELOPMENT BANK

*Paper presented at the Conference: POLICY OPTIONS AND CHALLENGES FOR DEVELOPING ASIA—  
PERSPECTIVES FROM THE IMF AND ASIA  
Organized by the International Monetary Fund (IMF) and  
Japan Bank for International Cooperation (JBIC)  
April 19-20, 2007  
Tokyo, Japan*

**The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.**

**Policy Options and Challenges  
for Developing Asia  
Perspectives from the IMF and Asia  
April 19-20, 2007**

**Key Common Challenges in Financial Sector Development  
in Low Income Asian Countries  
-The Case of Lao, PDR, Mongolia, and Viet Nam  
(Revised)**

**A. Noy Siackhachanh**

**Advisor**

**Office of Regional Economic Integration**

**Asian Development Bank**

The opinion expressed in the presentation is that of the author only and does not necessarily reflect that of the Asian Development Bank



## **Presentation Outline**

Country Background

Objectives of financial sector reforms

Salient features of the sector development

Reforms undertaken to date

Assessment of progress of reforms

Key common challenges



## Country Background

### Lao, PDR, Mongolia, and Viet Nam

#### Common Features:

- Transitional economies,
- Income per capita below \$1000;
- High growth rate over the past few years; and
- Have undertaken financial sector restructuring about the same time.

<b>GDP Growth In percent</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Lao, PDR	5.8	5.9	6.1	6.4	7.0	7.3
Mongolia	1.1	4.0	6.5	10.8	6.6	8.4
Viet Nam	6.9	7.1	7.3	7.8	8.4	8.2

  

<b>GDP per capita In US dollar</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Lao, PDR	406	419	432	447	440	463
Mongolia	554	567	599	655	690	764
Viet Nam	487	515	545	579	620	663



## Country Background

### Lao, PDR, Mongolia, and Viet Nam contd

<b>Deficit In percent of GDP</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Lao, PDR	-4.4	-3.3	-5.7	-3.4	-3.5	-4.0
Mongolia	-3.1	-3.3	-4.2	-2.1	2.9	9.0
Viet Nam	-5.0	-4.7	-6.4	-2.8	-5.9	-7.3

  

<b>Debt/GDP (GDP per capita)</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Lao, PDR	91.0	94.0	90.0	83.0	79.0	78.0
Mongolia	89.0	91.4	112.8	93.0	68.3	53.6
Viet Nam	36.0	38.2	40.8	42.7	43.7	45.5

  

<b>Population (In million)</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Lao, PDR	5.4	5.5	5.7	5.8	5.9
Mongolia	2.4	2.4	2.5	2.5	2.6
Viet Nam	79.5	80.4	81.3	82.2	83.0

# Objectives of Financial Sector Reforms and Areas of Reforms

**Objectives:** To develop a sound, deep, and efficient financial system to finance economic growth.

## **Key Areas of Reforms:**

- Financial sector liberalization,
- Establishment of legal and regulatory framework,
- Restructuring of insolvent state-owned commercial banks (SOCBs),
- Institutional building of prudential regulation and supervision, and
- Building market infrastructure for financial market development.



## **Lao, PDR**

### **Salient Features of Financial Sector Development**

<b><u>Banking sector</u></b>	<b><u>1991</u></b>	<b><u>2005</u></b>
Broad money as share of GDP	7.5%	17.3%
SOCBs' share of bank credit	100%	75%
SOCBs' Non-Performing Loans	Na	80% (2005)
SOCBs Capital	negative	negative
Number of banks closed/restructured	7 (1993-94)	3

#### **Capital market**

There is no equity market



## **Lao, PDR**

### **Key reforms undertaken to date**

Financial sector reforms began after the break-up of mono-banking system.

- The establishment of SOCBs came with portfolio of bad loans (NPLs) built up under mono-banking system.
- With (i) policy of directed lending to state-owned enterprises (SOEs), (ii) nonpayment of central and provincial authorities to bank customers for government contract, and (iii) lending in foreign currency to unhedged customers, SCOBs were settled with large stock and growing flows of NPLs

## **Lao, PDR**

### **Key reforms undertaken to date      contd**

#### **Bank restructuring**

- In mid1993, \$26 million of capital was injected into SOCBs to improve their balance sheet.
- Seven SOCBs, as the result, were merged into two.
- A policy bank was established to provide access to finance in rural areas and to carry out other policy lending.

#### **Another round of reforms was initiated in 2003 to address:**

- SOCBs's credit policy (including their authority to lend on commercial basis), and their corporate governance;
- SOE reforms to minimize the burden on SOCBs and the recapitalization of SOCBs based on the progress of reforms;



## **Lao, PDR**

### **Key reforms undertaken to date**      **contd**

#### **Policy environment**

- Interest rates were liberalized in 1996.
- The restriction on market entry by private and foreign banks was removed in early 1990's (SOCBs, however, were given preferential treatment).
- Amendments to commercial banking law was passed in 2006 to level the playing field for all banks regardless of ownership

#### **Banking Supervision**

- Steps were taken improve prudential regulation and supervision for banks and regulation on micro-finance put in place.



## **Lao, PDR**

### **Progress of Reforms**

The progress of reforms has been slow.

#### **Bank Restructuring**

- SOCBs have adopted new credit appraisal guidelines and improve their treasury management;
- NPLs were brought down from 95% in 2004 to 77% in 2005 at the larger SOCBs and from 90% to 40% in the smaller SOCB.

However,

- No significant change was made to corporate governance;
- SOCBs continue to lend to SOEs.
- The policy bank continues to perform poorly and will just now undergo restructuring.

## **Lao, PDR**

### **Progress of Reforms contd**

#### **Policy environment**

- Amendments to law on commercial banks facilitate market entry by private and foreign banks; a new private bank was recently issued a license.
- However, the Government has been reluctant to consider foreign banks' strategic investment in SOCBs

#### **Banking supervision**

- Some improvement with prudential regulation and supervision and with on and off site inspection.
- Supervisory activities remain constrained by limited capacity and the lack of clarity about the central bank's role as independent supervisor.

## **Mongolia**

### **Salient Features of Financial Sector Development**

<u>Banking sector</u>	<u>1998</u>	<u>2006</u>
Deposits to GDP	13.6%	40.5%
SOCBs' share bank credits		none
Non-Performing Loans	54%	9%
Capital/asset ratio	4%	15%
Number of banks closed/restructured	8 (1994-1999)	none
<u>Other deposit taking inst.</u>		
Number of Savings and Credit Cooperatives	800 (2005)	200 (2007)
<u>Capital market</u>	<u>2000</u>	<u>2007</u>
Number of listed companies	425	384
Number of listed companies with traded shares	NA	125
Market capitalization	\$37M	\$158.7M



## Mongolia

### Reforms undertaken to date

After the break-up of the mono-banking system, banks' financial conditions were under severe distress.

- Seven banks were closed from 1994 to 1999 and another major bank was placed under receivership and rehabilitated.
- Interest rates were liberalized and there has been no market entry restriction

Other reforms undertaken include:

- Privatization of SOCBs;
- Adoption of bank regulations according to international best practices;
- Adoption of IAS for better disclosure of information;
- Increase the capital requirement for banks by 100%;
- Expanding financial services to rural areas with the promotion of the establishment of savings and credit cooperatives (SCCs);
- A passage of a new legislation to unify and improve supervision of the non-bank financial sector, which has closed nearly 600 SCCs.

## Mongolia

### Progress of reforms

Following the reforms, confidence in the banking system was restored.

- Financial intermediation grew rapidly (deposits to GDP ratio grew from about 20% in 2001 to about 50% in 2006).
- The capital-asset ratio of the banking sector, rose from below 4% in 1998 to about 15% in 2006. NPLs declined from 54% in 1999 to about 9% in 2006.
- As of the end of 2006, the privatization of SOCBs was completed.



## Mongolia Progress of reforms contd

A number of problems remains.

- Banks' corporate governance need improvement;
- Banks' weak risk assessment, management capacity, and poor internal control. This, with the rapid credit growth, could put banks in at risk.
- The lengthy court procedures for securing and enforcing collateral.
- Weak capacity to effectively supervise and enforce regulations on a range and large number of financial institutions.

## Viet Nam

### Salient Features of Financial Sector Development

<u>Banking sector</u>	<u>1998</u>	<u>2006</u>
Deposits to GDP	27.8%	74.2%
SOCBs share banking credits		70%
SOCBs' Non-Performing Loans		8-10%
Capital/asset ratio	Negative	Negative
Number of banks closed/restructured	5	5
 <u>Capital market</u>	 <u>2005</u>	 <u>2007</u>
Number of listed companies	30	109
Market capitalization	\$500M	\$4.6B
Number listed SMEs	90	90
Market capitalization		\$4.6B



## **Viet Nam**

### **Salient Features of Financial Sector Development**

**contd**

Shares of equitized (partly privatized) SOEs are also traded outside the stock exchange, with volume of 3 to 4 times the size of former market.

Bond market is also emerging, with outstanding value accounting for about 10% of GDP (Government, municipal, and corporate bonds).



## **Viet Nam Reforms undertaken to date**

The financial sector reforms in Viet Nam have been gradual.

- After the break-up of mono-banking in 1986 and the establishment of SOCBs, entry into the banking sector has been liberalized in 1990.
- By 1992, licenses were issued to foreign banks.
- With policy loans and directed lending throughout the 1990s combined with weak credit risk assessment in the wake of rapid credit expansion, SOCBs rapidly accumulated NPLs.

## **Viet Nam**

### **Reforms undertaken to date contd**

To address growing NPLs,

- Asset management companies (AMCs) were established for each SOCBs to recover NPLs and the national Debts and Assets Trading Company (DATC) to resolve NPLs.
- Policy and directed lending was also phased out from SOCBs and moved to two specialized institutions in 2004.
- SOCBs have since been allowed more autonomy on lending.
- IAS audits were conducted on SOCBs' portfolio
- By the end of 2005, most of SOCBs' NPLs incurred before 2000 were resolved with a capital injection

## **Viet Nam**

### **Reforms undertaken to date**

**Contd**

Strengthening the Supervision and Regulation of the Financial Sector

#### **Banking Sector**

- New regulations on asset classification and loan loss provisioning

#### **Capital Markets**

- a new securities law was passed in 2006 to strengthen the supervisory authorities of the State Securities Commission (SSC), the capital market regulator, and promote disclosure of all public companies.
- A decree was also issued prohibiting inside trading and falsified information on firms with traded shares. Banks are prohibited from lending to affiliated securities trading firms.



## **Viet Nam**

### **Progress of reforms to date**

**contd**

- Resolution of NPLs was through write-offs.
- Re-capitalization was not subject to progress of restructuring.
- SOCBs' performance is reported under less reliable domestic accounting standards
- There is no reliable information on the level, size, structure and characteristics of NPLs.
- Corporate governance at SOCBs remains weak.
- Cross-subsidy from SOCBs to finance budget deficit remains to be addressed.
- The progress on NPL resolution has been slow. NPLs are resolved on an individual basis. DATC is only agency that is allowed to buy NPLs from SOCBs.
- There is no regulation on investment by foreign investors, nor on the bulk sales of NPLs.
- DTAC and AMCs have no legal authority to reach foreclosure, seize assets, and force liquidation of bad assets.

## **Viet Nam**

### **Progress of reforms to date**

### **contd**

- Supervision of the banking system remained constrained by the capacity and role of SBV.
- Supervision of the securities market remain inadequate.
- Difficult to enforce the new securities law
- Harmonization of domestic accounting standards with IAS is required for more reliable disclosure,
- No transparency in the trading of share of more 3,000 SOEs in the informal market, posing substantial risks to market participants

# **Viet Nam**

## **Road map for further reforms**

### **Banking Sector Roadmap**

- The restructuring of SOCBs is to be accelerated, with all SOCBs gradually equitized.
- All international prudential standards are to be applied by 2010.
- SVB is to be converted to a modern central bank with greater autonomy to supervise the banking system.
- SVB will no longer represent the ownership rights of the state in the administration of SOCBs, thus removing the potential conflict with its supervisory role.
- These reforms are to be incorporated in new legislation to be passed by the national Assembly by 2008.
- Foreign banks will be allowed to establish 100% foreign owned banks by 2010 as requirements for WTO accession.



## Key Common Challenges

1. SOCB's commercial orientation (Viet Nam and Lao, PDR) will require
  - (i) substantive restructuring of SOCBs
  - (ii) significant size capital injection
  - (iii) no interference on SOCBs' lending
  - (iv) more reliable disclosure requirements on both SOCBs and their borrowers
  - (v) SOE reforms to prevent government intervention in directing credit to loss-making SOCBs
  - (vi) better debt management and move towards market determined interest on debt instruments and
  - (vii) strong commitment from the government

## Key Common Challenges

contd

### 2. Addressing keys common weaknesses (Lao, PDR, Viet Nam, and Mongolia)

- Weak capacity to supervise rapidly growing financial intermediation
- Poor corporate governance at financial institutions
- Weak legal framework and judiciary system to facilitate the recovery of NPLs
- Weak credit risk assessment by banks
- Independence of Central Banks
- Unreliable disclosed information by financial institutions and borrowing firms and public companies
- Other relevant legislation such as bankruptcy and land laws and infrastructure such as effective commercial court system and credit information system are also required to deepen financial intermediation in the country
- These weaknesses partly contributed to Asian Financial Crisis in middle-income countries.



### 3. Rural Development at what cost?

- Popular policy to promote the establishment of SCCs to support rural development
- Size of SCCs in relation to financial sector's assets is small

However, there are risks

- Self-regulation in low income economies has not been effective
- If supervised by regulatory authorities, given their large number, they would take away resources from supervision of the banking system (where the systemic risks are).

Thank you

