VinaCapital

BANKING SECTOR REPORT August 15, 2006

Vietnamese Banks: A great growth story at inflated prices

- We believe the banking sector is still overvalued. We recommend investors wait for weakness before buying
- We feel the downside risk for the sector is another 5-10% until September
- Average forward P/E's of 29x imply a 90% premium to the Asian average of less than 15x
- Although profit growth is running at 50% per annum and ROE is above average, the premium is too high
- Over the next 2-3 years profit growth can continue at the current pace due to low penetration rates
- Deposit rates are rising sharply, spreads are shrinking and profit margins may come under pressure for the 2-H
- WTO entry will lead to a major consolidation in the sector as minimum capital requirements rise
- Dilution is another worry as banks must raise large amounts of additional capital to reach CAR hurdles
- Vietcombank will list early next year with BIDV to follow
- We initiate coverage of both Sacombank and ACB with a Hold rating
- We like the long term growth story but not at current prices

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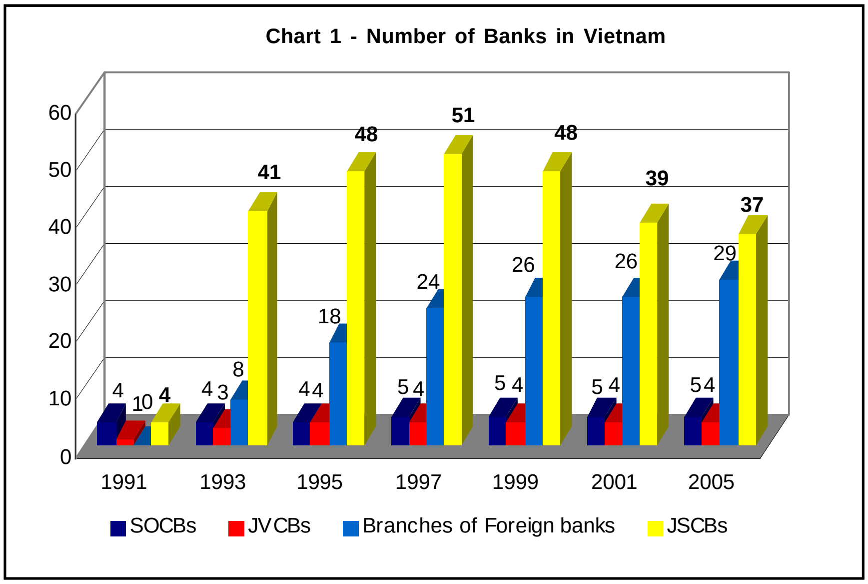


Source - SBV

The Banking Sector – A summary

There are a lot of banks in Vietnam. Too many in fact. Currently there are five state-run commercial banks, 38 joint stock commercial banks, four joint-venture banks, 29 foreign bank branches, 45 foreign bank representative offices, five finance companies and nine finance leasing firms operating in Vietnam.

Since 1992, Vietnam has moved to a diversified system in which state-owned, joint-stock, joint-venture and foreign banks provide services to a broader customer base. However, the four main state-owned commercial banks—the Bank for Investment and Development of Vietnam (BIDV), the Bank for Foreign Trade of Vietnam (Vietcombank), the Industrial and Commercial Bank of Vietnam (Incombank) and the Bank for Agriculture and Rural Development (VBARD) account for around 70% of all lending activity.

Currently the total chartered capital of the state owned commercial banks is a very paltry VND 21 trillion (US$1.3 billion). The state owned banks average charted capital of only US$250-300 each. This is hampering their development. The credit balance is currently 55% of GDP, far lower than the 80% average seen across Southeast Asia.

The joint-stock banking sector, which accounted for around 16% of total lending in 2005, has experienced a period of consolidation in recent years. In 1993 there were 31 joint-stock banks with capital of just US$9 million per bank, dominated either by state enterprises or agencies or ethnic-Chinese capital, and often existing primarily to meet the needs of their owners. The number of joint-stock banks rose to a peak of 51 in 1996, but has since dropped to 35.

Amongst the joint-stock banks, Saigon-Thuong Tin (Sacombank) is the biggest player in terms of chartered capital, with more than VND1.89trl (US$118m), slightly ahead of Asia Commercial Bank (ACB) which has chartered capital of VND1.1trl (USD$69m). Other leading joint-stock banks include Dong A (EAB), Phuong Nam (PNB), Technical and Commercial Bank (Techcombank), Military Bank (MB) and Vietnam International Bank (VIB). According to the central bank, most joint-stock banks have an average capital of VND200-300 billion. (USD12.5-19 million).

Overall undercapitalization remains a key challenge for the banking particularly when non-performing loans are taken into account. Lack of products and poor risk management are other areas of concern.

In 2005 foreign banks and joint ventures accounted for about 14% of lending activity, divided between foreign branches and joint-venture banks. Large banks such as HSBC, Citigroup, Deutsche Bank and ANZ have all established a presence and some have bought stakes in local players. However, restrictions on raising dong deposits prevent a level playing field and market share expansion has been slow.

In a trade agreement with the United States signed five years ago, Vietnam fully committed to allow in foreign banks by 2010 at the latest, and to expose the banking sector to foreign competition. Under WTO entry rules the door may have to be opened even sooner than that. Not all the current players will survive.

Chart 2 - Asian Banks Comparative Valuation

Unit:USD

	Banks	Countries	Price*	Share out. (mm)	Mkt cap (mm)	EPS 2005	EPS 2006E	P/E 2005	P/E 2006E	P/B 2005	P/B 2006	ROE 2005
1	**China Merchants Bank**	China	0.9	12,279.33	11,343	0.05	0.06	19.39	16.75	3.1	2.6	15.93
2	**China Minsheng Banking**	China	0.5	10,165.87	5,020	0.03	0.04	14.91	11.49	2.59	2.14	17.48
3	**Bank of China-HK**	Hong Kong	2.0	10,572.78	21,571	0.17	0.14	12.40	14.51	2.11	2.02	16.99
4	**Bank Rakyat Indonesia**	Indonesia	0.5	12,192	5,872	0.04	0.04	13.44	12.08	NA	3.29	27.9
5	**Kookmin Bank**	Korea	81.1	336	27,248	7.09	8.72	11.24	9.3	NA	1.82	21.55
6	**DBS Holdings**	Singapore	11.9	1,504	17,882	34.06	88.05	35.28	13.65	1.68	1.61	11.67
7	**Bangkok Bank**	Thailand	2.8	1,909	5,308	0.29	0.26	9.87	10.8	NA	1.32	15.76
8	**HSBC Holdings**	Global	18.1	11,334	204,987	1.35	1.52	13.43	11.96	2.22	2.06	16.8
9	**ACB**	Vietnam	868.8	1.1	956	16.71	23.69	51.99	36.67	10.84	7.87	28.02
10	**Sacombank**	Vietnam	3.8	190	730	0.08	0.10	49.84	38.18	6.21	4.12	16.47

Source - Reuters, VinaCapital, JP Morgan

** Share prices & foreign exchange rates as of August 7, 2006*

Why Vietnam's banks are not yet buys

Vietnamese banks still trade at a huge premium to their Asian peers following a massive run-up in pricing over the past twelve months. While prices have dropped by an average of 25% recently this has not brought the banks back in line. Let's look at several key valuation metrics. First take a look at price-earnings ratios.

Equitised Vietnamese banks are now trading at an average forward P/E of 29x. Current year average P/B's have them trading at an eye popping 7.8x. According to a recent survey by *The Economist*, publicly listed financial services companies around the world were valued last year at an average P/E of 14x, against a multiple of 18 for non-financial companies. Asian banks enjoy the slightest of premiums being valued at less than 15x current year's earnings. On a P/B basis the Asian average is 2x while most Vietnamese banks are trading well over 6x. Seen against this Vietnamese banks still seem hopelessly overvalued.

Vietnamese banks boast that their valuations are a function of their high level of return on equity (ROE) and rapid profit growth. Average ROE's of equitised Vietnamese banks are about 21%, which compares to an Asian average of about 16%. FY06 profit forecasts show pretax profit growth running at over 50%. We forecast that growth will continue for the next 2-3 years.

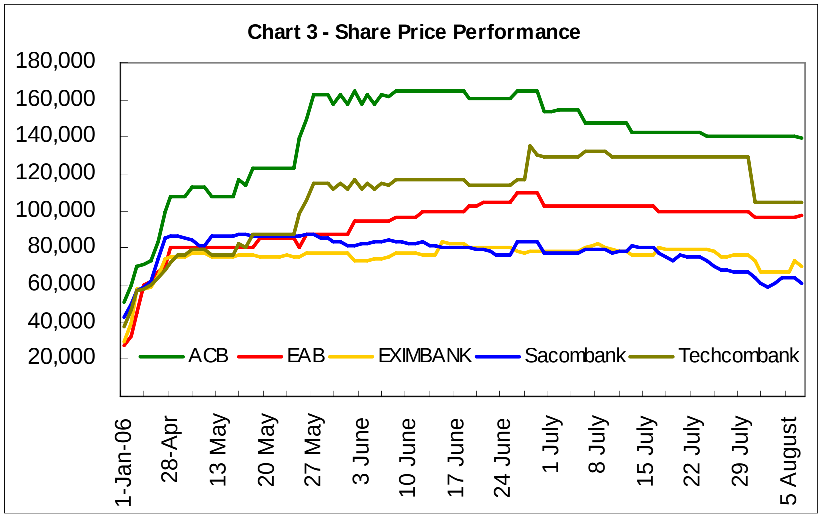
While the growth story and ROE metrics justify a higher valuation relative to their Asian peers, the premium of 70% is simply far too high. Indeed, their high ROE is largely a function of a thin capital base which leaves them very vulnerable in times of crisis.

We believe that all equitised Vietnamese banks trade at too high a premium both to the Vietnamese listed market average and their Asian counterparts. While they will enjoy very good growth going forward this is already reflected in current prices. But how did such a huge premium come about?

The premium is partly a function of a lack of supply in the overall market and specifically in banking shares. It is also partly due to the fact that most participants are not looking at fundamentals at the moment. In other words, an immature market has mispriced an entire market sector. But the mispricing problem does not end there.

The secondary problem is the range of valuations between the quality banks such as ACB and Sacombank and their lower quality rivals bear little relation either to earnings growth or ROE levels. For example, ACB is currently the most expensive bank and neither its ROE of 24% or fairly modest earnings growth forecast of 44% can justify a P/B of over 7x. Sacombank recently revised up its FY06 pretax profit forecast to VND600 billion, bringing its forward P/E down from an eye-popping 60x to a merely expensive 32x. In contrast, Techcombank at a forward P/E of 15x looked far more fairly valued given a very strong growth forecast of 100% and an ROE of 25% but 1-H earnings disappointed. One reason for its relatively low valuation has been rumoured disagreement amongst key shareholders.

Dilution is the third negative factor. All of the joint-stock banks have been trying to raise substantial amounts of capital this year in order to boost capital adequacy. The state sector faces the same issue. The five state banks will have to raise another VND30-50 trillion (US$1.8-3 billion) in equity capital to cross the 8% CAR hurdle by 2010. The government will only be able to pitch in about a quarter of this. The private sector joint stock banks will also have to raise about VND10-15 trillion (US$0.6-1 billion). Even with profit growth rates of 50% per annum much of the upside potential for the share prices over the next two years will be taken away by the fear of constant dilution as banks come to the equity or corporate bond markets looking to raise money.



Source - Reuters, brokers

The market has not yet learnt to properly price in key metrics such as growth rates, ROE, loan book quality, risk levels, management and profitability. We believe that this has led to some mispricing, partly a function of the lack of transparency that surrounds the banking sector in Vietnam.

And what of profit margins? Banks in Vietnam derive the bulk of their income from the spread differential between deposits and loans. Deposit rates have been moving up steadily in the last six months partly on the back of US rate hikes and partly due to a desperate scramble for deposits as banks try to accumulate money. This cozy club of state-owned banks that has been setting rates for the market is looking very creaky. Meanwhile, loan spreads are narrowing as loan rates have not moved higher. In the core loan buisiness margins are clearly under threat.

What about the 2-H? There is no escaping the fact that global rates will continue to move higher this year. The Vietnamese banking sector is heavily exposed through the high degree of dollarisation in the banking system. Higher dollar deposit rates feed through to the dong deposit market very quickly. And loan rate increases are lagging deposit rates. We believe that the interest rate spread is starting to fall which will have a direct and negative impact on profit margins. Of course with the high growth rates profits will continue to increase, but margins may fall and the quality of earnings will deteriorate.

Our sector view

We suspect that the momentum that has carried banks this far will ebb further over the summer, leading to a gradual correction in prices. The Sacombank listing threatened to release about US$200 million in additional bank paper on to the markets, leading to some switching and selling as investors make room. The postponement of part of this issuance until the year-end has stabilised sentiment for now. There is a further downside risk of 5-10% in this sector until September. From the end of Q3, however, a minor year-end rally in anticipation of the equitisation of Vietcombank next year, the APEC summit and WTO membership would not surprise us. We see that as the last opportunity for long term holders to take profits and exit the sector. A shake-out awaits next year.

In 2007, we expect to see a large increase in supply with the equitisation of Vietcombank, MHB and possibly BIDV. These three banks alone could add between US$3-4 billion in market capitalisation to the OTC market post-IPO. Currently the combined market capitalisation of the equitised banking sector shares adds up to about US$2.5-3 billion. This wall of supply will almost inevitably lead to a de-rating of the sector with valuations coming down to a more reasonable level. Even with strong profit growth expected to continue this de-rating will almost inevitably lead to lower share prices in the sector.

We recommend that investors reduce exposure to the sector on price strength. There may be a trading opportunity in the sector later this year but on fundamental grounds we believe the sector is substantially overvalued on a P/E basis. Given rising interest rates we also feel that the chance of major positive earnings surprises in the sector is lower than last year.

We beleive that share prices in the sector have already hit their medium-term high and while trading opportunities will appear in the next few months buying on fundamental grounds is not justified yet.

Characteristics of the Vietnamese banking industry

In our opinion the Vietnamese banking market has eight key characteristics:

(1) Very low market penetration

(2) Rate of growth in both loans and deposits far exceeding GDP growth

(3) A highly concentrated but highly fragmented banking market

(4) Heavy handed regulation with restrictions on foreign banks

(5) Lack of transparency concerning quality of lending

(6) Heavily undercapitalised

(7) Narrow revenue base and few product offerings

(8) Unknown quantity of non-performing loans

Whilst some of these characteristics may be alarming they are typical of a developing economy. What is exciting, however, is that the growth potential is fuelled not simply by the rapid rate of GDP growth but more importantly by the low level of current market penetration.

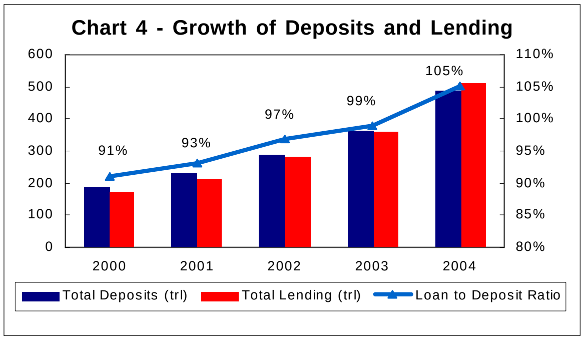
(1) Very low market penetration

There are only about six million bank accounts in Vietnam, five million of them for individuals which amounts to a penetration rate of about 6%. In reality, the effective potential market size is about 20 million or treble the current penetration level. That is the size of the AB socioeconomic class in Vietnam.

Even so, if we compare this to the internet and mobile penetration rate of 14% and 12% the number is rather low. The reason is simple: the distribution and infrastructure of banking services is very poor relative to the telecommunications industry, which has virtual national coverage. By contrast, banks are almost unheard of in secondary cities and rural areas. With a low urban population of about 29%, banks simply don't have easy access to over 70% of the population.

There are other reasons, of course. Until recently the government had encouraged a cash economy by paying state employees in cash; there is a traditional distrust of banks; the banks themselves have done a poor job of providing services to the retailing public; and small businesses too are poorly served by banks unwilling to give them large loans unless they have the collateral to back it up.

Of course the banking industry is growing rapidly with both deposits and loans expanding at high, double-digit growth rates per annum. And some banks such as Vietcombank, ACB, Sacombank, and Techcombank are making a determined effort to court the retail market.



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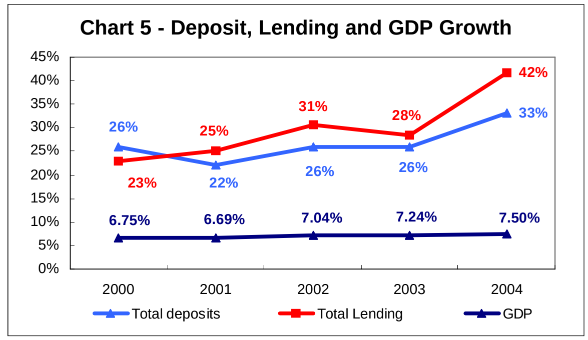


Source - VinaCapital

(2) Rate of growth in both loans and deposits far exceeding GDP growth

Credit growth in Vietnam has been expanding at a breakneck speed these last few years. Not surprisingly given heady GDP growth. Nonetheless, the sustained rate of increase over several years has raised eyebrows at international bodies such as the IMF and World Bank. They like their credit growth at room temperature, rather than piping hot. Well piping hot is what they've got. In fact, the state-owned banks saw credit grow at an annual average rate of 24% over the past five years.

Given the inability of some bankers to distinguish a good credit risk from a bad one (assuming they have a choice) this is not entirely a good thing. Hence the international sigh of disbelief that such stellar credit growth has been accompanied by a falling NPL ratio. Not on your Nelly say the foreigners.

According to some economists a 7% GDP growth rate can accommodate an annual credit growth rate of about 14-20%, roughly a factor of two without generating a lending bubble. However, credit growth rates above that level for any extended period of time are unhealthy for an economy. Admittedly credit growth rates have been falling for the last year down to about 15% as the central bank has tried to rein in credit departments. So far this year in fact lending has expanded at only about 16% nationwide and only 9% in HCMC. HIgh interest rates seems to be having an effect at last.

Going forward we suspect that the speed of credit growth may well start expanding again as WTO becomes a reality. One bank has forecast that credit could grow at 35% per annum over the next five years given sufficient access to capital. While the better banks could probably cope with this, the temptation for others to take on too much risk is high.

(3) A highly concentrated but highly fragmented banking market

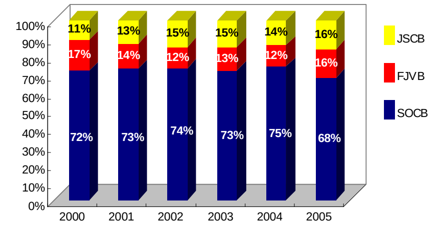
Four state banks have carved up 70% of the loan market while forty-odd joint-stock banks and a host of foreign banks scrap for the remaining 30%. Compare this with the US where the ten biggest commercial banks control only 49% of the country's banking assets, up from 29% a decade ago.

Chart 6 - Deposit market share between banking categories

	2000	2001	2002	2003	2004
SOCB's	77.0%	80.1%	79.3%	78.1%	75.2%
JSB's	11.3%	9.2%	10.1%	11.2%	13.2%
Foreign Banks	9.2%	8.8%	8.1%	7.8%	8.2%
JV's	1.1%	1.2%	1.3%	1.5%	1.5%

Source - BIDV

Chart 7 - Lending market share between banking categories



Source - BIDV

Thus, at the top tier, the market acts like an oligopoly, while beneath the surface there is a holy war going on as mite-sized private sector banks scrap for the rest. Since the market itself is growing so fast this may not seem so bad. The state banks are also slowly bleeding market share. Even so things look very lopsided.

Enter the State Bank of Vietnam (SBV), concerned about the fragmented nature of the private sector banks. They will introduce new regulations to force another round of consolidation in the near future. One way of doing this is to set high hurdles for any new established bank before it can get a license. All banks will need to have chartered capital of VND 1 trillion ($62.8 million) which is exceeded by the existing capital of only the very biggest JSB's such as ACB and Sacombank. All other existing banks fall far short and will need to scramble for new capital or merge in order to meet the new requirements. And thats just the first round. From next year the SBV has circulated a draft proposal to raise the minimum capital level to about US$300 million. And there you have the consolidation trigger. 50% of the JSB's face merger or takeover.

They will also have to demonstrate experience in banking governance. Banks will need to commit to Basel 2 standards from either 2008 or 2010. One of the key issues is the regulation of key stakeholders, such as a bar on lending to stakeholders or their affiliates. This is to prevent corporations from using their own banks as private piggy-banks. Currently a corporate of family can own up to 40% of a joint-stock commercial bank.

One reason for the concern is that large corporations such as the giant utility Electricity of Vietnam (EVN) and the Vietnam Insurance Corporation are chomping at the bit to set up banks. The EVN currently holds a 40% stake in An Binh Urban Joint-Stock Commercial Bank. The SBV hardly welcomes new entrants in an already overcrowded marketplace unless they have the size, experience and funds to help the consolidation process. And they are also wary of conflicts of interest from large corporations owning pet banks.

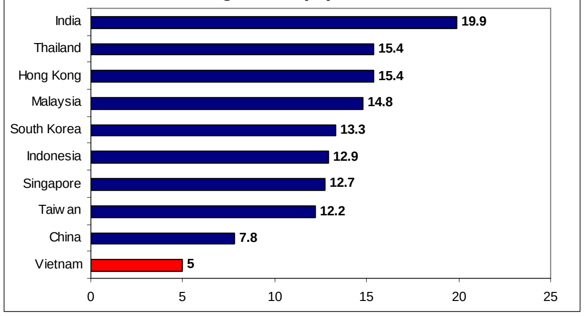
(4) Heavy handed regulation with restrictions on foreign banks

The government still exerts strong control on the banking sector in two ways. Directly, through various regulations and restrictions which govern how they conduct business and strictly licensing the type of businesses they can enter; and indirectly through the interference of a myriad of agencies and ministries, both local and national, who want to have a say on how scarce credit resources are allocated.

The state-owned banking system is trying to shift from directed policy lending to a commercial system. But the transition is proving slow and painful. Given the legacy of state control at both national and local level it's hardly surprising that the state-owned banks routinely complain about interference in their lending decisions and overall management. It seems that banking is too important to be left to bankers. The culture of social and political lending is still dominant amongst local officials and bureaucrats, as is the idea of consensus building and consultation before decisions are taken. Neither works well when you are trying to create a dynamic and profitable banking system in a hurry.

To be fair, the problem has been recognised and things are getting better. With the proposed reorganisation of the SBV for example, fewer local branches should reduce the amount of day-to-day noise coming in to credit departments. Local authorities will have less leverage in leaning on banks without the local central bank office to back them up. And the recently announced decree allowing for 100% foreign-owned bank branches will finally set the stage for a level playing field for foreign banks. However, without eliminating limits on branch openings and mobilisation of dong deposits (currently limited to 350% of total capital for foreign banks) some painful shackles will remain.

Chart 8 - Average CAR (%) Of 4 SOCBs In 2004



Source - World Development Indicators - World Bank

Chart 9 - Chartered Capital of Banks 2006

	Current (end 1-H)	Projected -end 2006	Increase
ACB	1,100.05	1,100.05	0
Sacombank	1,899.47	2,420.00	27%
Eximbank	815.32	1,200.00	47%
Southern Bank	580.42	1,200.00	107%
EAB	600.00	880.00	47%
SaigonBank	600.00	620.00	3%
OricomBank	363.50	630.00	73%
HDB	300.00	500.00	67%
An Binh	500.00	990.00	98%
Gia Dinh	80.00	300.00	275%

Source - SBV
Unit - VND Bn

(5) Lack of transparency concerning quality of lending

Lending decisions in Vietnam are still based more on relationships than cash flow. The assessment of loan customers is usually driven by the relationship with the bank and the size of the collateral being offered. Cash flow driven assessment and qualitative analysis is reserved for large private sector customers only. Amongst the large banks only ACB bank uses DCF analysis across their entire customer base. The problem is partly due to outside interference in the decision making process and partly due to a lack of professional guidance. The absence of IT infrastructure to support professional credit analysis is another major factor.

Another issue is exposure. Most banks lend a lot of money to a fairly narrow base of customers. The top 30 state-owned corporations probably account for over half of the state banks lending books. The private sector joint-stock commercial banks (JSCBs) are no different.

Good information is also scarce. Getting someone's credit history in Vietnam is often an exercise in futility. Banks don't share much and the state credit bureau only carries the history of the very largest lenders. Lack of credit information is probably the single greatest hurdle standing in the way of the development of a proper retail market. Currently only about 11 out of every 1000 people in Vietnam have a credit history, a penetration rate of about 1%. There is talk of setting up an independent credit agency this year to fill the information gap. Things are getting better but progress here is slow.

(6) Heavily undercapitalised

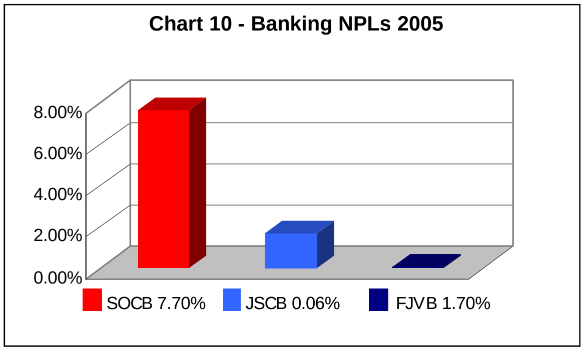
One of the legacies of state ownership is a severe shortage of capital at the state banks, a quality shared by private sector commercial banks as well. Government restrictions on equity holdings combined with a bond market that hardly functions has made raising chartered capital very difficult for banks.

Average capital adequacy ratios (CAR) in amongst Vietnamese banks stood at 4.5% at the end of 2005. This compares with an average CAR of 13.1% in Asia-Pacific and 12.3% in Souteast Asia. Admittedly with large scale raising of capital this year this number is improving. With most of the state banks well below the minimum 8% capital adequacy ratio for Tier 2 capital, lack of access to the international capital markets has constrained their growth. And this valuation is anyway based on a vary generous reading of their NPL's.

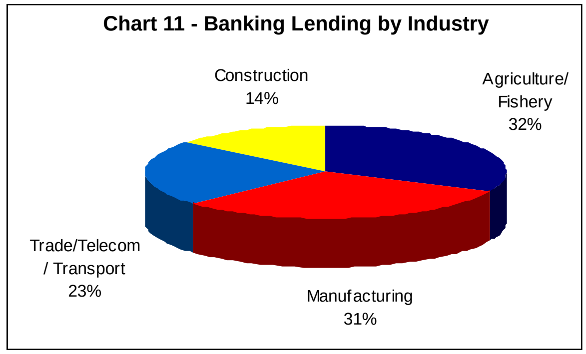
The JSCBs are in only a slightly better state with a handful able to cross the 8% hurdle rate. The rest are pitiful. And given that the domestic capital markets are still in the fledgling stages, raising new capital has been the biggest headache for all banks. The stronger JSBs have responded partly by selling shares to foreign strategic partners. Vietcombank and BIDV have both issued dong denominated domestic bonds in the last six months at a 1-2% premium to sovereign debt. BIDV has obtained an international rating in preparation for a stock market listing and possible overseas bond series.

Sacombank has raised some equity recently and most of the top tier of JSCBs have raised their capital substantially in the past twelve months. Further down the line, where profitability is lower and capital particularly skimpy the options are more limited. The SBV is chary of allowing smaller banks to raise capital from foreign investors.

Agribank, the behomoth currently has chartered capital of $400 million. Vietcombank, the second largest bank by assets, has chartered capital of US$487 million, BIDV about $240 million. Amongst the JSCBs Sacombank has chartered capital of US$118.6 million and ACB has capital of US$68.7 million. In recent years the top nine have been raising capital by about 40% annually. Going forward all of the banks have substantial appetites for raising further capital, to shore up their Tier 2 capital base to bring them over the 8% CAR hurdle by 2010.



Source - VinaCapital



Source - VinaCapital

(7) Narrow revenue base and few product offerings

Most Vietnamese banks make money from loans. And that's basically it. Compare that to Western banks that make about a quarter of their income from fees – credit card fees, lending fees, arranging fees, etc. – and most have branched into wealth management. Well, not in Vietnam. Some banks like Vietcombank ACB and Sacombank do of course generate good fees from remittances but the fee-paying retail market has barely been touched at all. To be fair this is tied into the lack of availability of credit history: banks don't like lending to strangers they know nothing about.

The state banks are generally geared to the large corporate and state-owned sector, providing syndicated loans for utilities, infrastructure projects, heavy industry and property developers. JSCBs are geared mainly towards lending to small and medium sized enterprises (SMEs) and the wealthier retail customers. However given their low penetration and limited branch network they only reach a fraction of their potential customer base. Car loans, mortgages and house improvement loans are retail staples. And small business loans using property as capital is the basic model for the SME market. Only about 20% of HCMC based SMEs have access to loans according to a recent survey. Imagine what the rest of the country is like. In general, the Vietnamese banking model is best described as relationship-based rather than product-based as in international banks. Those banks that make the transition soonest will be the long term winners.

(8) Unknown quantity of non-performing loans

If you were to believe the State Bank of Vietnam (SBV) statistics the non-performing loans problem has been largely dealt with since 2000. Amongst the state-owned banks, non-performing loans (NPLs) have fallen steadily from 12.7% in 2000 to 8.5%, 8.0% and 4.47% in 2001, 2002 and 2003, respectively. Under a new stricter definition, the official number in 2005 has risen to about 7.7%. BIDV, with an NPL ratio of 9% is dragging the average down.

Overall, about half of the NPL's are on the watch list, which is the second of five lending categories in the new SBV scoring system. The other half fall into the three categories below watch list which are of greater concern. For private sector JSCBs, average NPLs were said to be around the 1% level at the end of 2005.

Of course few believe the official numbers. International bodies carried out a similar exercise using Ernst&Young and found that NPL's in the system using international accounting standard definitions came to about 15-20% of outstanding loans in the state-owned sector. This number is conservative due to limited data; a figure between 20-25% is probably a fairer estimate. In this respect the slow development of the banking industry is a blessing in disguise, things could be a whole lot worse. The worry is that the gap between the official version and the real picture is large and may indeed be growing. What saves us from a real catastrophe is the robust property market and a generally healthy economy.

In the early years of the new millennium there were some efforts by the government to resolve NPLs. In 2001-2003 the government injected a large amount of money into the state owned banks to enable them to write down their NPLs. The banks worked through the problem, Incombank for example wrote off about VND5 trillion (US$312 million) worth of bad debts in 2004 alone.The downside to this approach of course is the moral hazard. A blank check from the government may solve the immediate problem but doesn't change the lending culture that gave rise to it in the first place.

Most NPLs are generated by state-owned enterprises (SOEs) refusing to pay their obligations to state-owned banks. Pre-equitisation is a favorite time to write off or simply clear out these loans. That way SOEs can start their new life in the private sector unencumbered by debts. This is just too bad for the banks unless the government coughs up. Usually it does. Out of resolved NPLs from SOEs, 36% were paid out by state budget sources, 40% were dealt with by risk provision funds and 24% by the liquidation of assets. The last option is a tricky legal prospect and seen as not very polite. One major reason for the fairly painless partial clean-up was the fact that land prices skyrocketed in 2001-2003. This enabled banks to sell off collateral land use rights and buildings at a profit on the rare occasion they did actually get their maulers on the loot.

So apart from asking the government to honor the SOEs' commitment and trying to seize collateral there is precious little banks can do. There is not yet an effective secondary market for bad debt, although attempts to kick-start one are ongoing. There are very few NPLs sale and purchase transaction taking place.

Chart 12 - Financial services

	Banks	Life Insurance	Non Life Insurance	Broking
Penetration	8.0%	0.73%	1.25%	0.1%
Top 4 market share	68%	97.3%	86.5%	56%
Number of players	82	8	16	15
Foreign and Joint-venture share	16%	61.6%	5.7%	0%
Supervised by	SBV	MOF	MOF	SSC
Restrictions on new entry	High	Medium	Medium	High
Restrictions on foreigners	High	Low	Low	HIgh

Source - VinaCapital, SBV, VN Express

Business environment for the banking sector

The insurance hare and the banking tortoise

The most telling way to look at the Vietnamese banking environment is not in comparison with its regional peers, but rather with a domestic success story – the life insurance sector. Since 2001, the insurance sector has managed to increase its effective penetration from 1% to over 10%

What lies behind this spectacular success?

An open market, good products, good distribution, good marketing and most importantly customer trust. By contrast, the banking sector is not open, does not yet offer a full product line-up with mass market appeal, has limited distribution capability, is not good at marketing and has yet to win the public's trust. Of course the task is a lot harder because the insurance companies only want some of your money while the banks want all of it.

Dig a little deeper and we find a benign government stance towards the life insurance sector played a key role in its development. A liberal early stance towards licensing new players followed by stricter controls to ensure the market did not become too crowded. Once licensed there were few restrictions on foreign firms entering any segment of the market leading to a level playing field. This led to tough competition, a more commercial business environment and rapid market growth benefiting all players. Life insurers lost no time in creating an enormous distribution system comprising armies of agents nationwide. And paying them to produce.

Banks have been shackled by a less benign regulatory environment. The SBV has tightly controlled everything. This has applied to all market players and ensured a slanted playing field by restricting foreign banks to certain niche market segments. As for existing players, the state-owned commercial banks (SOCBs) are on a tight leash and government officials frequently weigh in on lending decisions. Funnily enough, the one thing they did not restrict sufficiently early enough – the number of new JSCB licenses – has only made matters worse. In the market segments not dominated by the SOCBs there are too many banks chasing too few customers. This highly fragmented second tier banking market has prevented the emergence of scaleable business models able to challenge the big four.

The success story in the life insurance sector illustrates the potential of the banking sector as the regulatory climate becomes more commercial. Realistically this cannot happen overnight. The government, and the SBV in particular, are too heavily invested in every respect to ever let go completely. We can live with that, especially since most Asian governments follow a similar line. But what is necessary is that the government keep a discreet distance from the operating side of the banking business.

In fact over interference is not the main obstacle. The real problem is that the authorities have approached the sector in a hydra like fashion. In other words interfered without a strategy. They clearly want a strong credit market able to provide for Vietnam's investment needs. However they also want to get there without inflicting too much social pain. You can't have both. This tug of war between powerful interests groups has stymied the drive for reform since 2001.

As a starting point, the important thing is to gauge the government's preferred outcome for the banking sector and determine whether that outcome would be attractive to investors.

Cleaning up the existing NPL mess is in fact the easier task. In fact the job is about half done already. But preventing SOCBs from adding to the pile of rotting debt by constantly issuing new dodgy debt has always been the harder part of the equation. JSCBs have their own bad debt problems; locked out of the mainstream lending markets by the SOCBs, some of them have taken on too much lending risk.

Changing lending practices means (1) enforcing commercial best practice and (2) preventing outside interference in the lending decision. As this interference often happens at the local or regional level, centralised enforcement of a common lending code is crucial. In short, rewiring the culture of the SOCBs. Reducing the social role of the big banks so that they can get on with the business of actually earning a return is also a necessity.

The government's strategy

After a long period of hesitation and hints of action the government has come up with a fast-track roadmap to liberalise the financial sector by 2010. Under the roadmap all SOCBs, except for the Bank for Agriculture and Rural Development (Agribank), will be equitised by 2010. They are serious this time because frankly they have no choice. The date, agreed under the BTA with the Americans, will mark the market opening of the financial sector and is non-negotiable. In other words, no wiggle room.

Under the roadmap, the state will retain a controlling stake in the banks but its holdings will be quickly reduced to 51%. Foreign ownership will account for a maximum of 30% of total shares, while each strategic foreign institutional investor currently allowed to hold 10-20% at most. The 20% limit may be eventually erased but the 30% cap will stay for the time being.

So far, the government has given licenses to allow the Bank for Foreign Trade of Vietnam (Vietcombank) and Mekong Housing Bank (MHB) to go public. They are expected to have IPOs sometime early in 2007. The other two, BIDV and Incombank, will follow suit in 2008 or 2009.

The licensing process is twin tracked with a license needed from both the SBV and the State Securities Commission (SSC). Getting the nod from one is no guarantee that the other will follow suit. The SSC apparently kept Sacombank waiting a long time. They are expected to give BIDV the same treatment. Now that the licenses have been given, both Vietcombank and MHB are looking to hire advisors to strengthen operations and guide them to the market.

The SOCBs are anxious to jump into the market quickly in order to address their acute capital problem ahead of 2010. As of July 2005, the SOCBs had a combined registered capital of only VND18.47 trillion (US$1.2 billion) and average capital adequacy ratio of only 4.4%. By end 2005 this had improved to VND 21trl and 6% respectively. But with loan books rising by 15% per annum this year they will have to increase capital by a similar amount just to maintain their current CAR level. The state owned banks need to cross the 8% safety level comfortably in order to allow some international activity.

Since the summer of 2005 the banks have all been busy raising capital. Of course raising it is one challenge. Not losing what you have is another. Here the SOCBs have a problem: their customers. Most of the 5,500 SOEs in Vietnam are clients of the four SOCBs, and many of these enterprises are struggling. As a result, the four SOCBs run great risks providing unguaranteed soft loans without any guarantee to the state sector.

JSBs, which were set up in the 1990s, are not impacted by administrative burdens like the SOCBs. Thus, they are more flexible and can adapt to market conditions more easily. However, they have puny levels of chartered capital, and so cannot provide large loans. Unlike the SOCBs, they have fairly low rates of bad debts and outstanding letters of credit, even though it is difficult to completely evaluate the quality of their loans because of poor reports and a lack of transparency.

Basel 1 will be in effect until 2010, when the stricter Basel 2 standards for corporate governance will be introduced. The government will have to introduce further legislation before then to force banks' compliance, particularly at the ownership level. This may create some buying opportunities amongst the JSCBs as families are forced to reduce their stake.

Chart 13 - SBV latest draft reforms

(1) Banks must raise a minimum VND5trl ($330m) in capital from next year
(2) Foreigners can buy 5% of a Vietnamese bank without special permission
(3) Foreign investment firms can own up to a 10% stake in 4 different banks with special permission
(4) Basel 2 to be applied from 2010

Source - VinaCapital

State Bank of Vietnam – Freeing the tiger

In theory the central bank enjoys a wide remit. In practice it can't do much without a legion of agencies and ministries throwing in their penny's worth of advice. The central bank, the SBV, currently acts as the sole supervisory and regulatory body for the banking sector. It also owns the state-owned banks. And sets interest rates.

The SBV was broken up in 1988 and assumed an enhanced regulatory role, with commercial activities shifted to other institutions. The central bank still maintains a huge network of 61 branch offices. There is a widespread delegation of powers to the provincial branch level, amounting to effective collusion with local politicians to drive bank lending policies. Cutting down and limiting the autonomy of these branch offices is a key and necessary reform.

There is currently much debate about the future role of the SBV. Many international agencies, notably the World Bank have questioned the dual role of the SBV as key shareholder in and regulator of the state-owned banks. There are also noises from the SBV itself complaining about outside interference in the implementation of monetary policy. The IMF has been a critic, citing a lack of transparency and poor execution.

There is a clear need to separate the various roles of the SBV and give it increased autonomy in those areas such as monetary policy and regulation of the banking sector, which are clearly in its remit. The SBV also needs to be free of its role as custodian of the state's shareholdings in the banking sector. The SBV sees several key roles for itself in the future: compiling and executing monetary policy, ensuring stability of the credit institutional system, act as a regulator to the banking system. In order to achieve this it needs legislative backing to clearly define its relationship with the National Assembly, government and all government agencies. In simple terms stop the incessant interference from other parties so that the SBV can get on with the job. After all, if the central bank is not allowed to set interest rate policy and regulate the banking sector without being leaned on, what hope is their for individual banks to lend money without getting the same treatment.

To this end the SBV has submitted a proposal to amend the State Bank Law and accompanying decrees to clarify matters and hopefully set them free. SBV branches at the regional level would be consolidated. The intention is to rework the credit law and separate out the supervision and management roles of the SBV by 2008. The bank supervision division of the SBV will be strengthened and eventually spun off to form an independent government agency. Meanwhile the ownership role will be transferred to the Ministry of Finance (MOF) or some other dedicated agency. We believe that the sooner the central bank gets out of the ownership game the better.

Another issue is the lack of cooperation with the MOF on key issues such as bad debt and bank equitisation. MOF has often written off state-owned companies bad debt without consulting the banks. And the State Securities Commision (SSC), the stock market regulator often stalls on issuing licenses for banks to list. The two don't play well together.

Regulatory environment – Meeting international standards

There are a myriad of regulations and decrees covering almost every aspect of the financial sector but we would like to look briefly at just three topics: progress removing restrictions from foreign banks, meeting international banking standards and the treatment of NPLs.

The Law on Credit Institutions of December 1998 (amended June 2004) provides the legal framework for the banking sector. Article 14 allows any organisation that satisfies relevant conditions to operate banking operations in Vietnam provided it is issued with a licence by the SBV. Not all licenses are the same, though, and in practice the law allows four types of private sector banks (three types of foreign banks) to operate in Vietnam:

(1) Joint-stock commercial banks

(2) Foreign bank branches (FBB)

(3) Joint-venture banks

(4) 100% foreign invested branches (FIB)

Previously, only the first three types were possible as the government delayed issuing the necessary supporting regulations to allow banks to set up 100% foreign invested branches. This has now been solved by the publication of Decree 22 in February this year.

So what's the difference between a foreign bank branch and a foreign invested branch? The FBB is a dependant subsidiary of a foreign bank while an FIB is established as a separate Vietnamese legal entity. An FIB can only have foreign investors and a foreign bank must control at least 50% of the chartered capital. The important difference lies in the scope of business, as an FIB can be treated the same as a Vietnamese bank. Sounds like a level playing field but let's wait and see how it operates in practice.

All three types of foreign bank (JVB, FBB and FIB) can now be licensed for 99 years, up from the previous 20-30 years. One issue is whether an existing FBB can be converted into an FIB directly and so far it seems not. Any bank wanting to make the conversion would probably have to reapply for all licenses and re-register under the new structure. No doubt a time-consuming and expensive task.

With regard to meeting international banking standards, the government has appeared to follow WB recommendations to provide the necessary framework for an integrated financial system as required under WTO rules. And so in the last few years some of the necessary legislation has been pushed into place. We are nearly there now.

The government issued Decree 74 to counter money-laundering activities and amend regulations on deposit insurance. Under the Deposit Insurance Decree, deposits of VND50 million receive insurance protection, up from the previous VND30 million. The National Assembly Standing Committee also approved the Foreign Exchange Ordinance, which is expected to pave the way for an open, liberal and transparent foreign-exchange market.

The SBV currently is circulating a draft to force banks to have a minimum capital of US$63 million by the end of this year and US$330 million from the end of next year. And move towards meeting Basel 2 governance standards by 2008 or 2010. The draft also would also oblige all bank owners to have extensive operating experience and adhere to international corporate governance standards as a way of preventing inexperienced or unsuitable entities from getting a banking license. For the time being a corporate or a family can own up to 40% of a joint stock commercial bank. An Binh bank is 40% controlled by the Electricity of Vietnam (EVN) while Southeast Asia joint stock commercial bank is 40% controlled by family interests.

On the NPL's, the central bank issued Decision No. 493 to reclassify bad debts and risk reserves closer to international norms. So far, three state-owned banks (SOBs) claim to have successfully reduced their bad debt ratios to less than 5% in accordance with the new rules. Too successfully in fact, but more on this later. Overall the regulatory authorities are making an effort to converge with international standards in the financial sector, but with WTO membership and the 2010 deadline looming, time is not a friend.

One of the more irksome regulations Decision No 888/2005/QD-NHHN issued on 16 June 2005 requires that banks set aside capital of at least VND20 billion (US$1.25 million) before setting up a new branch. This has restricted the expansion of Vietnamese banks and has led many of them to expand by opening sub-branches which face no such capital requirements.

And foreign banks are still allowed to raise dong deposits only to a ceiling of 350% of their chartered capital. In effect this locks them out of the domestic deposit market and is the most important impediment for their expansion plans.

Chart 14 - Vietnamese Deposit and Lending rates

Banks	Currencies	Deposit Interest Rate				Lending Interest Rate*			
		3 mths	6mths	9 mths	12 mths	6 mths	12 mths	2 years	5 years
Vietcombank	USD	3.80%	4.00%	4.10%	4.50%	6.90%	6.90%	7.45%	7.45%
BIDV	USD	3.80%	4.20%	4.10%	4.65%	7.50%	7.50%	Sibor + 2.2%	
Techcombank	USD	4.10%	4.40%	4.40%	4.90%	7.5% + floating			
ACB	USD	1.20%	1.20%	1.50%	1.50%	Sibor + 1.8%			
Average		3.23%	3.45%	3.53%	3.89%	N/A			
Vietcombank	VND	7.44%	7.80%	8.04%	8.40%	10.20%	10.32%	11.64%	11.64%
BIDV	VND	7.56%	7.80%	8.04%	8.40%	12.00%	12.00%	11% - 12%	11% - 13%
Techcombank	VND	8.40%	8.64%	9.00%	9.24%	13.44%	13.44%	> 13.8%	
ACB	VND	8.16%	8.40%	8.58%	8.70%	11.64%	12.24%	12.36% + floating interest	
Average		7.89%	8.16%	8.42%	8.69%	11.82%	12.00%	N/A	

Source - Bank websites

** Lending rate is considered on case by case basia*

Interest rates – Deposit and loan rates

The government has gradually liberalised interest rates since 1996. Currently deposit rates are set by the SOCB's as they control 70% of the lending market. However despite liberalisation both deposit and lending rates have been somewhat inelastic in relation to demand. Loan margins are still thin and while this works to the advantage of the larger SOCBs, they have been a major disadvantage to the smaller private sector banks. Recently, though, competitive forces have begun to play a strong role in the setting of rates as banks scramble to attract new depositors and avoid losing existing ones. Customers have become very market savvy and are prone to switch accounts to follow higher rates.

Prime interest rate guidelines are issued by the SBV. In practice the four SOCBs have operated as a cartel to set the ceiling interest rate for 6 and 12 month deposits. This is then the base for other JSCBs to set their own deposit rates with the allowed variance not to exceed 0.05% per month for a deposit with the same term. There are ways around this of course. The JSCBs simply offer a higher interest rate for the 7, 9 and 11 month's deposit which are not covered by any agreement. Here the variance can be up to 100 basis points compared to the base set by the SOCBs. Recently this cartel has broken down as all banks scramble to raise capital.

Interest rates are on the rise and will move higher during the 2-H of 2006. Because of the high level of dollarisation in the banking system the SBV has to follow the Federal Reserve interest rate movement closely. As US rates go up so must Vietnam follow to avoid a shift out of dong deposits into dollar deposits.

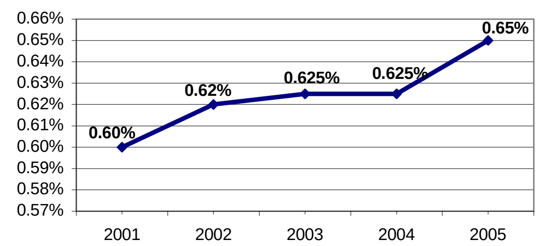
Accordingly, in 2005, the central bank pushed up adjusted recapitalisation and rediscount interest rates three times and primary rates twice. The recapitalisation rates rose from 5% to 5.5 per cent, the rediscount rate from 3% to 3.5%, and the prime rates from 7.5% to 7.8% per annum. Commercial banks' interest rates for dong deposits rose by 0.48-0.63% per annum and for dollar deposits by 1.25-1.5% year-on-year (y/y). The trend has continued this year.

So far this year deposit and lending rates have been rising about 4-5 basis points a month, with US dollar interest rates obviously following on from the Federal Reserve's tightening policy. The SOCBs met recently to try holding 12-month deposit rates at 8.4%, but this is unlikely as the demand for deposits is too high. A previous attempt to impose a deposit rate ceiling a few months ago broke down and we believe this second effort will suffer the same fate. Phuong Nam Bank has been offering 4 and 11 month CD's with a rate of 9.12% and 9.72% respectively. Larger private sector banks such as ACB are currently paying up to 9.18% for 12-month deposits.

Fierce competition amongst domestic banks to attract deposits is another factor in pushing up deposit rates. Deposits in the banking system are up 30% in the first half. One key reason for this deposit raising frenzy is the lack of an efficient and active interbank capital transfer market. There is no effective market for deposit rich banks to lend to banks that need it. Relationships rather than profit drives the interbank market. The surplus capital simply sits there. And banks are forced to compete with each other to raise deposits just in case they might need it. Instead of simply lending the excess to each other.

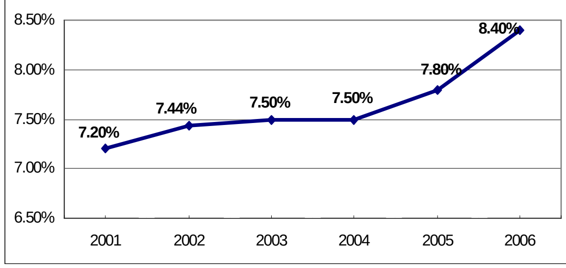
The central bank is getting nervous and has warned banks to lay off raising deposit rates. So far nobody is listening. Frankly speaking the SBV would be better off encouraging the further development of the interbank lending market based on commercial principles.

Chart 15 - Monthly Prime Interest Rates on VND



Source - The State Bank of Vietnam

Chart 16 - Annual Prime Interest Rates on VND



Source - The State Bank of Vietnam

Both factors have led to a rise in deposits and a falling interest rate spread between deposits and loans. For many banks, there is usually a two month lag between the time deposit interest rates rise and the process of raising loans rates is complete. Even then only floating rate existing loans can be adjusted. The fixed rate increase can only apply to new loans. Because of these factors the interest rate spread tends to narrow in a rising interest rate cycle with a fairly immediate effect on profit margins.

Interest spreads are narrowing

Currently, large corporate customers can generally borrow from the banks at a rate of about 0.75-1% per month (9-12% per annum). For most SME and private customers loans rates run in a range of about 0.9-1.3% per month (or 10.8-15% per annum). According to some SBV officials the average lending rate for large corporates is somewhere between 9 and 9.5%. We wonder if this can really be true as the interest spread in this key segment would be under 100 basis points already and falling fast. We suspect that the average lending rate for the large borrowers is somewhere closer to 10% (albeit lower for the state owned banks). But with the development of the corporate bond market the pressure to keep lending rates down will only increase as banks compete with the capital markets to keep large corporate customers. Larger enterprises can issue bonds with a coupon of 9.5-10%, undercutting the rates offered by many banks.

Interest rates are likely to drift upwards in 2006 and 2007 as the global interest cycle reacts to the end of zero rates in Japan and higher inflation everywhere.If Vietnamese banks are unable to pass on these higher rates to borrowers then spreads and margins will fall.

Developing the capital markets

Banks need more tier 2 capital and bonds will provide the bulk of that. However with the bond market in its infancy there are still major constraints on the banks' ability to raise sufficient capital quickly to reach the 8% capital adequacy ratio they crave. Vietcombank issued a domestic bond in December and BIDV has also recently carried a domestic issuance. Both have been very well received but there needs to be much more of these as all Vietnamese banks suffer from a chronic shortage of capital.

The infrastructure for developing the bond market is still not in place. HSBC is only now offering to provide a pilot rating scheme to enable potential investors to gauge the creditworthiness of various bond issuers. Fitch and Moody's have also dipped their toes in the market, rating Sacombank and BIDV respectively. However rating services are horribly expensive and there needs to be a domestic agency to offer these services at prices most banks can afford.

Another key hurdle lies with interest rate guidelines in place at all maturities along the yield curve. This prevents risk weightings and effectively bars smaller or weaker banks from coming to the market to issue capital whilst compensating for the higher risk by offering higher coupons. Currently the coupon on the 5-year bond is benchmarked at about 8.75%, the 10-year at 8.95% and the 15-year at 9.25%. The government is proposing to lift these guidelines but while they remain the bond markets will not be a likely source of finance for most of the smaller JSCBs.

Chart 17 - Vietnamese banking system - Economist snapshot and forecast

(Unit USD bn)	1997	1998	1999	2000	2001	2002	2003	2004	2005f	2006f	2007f	2008f	2009f
Bank loans (Unit USD bn)	4.5	4.8	5.6	6.8	8	10.2	13.3	17.4	20.3	24	28.3	33.7	39.6
Bank deposits (Unit USD bn)	6.1	6.8	8.6	10.5	12.7	14.5	17.3	19.0	22.2	26.1	30.4	35.7	41.8
Banking assets (Unit USD bn)	7.5	8.3	10.4	13.3	15.7	18.5	22.2	27.3	32.1	37.8	44.5	52.7	61.6
Current account deposits	1.2	1.3	1.9	2.7	3.1	3.5	4.4	4.7	5.3	6.1	6.9	7.9	9.0
Time & savings deposits	2.8	3.4	5.8	8.2	10.3	11.5	15.4	16.4	18.6	21.2	24.0	27.3	31.0
Loans/Assets (%)	59.4	58.5	53.9	51	53.3	55.4	55.4	63.7%	63.2%	63.5%	63.6%	63.9%	64.3%
Loans/deposits (%)	73.1	70.7	64.9	64.7	65.9	70.5	70.5	91.6%	91.4%	92.0%	93.1%	94.4%	94.7%
Net interest income	0.1	0.2	0.2	0.3	0.4	0.4	0.5	0.6	0.7	0.8	0.9	1.1	1.2
Net margin (Net interestincome/assets %)	2	1.8	1.9	2	2.4	2.3	2.4	2.4	2.3	2.2	2.1	2	1.9
Concentration of top 10 banks by assets (%)	95.9	96.6	96.4	96	95.8	95.78	95.75						

Source - Economist Intelligence Unit

Banking sector overview - A three-tiered market

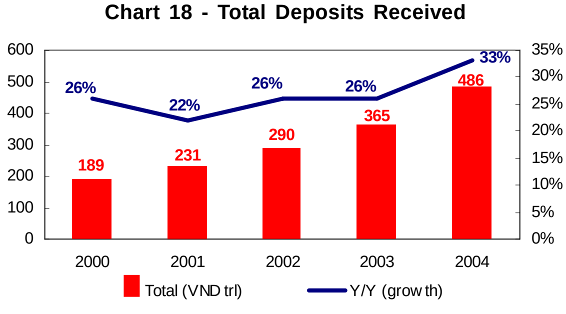
The Vietnamese banking system can be divided into three distinct tiers: the state-owned sector, the joint-stock banks and foreign-owned banks. As of 2004, the state-owned sector controlled just over 75% of the deposit market and slightly less than 77% of the loan market. Their market share has been dipping of late as the private sector has taken a bigger bite. The JSCBs have improved their share of the deposit market steadily to 13.2% in 2004, while their share of the loan pie has also risen to 11.6%.

While numbers are not available for last year all the evidence would suggest a further decline in the share of the state owned banks. This is especially true for dong deposits as the joint-stock banks have tended to offer higher deposit rates to attract new money. Total deposits in the banking system grew at an average annual rate of about 25% between 2000 and 2004, whilst loans rose by an average annual rate of 31.5% over the same period.

In 2005 loan growth rates fell back and are believed to have expanded by about 22.5% as the SBV reined in credit expansion. Deposits last year grew by 25%. So far this year deposits have been growing by 30% while credit growth has slowed further to 15%.

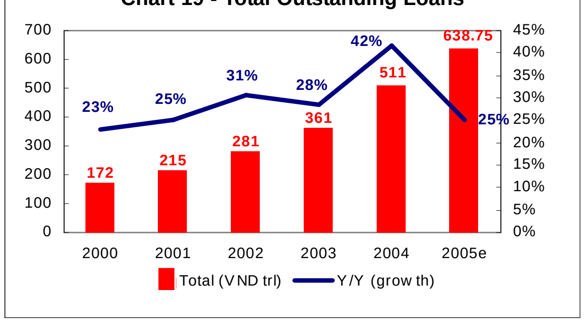
All of this heady expansion has enabled banks to grow assets and earnings at a very rapid rate underpinned by strong economic growth and sharp increases in property prices, particularly in the 2001-2003 period. This enabled the SOCBs to largely overcome their NPL problem with some generous help from the government. Some experts have questioned whether this period of heady growth has in fact stored up problem loans that will be exposed during an economic downturn.

Chart 18 - Total Deposits Received



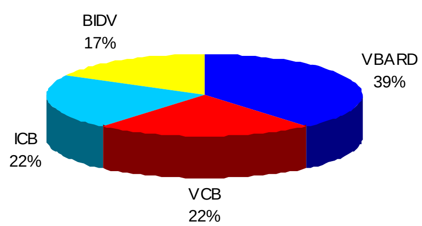
Source - VinaCapital

Chart 19 - Total Outstanding Loans



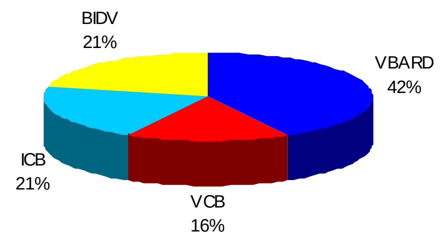
Source - VinaCapital

Chart 20 - Deposit Market Share of SOCBs



Source - BIDV

Chart 21 - Lending Market Share Amongst SOCBs



Source - BIDV

State-Owned Commercial Banks

Well, there are five of them and they basically run the show. Controlling 70% of the lending market, these five act as an oligopoly at the top of the Vietnamese banking market. All of these banks emerged as departments of the central bank, breaking away in 1988 to form independent banking entities, although in practice they remain tightly controlled. These banks include:

1. Bank for Foreign Trade (Vietcombank) – formerly the export and trade department of the SBV.

2. Industrial and Commercial Bank (Incombank) – formerly the industrial department of the SBV

3. Bank of Investment and Development (BIDV) – formerly the infrastructure department of the SBV

4. Agriculture and Rural Development Bank (VBARD) – formerly the agriculture department of the SBV

5. Mekong Housing Bank (MHB) - a relative newcomer specialising in finance for housing projects

Their current customer bases and hence their strengths and weaknesses are largely a carryover form their former role within the state bank. The state sector accumulated substantial bad debts in the years immediately after the Asian crisis necessitating a large injection of government capital which took place in 2001-2003. Having been recapitalised the SOBs have continued to grow rapidly in terms of deposits and assets. Bodies such as the World Bank and others have also offered considerable technical expertise in strengthening the banks' management and operational capabilities. Despite progress made in re-organising the SOCBs prior to equitisation, supporting agencies have identified the following areas that need further support before they can hit international standards:

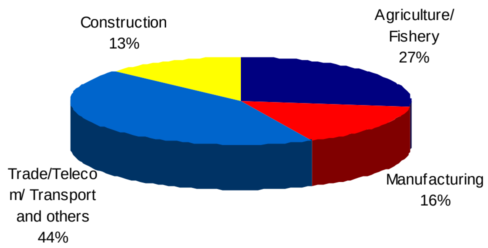
- Financial capacity
- Organisation and management
- Risk and liability management
- New products and services
- Management information services
- NPL resolution
- Human resources development

In other words everything. The gaps in these areas really can only be closed with the help of strategic investors or advisors, and the question is just how much knowledge transfer foreign investors will permit in return for only a 10% (or even 20%) stake in a bank. Vietcombank is currently in the middle of a beauty contest to select an advisor to help with equitisation and two foreign banks have been short listed. A decision is expected soon.

Credit growth has tapered off after the heady days of 2001-2002 when loans grew at an annual average rate in excess of 30%. The government took fright and slammed on the brakes. Hence lending growth in the state sector slowed down slightly in 2003 and 2004 to about 20% and 27% respectively. In 2005 the state sector saw credit growth expand at 20-25%. This picture is a little misleading as all banks, with the exception of Agribank, continued to expand credit merrily. Most loans are made to SOEs or their recently privatised counterparties. Agriculture and manufacturing cover over 40% of the total, but trade and services is the biggest single category at 44%.

Meanwhile deposit growth has been steady, ticking along at an annual average rate of 20% for the past couple of years, although falling somewhat from the growth of over 30% seen in 2001-2002. With increasing competition for deposits since the begining of the year, however, the state sector has had to push up deposit rates simply to hang to their share of the market.

Chart 22 - SOCB Lending by Industry



Source: VinaCapital

Capital shortage - The biggest challenge

The biggest challenge facing these banks is crossing the 8% CAR hurdle rate by 2010. Basically they need money and lots of it. Depending on the fragile capital markets to raise all the loot won't work. The government, which stepped in before in 2001-2003, will have to step in again and rustle up some dough.

Luckily they have a plan. The central bank is drafting a plan to inject VND11 trillion (US$687 million) of government money into three banks between 2006-2008.

Incombank, BIDV and Agribank have all extended their paws. According to the central bank this injection will form only part of the total VND 25 trillion (US$1.25 billion) the banks will need to cross the 8% hurdle. The balance, apart from a token US$99 million soft loan coming from the World Bank will have to be raised on the capital markets. Thats about US$700 million between now and 2008. We think this number is lowballed because it does not take into account future asset and loan growth. According to our models the SOBs will have to raise USD$2-3 billion before 2010 if they are to maintain current growth rates and leap across the 8% CAR hurdle with comfort.

This is quite a challenge and raises the probability of large capital issuance shortly after listing. Of course the advent of the corporate bond market will be a big help. Vietcombank and BIDV have both taken advantage of the more relaxed regulatory environment to raise capital in the bond markets over the past nine months. BIDV has issued a total of VND 2.2 trillion (US$137.5 million) worth of 10-15-year bonds. And in fact, Vietcombank has just received permission to issue another straight bond in the near furture. Incombank and BIDV have the lowest levels of equity and will receive the lion's share of the government handout. The issue for investors is the need to incorporate the dilution effect of all this bank paper on valuations.

Not to mention the overall impact on the market as banks represent by far the largest sector in the listed market/OTC market combined.

The future

The state sector is leaking market share gradually to both the private and foreign sector banks. Given that the banking sector is growing so fast this is not so noticeable right now but we believe the trend will acelerate after 2010. Their share of the deposit market fell from 80% to 75% in the four years to 2004 while their share of the lending market fell from 79% to 76.9% over the same period. At this pace the state sector is losing about 0.5% of the lending market and 1% of the deposit market every year. 2005 numbers are not all in yet but the anecdotal evidence suggests that this trend has continued.

One of the key shortcomings is that with the exception of Vietcombank, the state sector has chosen not to focus on the fast growing new areas such as the SME lending and retail markets. Having little expertise and even less of an appetite they have been slow to exploit the opportunities offered by their large branch networks and nationwide distribution. We believe that Vietcombank is by far the best fo the bunch and will gradually take market share from the other state banks to emerge as the clear market leader in Vietnam.

Chart 23 - Earnings Model - Vietcombank

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	5,284,529	*9.18%*	7,320,490	*38.53%*	14,142,616	*40.03%*	19,803,327	*40.03%*
EBT (VND mm)	1,498,585	*70.91%*	1,759,883	*17.44%*	4,102,237	*53.38%*	6,398,981	*55.99%*
Net Profit (VND mm)	1,103,813	*79.40%*	1,292,553	*17.10%*	3,199,745	*59.99%*	5,119,185	*59.99%*
Pre-tax Profit Margin	28.36%		24.04%		29.01%		32.31%	
Net Profit Margin	20.89%		17.66%		22.62%		25.85%	
ROE	15.80%		14.28%		27.46%		32.38%	
Equity	8,051,755		10,051,755		13,251,500		18,370,685	

Source - VinaCapital

Vietcombank (VCB)

- Vietcombank is the largest and best managed state owned bank
- VCB boasts the highest margins and can grow profits over 50% for the next two years
- VCB is planning to list in Q2 2007
- The bank is dominant in both the retail and corporate market in Vietnam.
- Second only to Agribank in market share of the deposit and lending market
- ROE is 22.1% and the NPL ratio currently stands at 2.5%

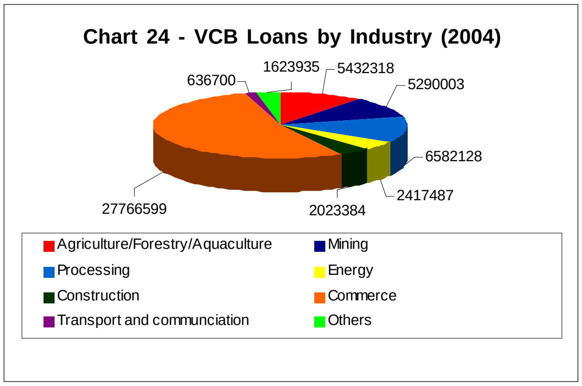
Vietcombank had total assets of VND136.7trillion (US$8.68 billion) and an ROE of 22% in December 2005. Vietcombank is the largest and best managed of the state banks. The core business is centered on foreign exchange transactions, trade and providing long term finance to the largest SOEs. Vietcombank handles one third of Vietnam's trade payments, its traditional business area which includes trade finance and international payments. The bank also dominates the interbank foreign exchange market. VCB has an active retail banking business, issues credit and debit cards, makes secured loans and offers foreign exchange services. VCB is the closest you can get to a full service bank in Vietnam.

The bank had a total of 26 branches, 41 sub branches and 47 transaction counters at the end of 2004, the latest published numbers. VCB also has a financing company; a securities company; and leasing arm and an asset management company. It also has stakes in two insurance companies, seven banks, three real estate companies and one credit fund.

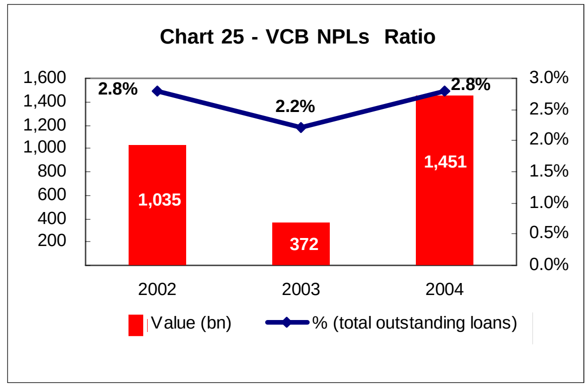
VCB has captured the lion's share of lending to the best quality SOEs, mainly export related industries. Large loan customers include Electricity Vietnam (EVN) and the shipbuilding giant Vinashin. VCB's corporate customer list include most of Vietnam's blue chip state-owned or equitised companies Typically Vietcombank plays the lead in large scale syndication for infrastructure projects such as refineries. For example the bank has promised to loan $250 million to bridge a funding shortfall for Vietnam's first oil refinery at Dung Quat. This marks an additional commitment as the original price tag of US$1.2 billion has doubled.

Vietcombank is also leading a consortium of four banks lending a total of VND42 trillion (US$2.7 billion) to EVN for the construction of power startions in 2006-2010. This is four times what was lent to EVN between 2001-2005 and makes the utility company VCB's largest customer. Going forward the development of the corporate bond market will change VCB's business model as it will arrange and underwrite bond issuances through its securities arm rather than lend large sums directly to these corporations. Marginwise this is not a major profit earner for the bank and we do not anticipate any margin decline as the focus shifts from pure syndication to a mix of lending and bond underwriting.

Vietcombank's first quarter profits rose to VND1 trillion (US$64.3 million), a rise of 42.7% yy/y. Total credit balance was at VND53,357 billion (US$3.3 billion), a drop of 5%. Assets at the end of the quarter amounted to $9.3 billion. The bank is on target to meet its FY2006 pre tax profit target VND4.1 trillion (US$256 million) and a pre tax profit margin of 29%. The bank is striving to improve the quality of its loan book ahead of listing and growing the retail business. As a result we see profits and margins continuing to grow into 2007.



Source - VCB Annual Reports



Source - VCB Annual Reports

Vietcombank has improved its operations dramatically in the past five years. Margins and ROE have recovered sharply since 2002 when ROE hit a low of just under 7.5%. A cleanup of the loan book with some government help was the key to the turnaround but we can honestly say that the bank has taken major strides in boosting its internal controls and strengthening management.

A risk management (RMC) and asset liability commitee (ALCO) have both been set up to manage the bank's risk profile and hopefully avoid some of the mistakes of the past. Like all state owned banks, VCB has received considerable help and input from organisations such as the World Bank in order to create a better framework for effectively managing credit risk.

Loan growth has averaged about 55% per annum over the past six years, slowing down recently as the bank moves to clean up the books ahead of listing. The loan to deposit ration stands at about 60% which is the industry average.

According to the bank, its NPL burden has been largely dealt with over the last five years. Out of a total of VND5.6 trillion (US$354 million) worth of bad debts by December 2005, VND4.41 trillion (US$277 million) has apparently been settled under the equitisation program.

Under the latest SBV standard definition of NPLs, known as decision 493, Vietcombank has a total bad debt ration of only 2.6% at the end of Q1, 2006. The reality under international standards is probably at least double that. Even so the bank is in far better shape than its peers.

As of December 2004, Vietcombank's CAR stood at 7% as calculated by Vietnam Accounting Standards (VAS). However under the more relevant International Accounting Stabdards (IAS) the CAR was a far more modest 4.4%.

Vietcombanks shareholder's equity (Chartered capital, reserves and retained earnings) totalled VND7.8 trillion (US$487.5 million) in December 2004. In 2002-2003 than bank received a total of VND2.0 trillion (US$125 million) in government help though the issuance of special bonds. Since then VCB has been raising money through the bond markets.

Vietcombank issued a total of VND1.34 trillion (US$84.4 million) in convertible bonds last December to a mix of institutional and retail investors. The 7-year bonds carry a coupon of 6%. VCB is due to come to the market again this month. After equitisation next year, convertible bond holders will be able to become shareholders of the bank

Chart 26 - Earnings Model - Incombank

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	8,120,031	*33.56%*	10,845,510	*55.00%*	14,485,793	*33.56%*	19,347,932	*33.56%*
EBT (VND mm)	253,024	*13.37%*	717,333	*183.50%*	1,015,367	*41.55%*	1,437,226	*41.55%*
Net Profit (VND mm)	206,869	*1.00%*	538,000	*160.07%*	761,525	*42.00%*	1,077,920	*41.55%*
Pre-tax Profit Margin	3.62%		6.61%		7.01%		7.43%	
Net Profit Margin	2.55%		4.96%		5.26%		5.57%	
ROE	4.57%		10.39%		13.07%		7.99%	
Equity	4,908,773		5,446,773		6,208,298		7,286,218	

Source - VinaCapital

Incombank

- Incombank has turned itself around in the past five years with considerable government help.
- NPL ratio has dropped to 2.18% and CAR is around 6.07% at the end of last December.
- Revenue growth was a very strong 55% last year with earnings up 183%.
- We see good growth this year and the bank may list as soon as 2008.

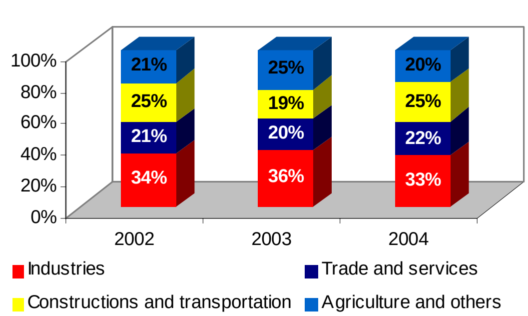
Incombank has evolved from a basketcase five years ago into a fairly conservative commercial bank.

Established in 1988, the Industrial and Commercial Bank of Vietnam (Incombank) has 134 branches, 500 sub-transaction offices and savings offices in most of Vietnam's citites, provinces and commercial centers. After the Asian crisis the bank was bogged down with NPLs and poor management, but with government help climbed out of the pit.

The bank boasted a CAR of 6.07% at the end of 2005 and an NPL ratio of 2.18% of total outstanding loans. Incombank provides deposit and savings accounts, short, medium and long term credit facilities, syndicate loans, financial leasing, loan guarantees, overseas remittances, credit card services, traveler checks, foreign exchange and securities trading. Its core customer base is state-owned heavy industry although it is expanding into new areas.

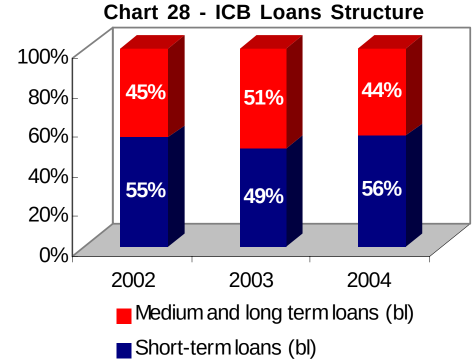
In 2005, Incombank reported a 28.2% growth in total assets to US$7.27 billion and a 18.3% increase in total lending to US$4.7 billion. For FY06 the bank is forecasting 33% revenue growth and 42% growth in EBT and net profits.

Chart 27 - ICB Loan Book by Industry

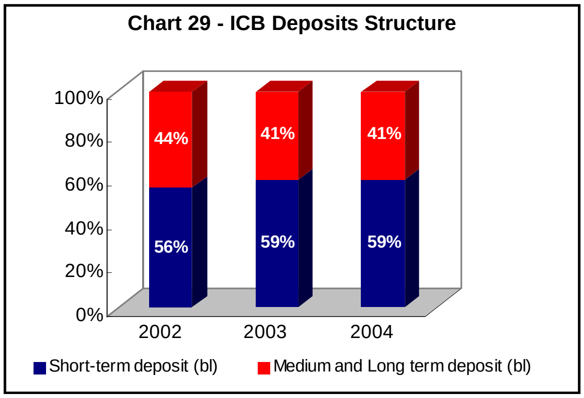


Source - ICB Annual Reports

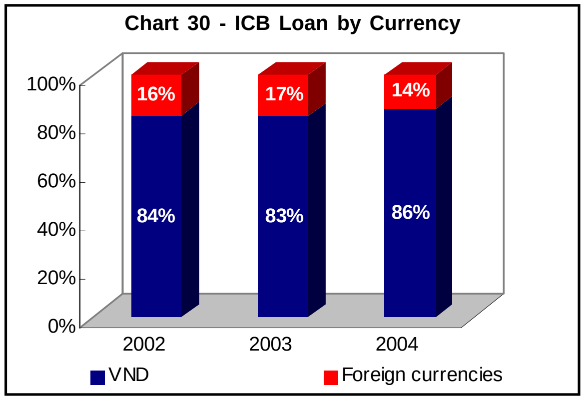
Chart 28 - ICB Loans Structure



Source - ICB Annual Reports



Source - ICB Annual Reports



Source - ICB Annual Reports

Incombank's most pressing need is to improve its margins and raise capital to push it over the 8% CAR hurdle by 2010.

Last year lending growth rose 18% to VND75 trillion (US$4.68 billion) while total assets rose 28% to VND116 trillion (US$7.25 billion. By sector the bank loan book was 33% exposed to the industrial sector, with a further 22% in the construction and transportation sectors. These tend to be heavy state owned industries or domestic developers and much of the debt is at favourable or below-market terms. In fact their exposure to these traditional sectors is second only to BIDV and explains the below average profit margins. One other area of concern is the fairly large percentage of foreign currency loans although this is declining.

Incombank will be a benificary of government aid in the next two years, although the size of the handout will be less than that to BIDV and Agribank simply because the bank is in relatively better shape. NPLs ratio fell from 3.5% to 2.18% and while these numbers do not reflect the full picture, they illustrate the progress that Incombank has made recently.

In 1998 the bank had a total of VND10 trillion (US$625 million) in bad loans and managed to dispose or settle VND8.9 trillion (US$552 million) since 2001. About half of this VND5 trillion (US$312 million) was settled in 2004, enabling the bank to reduce its NPL to manageable levels. Pre-2000 bad debt has now been almost completely cleared. Before we begin celebrating this remarkable turnaround story bear in mind that the government paid for the bulk of it through a series of capital injections that tripled chartered capital.

Risk management and corporate governence are still issue, as illustrated by recent events at the bank.

Both Agribank and Incombank have recently suffered losses speculating on the forex markets and offering loans against stocks. While the size of the losses at Incombank – VND85.6 billion (US$5.35 million) – is manageable, it speaks volumes about the weakness of internal controls at both banks.

By and large Incombank is still a work in progress, unrecognisable from 1998 but still with a long way to catch up with Vietcombank.

Chart 31 - Earnings model - BIDV

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	6,991,713	*25.60%*	8,852,923	*26.62%*	11,331,741	*28.00%*	14,731,264	*30%*
EBT (VND mm)	222,286	*46.78%*	295,878	*33.11%*	399,435	*35.00%*	495,300	*24%*
Net Profit (VND mm)	38,338	*45.25%*	114,992	*199.94%*	192,037	*67.00%*	307,259	*60%*
Pre-tax Profit Margin	3.86%		3.89%		3.52%		3.36%	
Net Profit Margin	0.67%		1.51%		1.69%		2.09%	

Source - VinaCapital

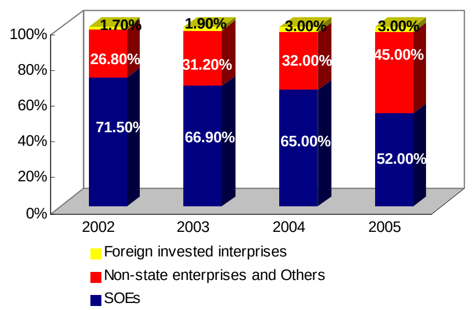
BIDV

- BIDV has the highest NPL ratio at 10.49% and the lowest profit margins at 3.89%.
- Revenues have been growing at over 25% and earnings at around 35%.
- The bank is the first to receive a rating from Moody's and has issued VND3.25 trillion in bonds.
- BIDV has a mountain to climb to boost margins ahead of equitisation next year.
- BIDV will recieve a further capital injection from the government before listing.

BIDV has total assets of VND131.8 trillion and had an ROE of 10.5% in December 2005. The CAR has risen from 2.16% in 2001 to 6.18% in 2005. The bank is set to equitise sometime next year and in preparation for that has acquired a rating from Moody's and recently issued bonds. The bank has set a target for loan and asset growth in excess of 20% between now and 2010. Interestingly, given its low profitability and high level of NPLs the bank seems less clear on setting a profits target.

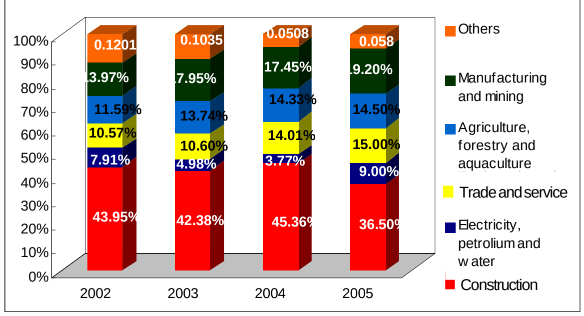
Historically BIDV was the principal conduit for major financing projects as the bank inherited most of the problem customers and combines a loan book that is bigger than Vietcombank with profits of less than a tenth. The bank tends to focus on medium and long term project lending to SOEs. BIDV has intimated that it will list on the market next year or by 2008 at the latest. In preparation for that move the bank issued some convertible bonds and got a rating from Moody's. The rating agency estimated the bank's return on risk adjusted assets at a lowly 2.7% and gave the bank an E rating for financial strength. Nonetheless BIDV was given a Ba1 rating for dong deposits and a B1 for foreign currency deposits, which is comparable with similar Chinese banks. The ratings will be updated annually.

Chart 32 - BIDV Lending by Economic Entity



Source - BIDV Annual Reports

Chart 33 - BIDV Loan by Industry



Source - BIDV Annual Reports

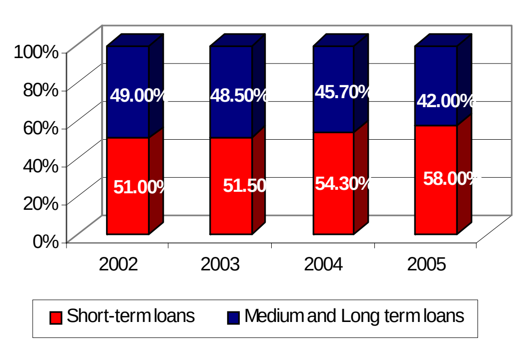


Chart 34 - BIDV Credit Structure

Source - BIDV Annual Reports

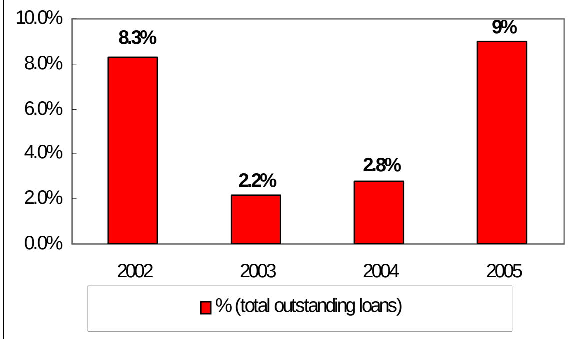


Chart 35 - BIDV NPLs Ratio

Source - BIDV Annual Reports

BIDV had an NPL ratio of 10.49% in December 2005 according to the official method. This number is sharply higher than the 2004 level due to the redefinition of bad debts under Decree 493. In reality NPLs are several times higher, making it by far the weakest state bank in the sector. To cope with concerns about bad debts BIDV has set aside a management reserve of VND5 trillion (US$314.4 million) as of December 2005. BIDV has easily the worst returns amongst the large SOBs, a clear indication of a problematic balance sheet.

The bank has rescheduled VND1 trillion (US$65.7 million) in loans to the seven largest property developers but this is only a fraction of the questionable debts. BIDV has a total exposure of about VND2.8trl (US$176.1m) to the property development market. Overall about 26% of its loan book in 2005 was to the construction sector, its largest sector exposure. And it has a further 4.9% exposure to the cement sector.

If a poor quality loan book and low returns is one problem, the lack of Tier 2 capital is another. To address this BIDV has recently issued bonds worth a total of VND3.25 trillion (US$204.4 million) with a maturity of 10-12 and 15 years.

BIDV will be first in line with Agribank to get help from the government next year, and we suspect a capital injection of VND3-4 trillion (USD187.5-250 million) will be made. Not enough to solve all of BIDV's problems.

The real issue going forward is managment quality and how avoid making further bad loans to high risk sectors such as the construction industry. Hard decisions will have to be made and some long-standing customers cut off from funding. This will mark a major turning point for BIDV. Until then the bank will start and sputter and remain very vulnerable to any economic downturn.

To be fair they have improved disclosure markedly and have given us more information than any other bank. Their strategy, hold nothing back and expect investors to give them the benefit of the doubt may well work in an environment of very poor disclosure.

BIDV looks to be the most vulnerable of all Vietnam's major banks and will need to be watched carefully especially if interest rates continue to move higher.

Chart 36 - BIDV Moody's rating 2006

	Credit Ratings				Financial strength
	Deposits		Issuer		
	Dong	Foreign currency	Dong	Foreign currency	
BIDV	Ba1	B1	Ba1	Ba3	E

Source - Vietnam Economic Times, Moodys

Chart 37 - Earnings Model - VBARD

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	16,891,176	*30.13%*	21,980,330	*30.13%*	28,602,800	*30.13%*	37,220,559	*30.13%*
EBT * (VND mm)	1,054,963	*58.95%*	1,676,821	*59.00%*	2,538,679	*51.40%*	3,843,514.67	*51.40%*
Net Profit (VND mm)	791,222	*132.36%*	1,257,616	*58.95%*	1,904,009	*51.40%*	2,882,636	*51.40%*
Pre-tax Profit Margin	6.25%		7.63%		8.88%		10.33%	
Net Profit Margin	4.68%		5.72%		6.66%		7.74%	
ROE	10.16%		13.66%		17.65%		21.87%	
Equity	8,576,775		9,834,391		11,738,400		14,621,035	

Source - VinaCapital

VBARD (Agribank)

- VBARD has the largest share of the lending and deposit market in Vietnam.
- This behomoth has branches in every small town and is deeply embedded in rural areas.
- Disclosure is minimal.

It's big and covers a lot of ground. Agribank is seen as more of a social than a commerical bank with deep roots in the countryside. There are no immediate plans to equitise the bank and it would require a mammoth effort and a lot of pain to clean it up for listing. Oh yes, and disclosure is limited.

At the end of 2004 Agribank had a total of 1,800 branches, 28,000 staff and total assets of VND 182 trillion (US$11.37 billion). In Q-1, 2006 the bank had a loan book of VND155 trillion (US$9.7 billion). Apart from its role as a commerical bank, Agribank is responsible for rural development by providing medium and long term credit to the agriculture, fishery and forestry sectors. In other words: soft loans.

As well as providing loans to its traditional customers in the agricultural sector, Agribank seems to be focusing some effort on the SME lending market. This year the exposure to that sector has reached 29% of total loans, or VND45 trillion (US$2.8 billion). The bank also loans to the retail market and has plans to increase the weight of consumer loans from 10% to 30%. In practice most these loans would be made to individual small farmers and in fact are better seen as business improvement loans by and large.

The bank claims to have 10 million customers, but this number raises some doubt since it is greater than the number of accounts in the entire banking system. Anyway they have a lot.

The bank aims to increase its assets by 25% per annum and loan portfolio by 20-25%, and reduce NPLs to less than 1%. It also hopes to increase profits by 10% a year. Judging by recent results, they are doing quite well on the profit front, and we believe they can continue to increase both profits and margins for the next two years.

It's best to look at Agribank from the point of view of a semi-social, semi-commerical bank that could potentially crowd everybody else out of the countryside. As long as it caters to underdeveloped regions it plays a very important social role. If, however, it starts to compete in small towns and larger urban areas after the rest of the state-owned sector has gone public, it may hurt the banking sector as a whole by crowding out the private sector.

We expect that the government will recapitalise Agribank next year and inject VND5-6 trillion (US$312.5-375 million) into the bank.

It's anybody's guess as to what the real NPL problem is over at Agribank. We suspect that it must be similar to BIDV in scale. Farmers have had a tough time of it in recent years what with SARS, bird flu, drought and flood. That said the problems have been largely localised and the agricultural industry as a whole is doing well thanks to higher prices for soft commodities on the world's markets.

Chart 38 - Earnings Model - Mekong Housing Bank

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	823,768	77.25%	1,591,024	93.14%	3,072,900	93.14%	5,934,993	93%
EBT (VND mm)	42,246	65.21%	97,333	130.40%	136,266.67	40.00%	226,185.54	66%
Net Profit (VND mm)	34,173	70.00%	73,000	113.62%	102,200	40.00%	169,639	66%
Pre-tax Profit Margin	5.11%		6.12%		4.43%		3.81%	
Net Profit Margin	4.14%		4.59%		3.33%		2.86%	

Source - VinaCapital

Mekong Housing Bank (MHB)

- Mekong bank is a relative newcomer in the state sector having being set up in 1997
- The bank has a remit to finance housing developments
- MHB has grown assets at a heady 60% pace per annum recently
- Deposits are also rising by over 70% and the bank is opening 20 new branches a year
- Profits have been doubling every year led by the frenetic expansion in assets
- The bank wants to equitise next year and is currently holding an advisory beauty contect
- Low margins and the uncertain quality of the loan book are major concerns

Mekong Housing Bank is the smallest of the lot established in 1997 with a chartered capital of VND800 billion. With a HQ in Ho Chi Minh City MHB has a nationwide network of 110 branches, opening 20 branches in 2005. The bank's main function is to provide medium and long term financing to the housing market.

It may be late to the party but MHB is on a mission to catch up with the other state owned banks. Mangement have chosen assets size, deposits and branches as key growth metrics. Alas, not profits.

At the end of the 1Q, 2005, MHB had assets of VND14.007 trillion (US$875 billion) up 10% quartery/quarter. Loans and investment totalled VND 13.65 trillion, (US$853 million) soaring 11% quarter/quarter.

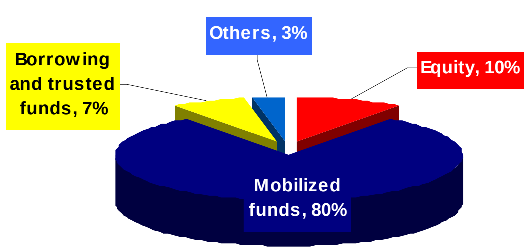
At the end of 2005, the deposit base was about VND6.35 trillion, +72% year/year, the vast majority of these being in term deposits. The loan book totalled VND8.56 trillion, up 55% year/year. The bank is very thinly capitalised with an equity base of only VND794 billion (US$49 million) at the end of 2005.

For 2006, MHB has targetted a further 50% jump in assets to VND19trl (US$1.18bn) and a 40% expansion in the loan book. MHB is currently offering only 0.62% per month (7.44% per annum) for three month term deposits far lower than most competitors but seems to be able to use its branch network to reach customers not covered by other banks. We believe that this may be more difficult going forward.

Much of MHB's funding comes from the World Bank explaining the large size of the loan book when compared to the modest size of its deposit. The deposit-loan ratio is an eye boggling 135% more than double the average.

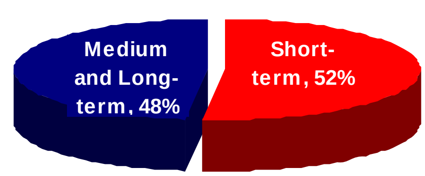
Most of the banks loans are made to improve the quality of rural housing stock. Houses for farmers in other words. And as the name suggest most of the banks operations are conventrated in the heavily populated Mekong region, the breadbasket of Vietnam

Chart 39 - MHB Breakdown by Capital Source



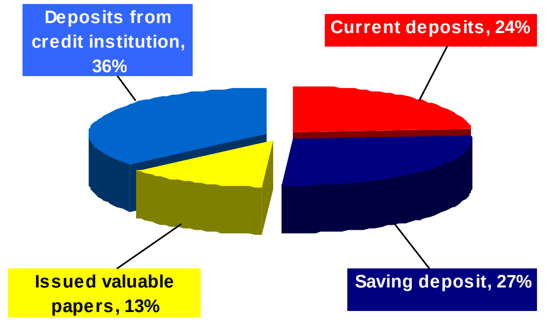
Source - MHB Annual Reports

Chart 40 - MHB Outstanding Loans by Terms (2004)



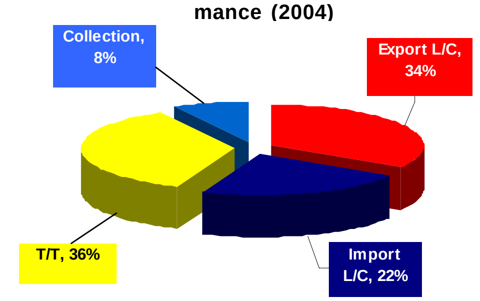
Source - MHB Annual Reports

Chart 41 - MHB Breakdown of Mobilised Funds (2004)



Source - MHB Annual Reports

Chart 42 - MHB International Banking Performance (2004)



Source - MHB Annual Reports

As you can see the pace of expansion is break-neck and seems to be driven partly by management's ambitions and partly by the dire need for better housing in the delta region. The bank's role as a regional social bank has to be taken into consideration when evaluating its future.

MHB would like to equitise in 2007 and to this end has received permission from the SBV to hire an adivsor to get the ball rolling. No word yet on who that might be or when the listing might take place but we suspect summer of next year at the very earliest. The bank faces a hard slog to convince investors that its social role will not detract from the need to boost profitability in the future.

Indeed while MHB's growth performance is very impressive we are concerned about its very low equity base and extremely low profit margins. Clearly improving its balance sheet and lifting profit margins have taken a bit of a back seat as the drive to boost assets and deposits have been given higher priority.

Disclosure is very limited and we have no idea as to the current quality of the loan book. However as far as we can judge most of the loans are small in size and therefore the risk is fairly well spread compared to other state owned banks who tend to lend a lot to very few.

Chart 43 - Joint-stock Commercial Bank Valuation and Forecast

Name	Par value	Price as at 7th August	Forecasted Net Income 2006	Year/Year %	EPS 2006e	Forecasted ROE 2006	Forward P/E	Price to Book
Sacombank	10,000	61,500	306,000,000,000	31%	1,611	13%	38.2	6
East Asia Bank	1,000,000	9,400,000	150,000,000,000	55%	300,000	19%	31.3	7
Techcombank	5,000,000	52,500,000	412,312,000,000	100%	2,481,132	31%	21.2	9
Eximbank	1,000,000	7,000,000	215,000,000,000	919%	307,143	23%	22.8	6
Saigonbank	250,000	1,289,000	130,000,000,000	62%	52,419	17%	24.6	5
ACB	1,000,000	13,900,000	417,000,000,000	42%	379,075	25%	36.7	11
Habubank	10,000	52,000	132,160,000,000	76%	1,583	18%	32.9	11

Joint-Stock Commercial Banks

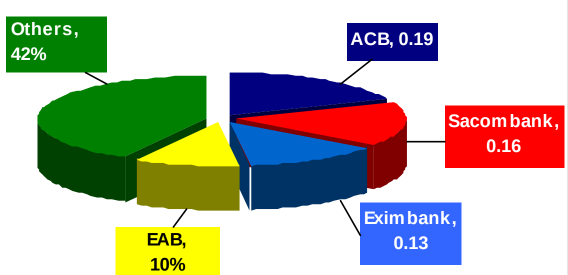
JSCBs, which were set up in the 1990s, don't face administrative burdens, legacy issues and social lending pressures like the SOCBs. Thus, they are more flexible and can adapt themselves to changing market conditions. However, they have serious weaknesses: a tiny capital base, poor IT infrastructure and weak operational and management controls. Average capital amounts to about US$20 million per bank, so they cannot provide big loans. Nonetheless, unlike the SOCBs, none of them are saddled with high levels of bad debts even though it is difficult to evaluate this because of a lack of transparency.

In the past two year JSCBs have made strenuous efforts to increase their chartered capital by issuing shares. Some have sold shares to foreign banks. For the smaller JSCBs this problem is so acute that they are mainly limited to retail banking services such as remittances and collection/spending under customer authorisation. They are largely locked out of the commercial lending market due to lack of capital.

The joint-stock banking sector is clearly a work in progress. Despite a round of restructuring and mergers in 1999-2001 too many banks are still chasing too small a slice of pie. The number of JSCBs was reduced from 51 to a total of 36 banks currently in operation.

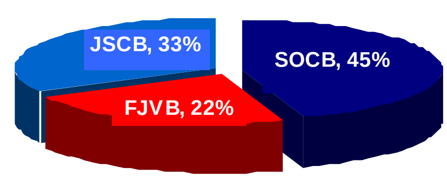
This number is still far too high and we believe that it will halve over the next few years as another wave of consolidation is overdue. The private sector banks are competing fiercely and many of them are choosing identical strategies to do so. Resources are spread too thinly as they try to compete across the broadest range of businesses. The result is thin margins and meager returns. This situation only adds to customer confusion as they try to choose between a High Street full of look-alike banks.

Chart 44 - Lending Market Share of JSCB (2003)



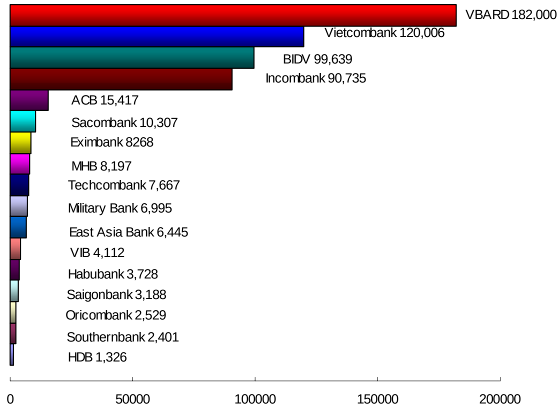
Source - VinaCapital

Chart 45 - Lending Market Share in Ho Chi Minh City (2005)



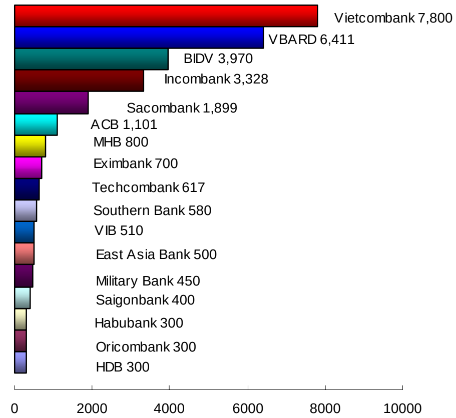
Source - VinaCapital

Chart 46 - Relative Size of top 17 CBs in terms of Assets (bn)



Source - VinaCapital

Chart 47 - Relative Size of top 17 CBs in term of Chartered Capital (bn) in 2005



Source - VinaCapital

To be fair there is a world of difference between the top tier, Asia Commercial Bank, Sacombank and the rest. They are expanding branch networks and loan books aggressively, boast good management and have a clear product strategy to differentiate them from the pack. The second tier which includes banks such as Techcombank, Eximbank and EAB are a more mixed bag. Techcombank's recent shift of strategy towards the retail market is seen as a significant positive move while EAB is leaning in the direction of SME lending. EAB's management is generally well regarded. Smaller banks such as Phu Nam Bank and VIB deserve an honorable mention because of their pursuit of niche strategies with strength in SME lending and retail loans respectively.

Chart 48 - Earnings Model - ACB

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	1,008,433	*30.38%*	2,092,683	*108.00%*	2,511,220	*20.00%*	3,063,688	*22%*
EBT (VND mm)	277,999	*47.56%*	385,071	*38.52%*	555,000	*44.13%*	810,300	*46%*
Net Profit (VND mm)	211,679	*60.00%*	294,120	*38.95%*	417,000	*42.00%*	604,650	*45%*
Pre-tax Profit Margin	21.31%		18.40%		22.10%		26.45%	
Net Profit Margin	16.23%		14.05%		16.61%		19.74%	
EPS	192,435		267,382		379,075			
P/E	76.65		55.16		38.91			
P/B	22.14		10.82		7.90			
ROE	33.39%		27.37%		24.39%			
Equity	705,684		1,443,517		1,976,248			

Source - VinaCapital

Asia Commercial Bank - Hold

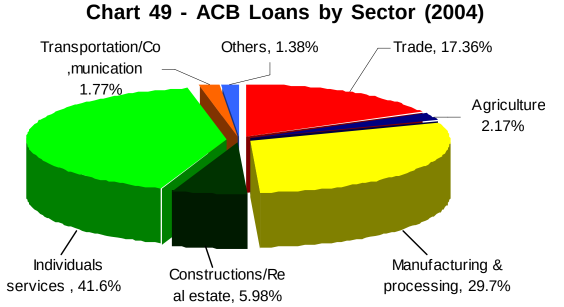
- Asia Commercial Bank (ACB) is Vietnam's best managed bank
- The bank has a strong niche franchise in both the retail and SME lending markets
- More conservative than Sacombank it is nevertheless expanding profits at about 40%
- Profit margins are second only to Vietcombank with an ROE of 27%
- Valuations are heady at over 7 times book

As of June 2006, ACB had assets of VND32.458 trillion (US$2.03 billion) up 32.9%, deposits of VND27 trillion (US$1.71 billion) up 23% and outstanding loans of VND12.2 trillion (US$763.9 billion) up 27.8%. In the 1-H, pretax profits rose 155% to VND280.5 billion (US$17.5 million) which was pretty much on plan. The bank has a capital adequacy ratio of 12%. ACB has set itself an ROE target of 30% over the next five years. ACB is the best-managed bank in Vietnam and has a clear lead in retail banking. Adding about 20-25 branches or sub-branches over the next twelve months the bank aims to use its locations as a distribution platform for a wide range of products aimed at the retail customer. At the end of 2005, the bank had 2,128 employees, a year/year rise fo 50%.

Retail customers account for about 60% of their total lending, with the rest mostly in SME lending. ACB is strongly focused in the southern market and has few plans to increase its presence in the north for the time being. The bank also has some wholesale banking businesses covering large corporate customers such as EVN.

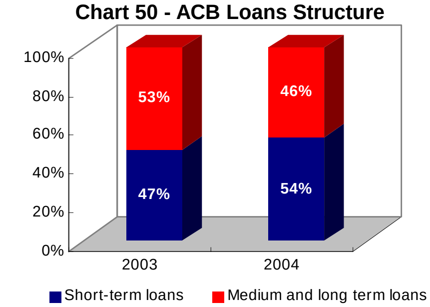
Exposure to the real estate sector is minimal at about 3%. Overall the bank has a very low loan to deposit ration of 44% far less than the average 60% ratio prevailing in Vietnam. This is a reflection of a generally cautious stance and has been rewarded by an NPL below 1%.

Chart 49 - ACB Loans by Sector (2004)

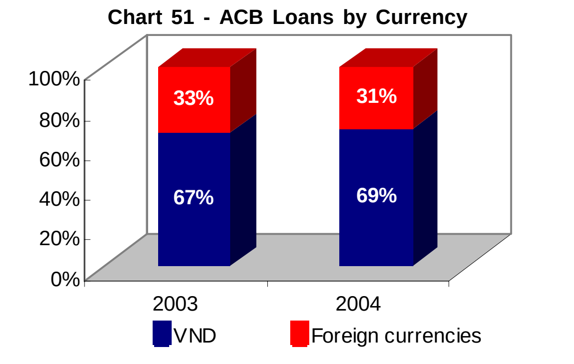


Source - ACB Annual Reports

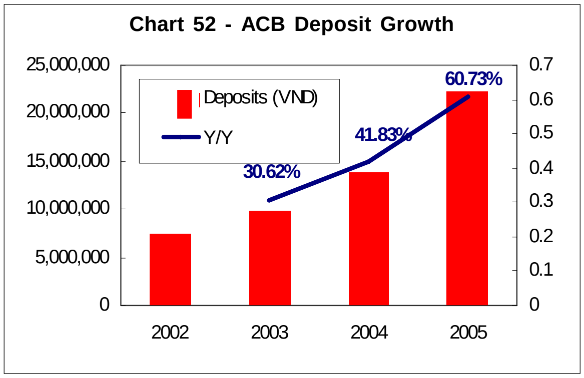
Chart 50 - ACB Loans Structure



Source - ACB Annual Reports



Source - ACB Annual Reports



Source - ACB Annual Reports

ACB's balance sheet reflects their conservative approach with about 50% invested in government securities and the rest lent out. Their approach to property collateral is also prudent; adopting government valuations which are only 50% of market, they offer loans up to 50% of the value of property (25% of market value).

The retail business has been built around some key products such as car loans, mortgages, credit cards and more recently unsecured loans. The unsecured loans business enables customers to borrow up to VND200 million (US$12,580) at a monthly rate of 1.2-1.3% (14.4-15.6% per annum).

The biggest challenge facing ACB as a retail bank is how to improve the flow of credit information on its potential customers. The lack of reliability of third party services such as the CIC means the overstretched credit department is forced to do its own legwork. The bank is keen on the idea of an independent credit bureau as long as the government doesn't get too closely involved. ACB has been a market leader in the new unsecured lending market and the use of DCF valuation method to assess its customers.

In the medium term, ACB's strategy is to leverage its existing distribution platform to increase the number of fee based services it offers customers such as brokerage (both real estate and securities), investment, leasing, insurance and fee based banking services. The bank has already set up these businesses as subsidiaries to the bank and it may move to a holding company structure within the next five years.

Products such as leasing, insurance and investments carry higher margins and are seen as key to the bank's future growth. The bank takes a niche strategy approach to market entry depending on where the gaps are. For instance, in the leasing market ACB is mainly interested in big ticket items over US$2 million whereas its strategy in the insurance market is to concentrate on low income, low ticket customers. IT is seen as the key to developing and managing all of these myriad businesses, and ACB has made considerable investments there in the past few years. The bank has two major subsidiaries, ACB securities and ACB asset management.

The management of the bank is widely considered to be one of the best and they have introduced incentivised pay schemes for top and middle management based on targets such as profits and ROE.

The bank has submitted papers with the central bank applying for a listing and hopes to get a positive response soon. However even with this they still have to face the SSC, a rather less friendly bunch as Sacombank discovered. We expect them to list late in 2007 or early 2008 as the governmentmay want to give Vietcombank and possibly BIDV a clear shot next year.

Like all OTC traded banks the share price has fallen since May with domestic sellers offsetting foreign buyers. We see further short term weakness as the shares are not a steal at current valuations.

Chart 53 - Earnings Model - Sacombank

	FY 2004	yoy	FY 2005	yoy	FY 2006e	yoy	FY 2007e	yoy
Sales (VND mm)	835,978	*35.30%*	1,208,643	*44.58%*	1,628,000	*34.70%*	2,096,154	*28.76%*
EBT (VND mm)	197,951	*58.29%*	306,054	*54.61%*	407,000	*32.98%*	545,000	*33.91%*
Net Profit (VND mm)	151,160	*67.63%*	234,390	*55.06%*	306,000	*30.55%*	408,000	*33.33%*
Pre-tax Profit Margin	23.68%		25.32%		25.00%		26.00%	
Net Profit Margin	18.08%		19.39%		18.80%		19.46%	
EPS	1,209.28		1,234		1,611		2,252	
P/E	77.28		49.84		38.18		28.63	
P/B	12.11		6.21		4.12		3.17	
Equity*	964,904		1,881,096		2,837,114		3,688,248	
ROE	18.78%		16.47%		12.97%		12.51%	

Source - VinaCapital

Sacombank - Hold

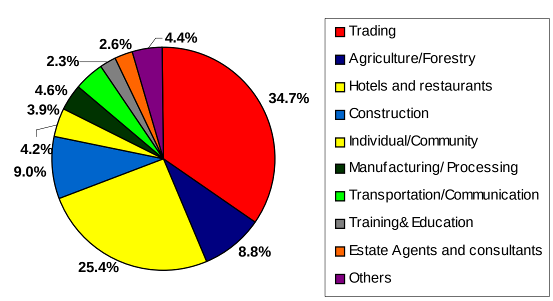
- Sacombank has become the first listed bank and has a current market cap of $950m
- Forward P/E of 38 and P/B of 6 make is one of the most expensive banks in Asia
- We expect profits will continue to grow at over 30% going forward
- Sacombank is expanding rapidly and has a strong foothold in the retail and SME market
- The bank recently revised its full year forecast but we stick to the original one
- We like the banks growth story but find the current share price too high

Sacombank has a large, nationwide banking network with 128 branches and sub-branches. It also employs 3,125 employees. The bank is focused mainly on the SME and retail markets and is rightly seen as the most aggressive of the JSCBs. Sacombank currently has a 4% market share as against ACB's 5% share with a strong focus on SME and retail loans.

ANZ recently bought a 10% stake and hinted it would be interested in raising its stake as part of an Asian expansion plan. Formed in 1991, Sacombank has two other foreign owners, the World Bank's International Finance Corporation and Dragon Capital. REE also holds 7.7%.

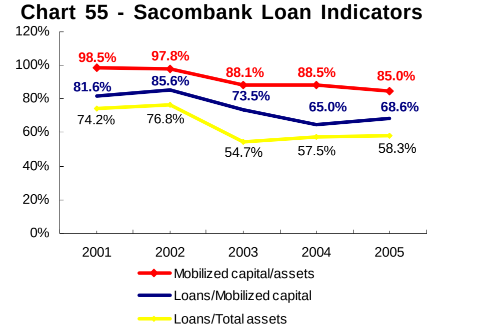
Sacombank's gross assets were VND18.9 trillion (US$1.2 billion) as of the end of May, up 30.7% y/y. Gross profit has almost doubled to VND235 billion (US$14.8 million) over the same period.

Chart 54 - Sacombank Loan Book by Sector (2005)



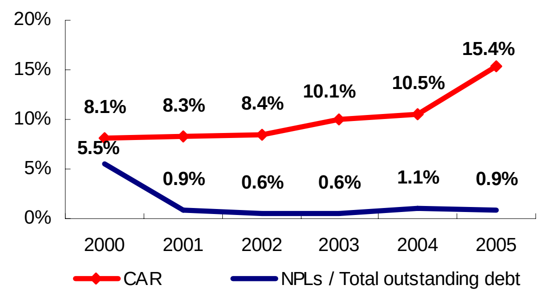
Source - Sacombank Annual Reports

Chart 55 - Sacombank Loan Indicators



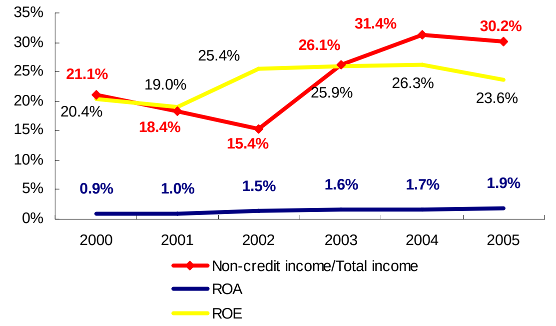
Source - Sacombank Annual Reports

Chart 56 - Sacombank CAR and NPLs



Source - Sacombank Annual Reports

Chart 57 - Sacombank Returns



Source - Sacombank Annual Reports

For FY06 the bank has revised up its pre-tax profit forecast from VND457 billion (US$28.1 million) to VND600 billion (US$37.5 billion), a year-on-year increase of 95%. The bank has a mixed record for meeting its forecasts so we shall see. We have stuck to the original forecast in our earnings model.

Sacombank is generally seen as more aggressive than ACB both in terms of lending policy and overall expansion policy. Its collateral policy is believed to be more flexible with lending perhaps up to 70% of the value of property collateral in some cases. According to a recent Fitch report its lending exposure to top 20 borrowers accounted for 91% of the pre-listing equity. The report also noted that its foreign currency loans, at 19% of the total were quite high. In general though its loan book is short term and very well secured.

The bank has a strong retail franchise and recently started to offer 15-20 year mortgages through its real estate subsidiary. Going forward we see Sacombank challenging both Vietcombank and ACB across a full product range in the retail market. Cureently income is split 70% interest income and 30% fee income. The latter comes mainly from treasury, trade finance remittances and financial investment.

Sacombank has recently tied up with the ANZ Banking Group to set up a joint-venture in credit card services. It also holds a 51% stake in Vietfund Management, a joint-venture fund manager that operates the listed VND300 billion VF1. The bank, which now also operates realty investment and asset management firms, has recently launched its finance leasing off shoot with VND100 billion in capital. Sacombank is currently seeking a license to launch a securities brokerage house with VND300 billion in capital as well, having divested its 11% stake in HCMC securities.

Sacombank has a CAR of 15% under VAS rules and an NPL of less than 1%. The bank has focussed on loans to high yielding small businesses and the quality of the loan book is high.

The bank's relationship with ANZ is likely to intensify over the next few years and we see ANZ's stake increasing as the law permits. A transfer of technology and product knowhow seems to be taking place which can only serve to increase the bank's competitiveness especially in the retail market.

Sacombank shifted from the OTC market to the listed market on the 12 July, the first bank to do so. Shares were traded at first at US$5, giving the bank a market capitalisation of around $970 million. Since then prices have fallen and the shares now trade closer to $4.25. The bank has postponed an issuance of an additional VND 200 billion (US$12.5 million) to new investors, and only issued shares to exiting holders due to a slump in the post listing share price. Currently the bank has 190 million shares outstanding. Foreigners currently hold about 29% of the equity and have been buyers. We see further weakness in the share price despite the postponement of the new share issuance as Sacombank will surely come to the market again before the year-end.

Sacombank is an excellent bank with strong management, profitable niche focus and a compelling growth story going forward. Its hard to set a fair value for the bank simply because its the first bank to list. However despite a good brand name and strong growth potential we cannot justify paying over five times book value for any bank. Note that our book value calculation is different to the bank's as we use chartered capital plus reserves plus retained earnings in our price to book formula.

Therefore we have initiated coverage of Sacombank with a hold rating as the growth story, while compelling is more than full reflected in the current share price. We wonder if the stock can hold its current valuation level next year as Vietcombank and MHB come to the listed market. More investor choice cannot be good news and the stock risks being de-rated back to more normal valuations.

Chart 58 - Foreign Banks Stakes in Local JSCBs (2005)						
Foreign banks	**Local JSCBs**	**No. of shares acquired (estimated)**	**Average Price (USD)**	**Over par value**	**Value (USD mm)**	**Percent on total**
HSBC	Techcombank	11,019	1,570	5x	17.3	10%
ANZ	Sacombank	12,676,056	2.13	3.4x	27	10%
Standard Chartered	ACB	56,180	390	6.2x	22	10%
OCBC	VPbank	5,496,454	2.82	4.5x	15.5	10%

Source - VinaCapital

Foreign Banks

If the JSCBs resemble a pack of terriers fighting over a single bone, the foreign banks are like well-honed greyhounds locked in a cage and well muzzled. The cage is being unlocked but at a frustratingly slow pace. The pace may now be picked up. As of the end of 2005, there were 28 foreign bank branches, four joint-venture banks and three foreign-invested leasing companies established in Vietnam.

- At the end of 2005, foreign invested credit institutions had $536 million in registered capital and almost VND100 trillion (US$6.3 billion) in total assets, the latter, a year-on-year increase of 25%.
- Total pre-tax turnover of foreign invested and joint-venture bank branches increased by an average of 45% last year.
- Total outstanding loans by foreign banks rose 30% by the end of 2005, growing at double the rate of the overall banking system. These loans now total VND49 trillion ($3.1 billion), or 9% of total outstanding loans.
- Doubtful debt levels remain well controlled, accounting for only 0.06% of the total.
- Joint-venture banks' outstanding loans have reached VND 6 trillion (US$37.5 million) by the end of last year, a 2% market share. Profitability at joint venture banks rose 15% to VND200 billion (US$12.5 million).

Foreign enterprises are the main market for the foreign banks. The most important metric for foreign bank lending growth is FDI, or more specifically the setting up of industrial zones in Vietnam. Currently there are 130 industrial zones attracting 4,516 projects valued at US$18 billion in foreign capital and 15 new zones are under construction. Foreign banks feed of this and it provides the bulk of their credit growth.

While many foreign banks have entered the Vietnamese market, few of them have expanded beyond one or two branches. Restrictions and difficulties in licensing are to blame.

Simply put, there are two ways for foreign banks to expand in the banking industry, organic growth or investment. Through organic growth banks build their own business facilities, including infrastructure, human resources, equipment and network. As a result, all banks start with a modest scale. This is a traditional method, whose biggest drawback is time.

By investing in existing banks, foreign banks take advantage of existing infrastructure and business networks to expand operations much more quickly. However there are two problems with this approach: high prices and lack of control. The prices of Vietnamese banks, trading at about 5-7 times book value is very expensive compared to regional peers. Even with high growth potential and high ROEs the premium is hardly justified.

Secondly, given that foreign banks are currently restricted to holding only 10% of a domestic bank lack of operational control is another disadvantage. Most banks that have bought stakes have done so in the hope that this restriction may eventually be lifted altogether allowing for a majority stake. This will happen after 2010 but it will be a long haul.

Twin strategies – Organic growth or strategic investment

Foreign banks are following two strategies in Vietnam, organic growth and strategic investment in local banks. The first strategy has yielded steady growth but from a low base given the various restrictions in place. Foreign banks are restricted in mobilising capital, need capital of $1.5 million to open a new branch and are limited in who they can lend to and the proportion of Vietnamese dong deposits they can accept (350% of capital).

HSBC, the largest foreign bank in Vietnam, has only two branches (HCMC and Hanoi) with a prescribed registered capital of $30 million. Standard Chartered Bank, which has been in Vietnam since 1904, has also recently announced plans to open a second branch in Ho Chi Minh City. But with the hint of liberalisation in the air many foreign banks are setting up 100% owned subsidiaries to offer leasing, consumer lending and credit card services in the domestic market. Even so, until 2010 organic growth has it limits.

The second route is to buy shares in local banks, and 2005 demonstrated major interest in this approach. Previously only long-established institutions such as the IFC and Dragon Capital had become strategic shareholders in the domestic banks. Last year, three foreign banks purchased shares in three JSCBs. Namely, ANZ bought 10% of Sacombank's equity, Standard Chartered acquired a 10% stake in ACB and HSBC snapped up 10% of Techcombank. Recently Singapore's Overseas Chinese Banking Corporation announced it would buy a 10% stake in VB bank for US$15.7 million, with an option to increase this to 20% by the end of 2007. EAB and Eximbank are also expected to sell stakes to foreigners soon.

Strategic shareholding also has its limits. 10%, in fact, for any one foreign shareholder. And no more than a 30% stake for all foreigners. The 10% restriction will be raised to 20% soon but the 30% remains firmly in place. Anyway, given that most of the attractive banks already have established foreign partners the good pickings are quite slim.

Hence foreign banks have been asking the SBV to loosen restrictions on opening new branches and the proportion of deposits mobilised on Vietnamese dong. In other words, fully implement most favoured nation treatment principles to satisfy WTO regulations. The government has recently approved a new law that will allow foreign banks to set up 100% owned banks (provided they have US$20 billion in assets, or US$10 billion in the case of a joint venture). But foreign banks will have to raise their registered capital to US$63 million, in line with local banks.

Currently foreign banks have between US$15-30 million in registered capital. The SBV has yet to figure out the associated regulations, which will give this new law teeth so we shall see whether or not it amounts to a significant market opening gesture.

While there are no restrictions on the number of branches a foreign bank can set up, as mentioned before they must add US$1.5 million in capital for every new branch. The SBV is considering relaxing this rule for the first five branches, which would cover all foreign banks currently operating in Vietnam.

But restrictions remain in place. US and EU can mobilise dong deposits from companies only up to 400% of their legal capital or 350% of their legal capital in the case of the general public. Other banks can only raise 50% of their legal capital in dong deposits.

Of course if the ceiling on dong deposits were also lifted we could expect a dramatic turn of events. In theory the new FIBs will be able to raise as much dong deposits as they can handle, The question remains as always whether they can do so in practice.

There are basic differences between the business practices of local and foreign invested banks. First, foreign banks are happy to provide loans without mortgaged assets while local banks insist on collateral security. Foreign banks tend to be more client focused and skilled at cross-selling products. Fees tend to be higher, with local banks charging sources fees of 1-1.5% instead of the 2-2.5%, charged as in the case of Citibank, HSBC, or Deutsche Bank.

However, opinions still vary on banking trends and some foreign banks have said that limits on deposit capital mobilisation and branches will be fully removed only when Vietnam joins the WTO

Chart 59 - Chartered capital of top 9 banks (VND bn)

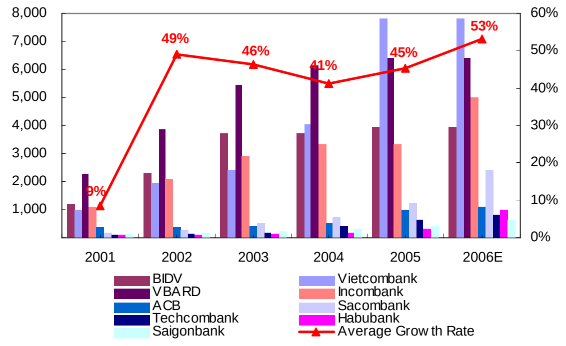
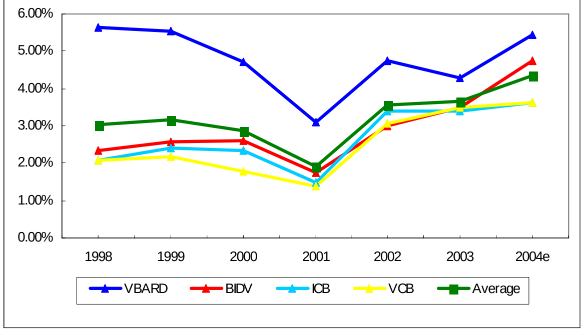


Chart 60 - Chartered capital of Loans and Investment Outstanding Ratio of 4 SOCBs



Source - The VN Economic times

The challenges facing the banking sector

The banking sector faces several key challenges in the run-up to market opening in 2010. The most important of these is developing the necessary strength in depth to compete with the foreign invasion expected after 2010. Much needs to be done to improve the competitive strength of the state-owned and private sector banks in the meantime.

Raising capital – It's never enough

As we mentioned before one of the key challenges for the banking sector is to raise their tier 1 and tier 2 capital to the international standard by 2010. To do so they will need to raise billions in both debt and equity financing between now and then. Bond issuance is currently only a realistic option for the SOCB's and the best of the JSCB's. The second tier banks will have to rely on issuing equity capital until the ceiling rates on bond coupons are lifted, hopefully soon.

On the equity side all is not plain sailing either. Foreign investments in commercial banks are regulated under decision 228 (issued on 1 December 1993). The SBV stipulated that total charter capital of JSCBs in Vietnam, held by foreign investors, must not exceed 30%. And they cannot trade their shares within five years. Finally, only the world's top banks can be considered as potential investors and must be vetted by the government.

What's at stake here is not just the 8% hurdle for capital adequacy. Banks' ability to expand their lending base is constrained by the lack of long term capital. The result is a constraint on medium to long term lending and a well known deposit/lending mismatch.

Since May 2003, the SBV has allowed commercial banks to lift the cap on their use of short term deposits mobilised to provide medium and long term capital loans from 25% to 30%. This is only a temporary solution.

In December last year, Vietcombank issued VND1.2 trillion (US$75 million) in seven year domestic bonds at a coupon rate of 8.5%. BIDV has also recently completed a VND 1.5 trillion (US$94 million) dong denominated bond issuance consisting of a 10-year bond with a coupon of 9.8% and a 15-year bond carrying a coupon of 10.20%. Both are priced at a spread of 1.05-1.26% over the Vietnamese government 5-year and 10-year bond respectively, and both carry call options.

The domestic market's appetite for bank paper has now been tested. The Vietcombank and BIDV issuances were heavily oversubscribed with the BIDV offer oversubscribed by 250%. Moody's announced credit ratings for BIDV ahead of the offer, giving the bank a stable outlook for both domestic and foreign currency deposit and a positive outlook for financial strength.

According to our model estimates the five SOCBs will have to raise about VND75 (US$4.5 billion) in capital over the next four years to exceed the 8% target by 2010. We assumed constant annual lending growth of 15%, and expect that the banks will be able to raise 25% of the total by internal profit growth. That leaves them coming to the market for a further US$3.5 billion in equity or bonds.

The JSCBs are another ball of wax. ACB and Sacombank will also have substantial capital needs going forward. ACB has recently increased its chartered capital from VND948.32 billion to VND1.1 trillion. VIB has upped capital from VND595 billion to VND711 billion while Eximbank increased capital to VND815 billion. Most of this fundraising has come from tapping existing shareholders for new money whilst adding some new investors. We expect the top five JSB's to about raise VND25 trillion (US$1.5 billion between now and 2010 to keep ahead of the proposed new capital requirements.

Introducing Qualitative Lending Practices

"Without a strong profit orientation and enhanced credit risk management lending decisions continue to influenced by the entanglement of government agencies and provincial officials driven by social and developmental considerations" - Fitch Ratings Report on Vietnamese Banking System, March 2006

Observing Vietnam's state owned banks lend money makes foreign auditors swoon. Of course the banks would argue that they are just doing what they are told. By the SBV, by the provincial and regional governments, and by large public-owned corporations. The list goes on. It is surprising that any lending goes place without someone outside the bank having their say.

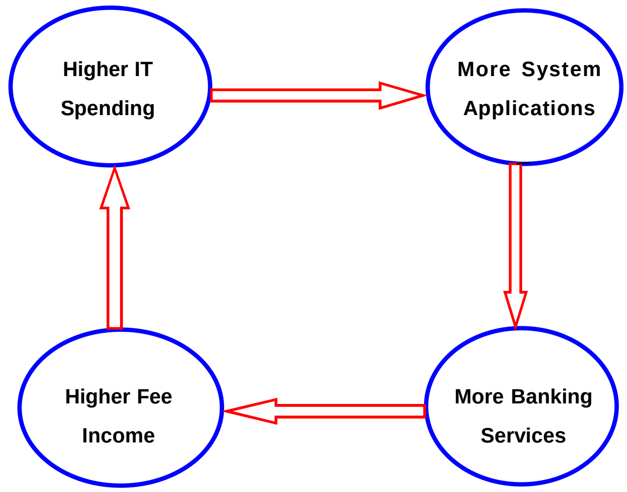
Each SOCB has a branch office in every province in Vietnam and every branch is reported to be controlled not only by its central office, but also by the provincial governments who have a say in appointments to top posts at provincial branches. This branch network is duplicated by the SBV, whose local officials also enjoy a cosy relationship with local government. Lending priorities and practices are set not in the credit department but by local politicians acting in concert with local SBV officials. Local state-owned branch managers must be approved by the local party leadership. This creates a hierarchy and places local branch management inside the provincial political network. Even though interference at the central government level has been steadily reduced in the past few years, with banks refusing to sign on for some lending projects to large state-owned corporations, meddling at the local level continues undisturbed.

It's almost impossible to quantify what percentage of lending decisions are made along political lines. Too many. All we can say is that it is falling slowly. As companies equitise and move into the commercial orbit ties with local authorities are slowly loosened and relationships with banks evolve into a healthier profit driven one. The equitisation process itself is seen by companies as an opportunity to shed old loans and start afresh. While the process is painful for the banks any subsequent relationship is more arms-length.

Credit evaluation at all banks depends on size. Large loans are generally evaluated using modern discounted cash flow methods and both quantitative and qualitative measures are used to support the analysis. Improvements have been apparent in the last five years as both technology and knowledge transfers from international agencies have filtered through. Small to medium sized loans are a different story. Here financial assessment is rare, decisions being taken more on the strength of relationships and the views of credit officers. In practice the methodology is weak at this level. Of course part of the fault lies with the lack of available credit information as mentioned above. Another more insidious problem is the practice of taking unofficial commissions from customers. Potential borrowers may find themselves paying bank staff a commission for processing loan applications successfully. According to newspaper reports the number can vary from VND50,000 to VND100,000 for small loans and far higher for larger loans.

One further issue that has emerged recently has been the use of shares as collateral to cover loans, often for further share purchases. At the height of the recent market run, on 20 March, a total of 13 million shares worth VND 752 billion was being used to cover loans. The SSC took fright and issued a letter to the SBV calling for the practice to be reined in. The cryptically named Letter 99 was duly issued, triggering a market correction.

Chart 61 - IT spending - The virtous circle



IT spending

As ACB has demonstrated, good information technology is a key competitive advantage in the Vietnamese bank sector. It provides the platform for offering and managing a wider array of products and services to clients. IT spending would seem to be one way to separate the winners from the losers, enabling banks to charge higher fees and offer a genuine service to their clients. There is a great need for spending on IT to build core banking systems, risk management and ATM software. However, IT spending at most banks in Asia, including Vietnam, is an unknown. The numbers are not disclosed in annual reports and information is generally anecdotal. It is possible to take capital expenditure as a proxy, as IT spending is a large portion of it.

Data from European banks is easier to come by and we have found that these banks spend an average of 10-30% of operating expenses on IT. Alas there is no proven relationship between a higher IT spend and greater operating efficiency as a higher spend raises cost in the short term while the revenue gains only come at a later stage. Asian banks such as DBS, Kookmin, and Bank of China spend between 4.2% and 17.7% of operating expenses on IT with an average of about 11%.

How do Vietnamese banks stack up? Some larger banks such as Vietcombank are spending 6% of revenues on IT (approximately 10% of operating expenses) and are planning to increase that ratio. Sacombank recently invested US$4 million in a new core banking system. Small joint-stock banks such as Habubank, however, have more modest budgets, spending only about 2-3% of revenues, hardly enough to upgrade their systems. In general we believe that Vietnamese banks are under-spending their Asian counterparts by approximately 30-40%. This gap needs to be closed if the Vietnamese banking sector wants to offer a comprehensive service to their clients.

Of course effective IT spending is a balancing act, since most modern banks need to run at least 380 applications on their software. However banks that overcomplicate their platform by running too many applications tend to lose efficiency. In IT terms, simple and easy is always better. Qualitative assessment of an individual bank's IT spending is hard to carry out. There are warning signs though; highly customised and complex systems which take a long time to build are nearly always too expensive and less efficient than simpler off the shelf solutions that provide the basics.

There are three spending patterns in IT investments among Vietnam's banks. The smallest banks focus on making basic upgrades to their infrastructure and the top tier state-owned banks continue to rely on government-supported budgets to allow them to undertake large-scale technology projects.

In the middle tier, more dynamic joint-stock banks take a more effective approach to technology investments, resulting in a harmonious match between investments needed and available resources.

The information black hole: The case for an independent credit bureau

One of the greatest obstacles preventing a healthy retail banking market is the lack of timely and accurate credit information available to banks. Without any way to easily check their customers' credit history, banks find themselves spending oodles of time and money checking up on potential borrowers. The work is very time consuming, prone to error and greatly limits the number of customers a bank can lend to. What takes minutes overseas can take months in Vietnam. Usually it's just easier to say no. Or to attach unattractive conditions to the loan. For example, to get a credit card in Vietnam requires you to place a term deposit with the bank, equal to the amount of your card limit. As a result, after ten years, only 100,000 credit cards have been issued in Vietnam compared with over two million debit cards.

Without a private credit database, banks' credit departments are overloaded collecting accurate information related to its borrowers ranging from their repayment capability to appraising the value of their assets. Proper risk management is very difficult under those circumstances.

Vietnam has an existing public credit registry called the CIC (Credit Information Centre) which comes under the SBV. However the database is limited to carrying information on companies and large borrowers. The CIC simply doesn't have the resources to cover SMEs and consumer loans, not to mention utilities and insurance companies. Tran Minh Tuan, deputy governor of the SBV, has stated that because of the fast growth of consumer credit, the CIC with its current capacity cannot keep up with credit institutions demands. Experts expect the number of individual borrowers to soar to about 25 million by 2010 and the CIC has pointed out that it could increase its capacity to around 10 million by then. Currently credit information records exist for about 11 out of every 1000 people. This compares with 184 out of every 1000 people in Thailand for example and just about everybody in Australia.

The growth of a consumer debt market depends on the widespread acceptance of unsecured lending. This in turn requires a private credit bureau to enable banks to check their customers' creditworthiness. To save the day, the International Finance Corporation (IFC) has introduced a model private credit bureau in which foreign and domestic banks would work together as stakeholders. The bureau would act as a database compiling credit information related to individuals and small businesses. Information would be collected from member banks, and payments could be made in return for information provided by concerned agencies and local authorities. Potential bureau users will be banks, credit card providers, local finance companies, retail credit firms, insurance companies, utilities, and others.

A private credit bureau would complement Vietnam's public registry because it would maintain and investigate the borrowing histories of a much broader range of potential customers. Detailed credit histories would enable financial institutions to better assess risk and determine what interest rates to charge. Consumers would benefit as average interest rates would fall along with banks' risk levels. Loans could also be offered with little or no collateral. Banks could then manage their overall risk professionally and expand their consumer business faster.

The need is clear and it appears that the SBV would like to set up a private credit bureau and this year under the auspices of the CIC, with help from the IFC. And herein lies the problem; many experts feel the bureau would operate better as a private sector venture without any control from the SBV. Potential conflict of interest you see. Banks also are a little hesitant about the operating mechanism for any credit bureau. Large banks want specific regulations related to the price mechanism banks issued, as well as regulations to control users. They also want the bureau to take responsibility for quality control. That's a sticking point as the bureau would need huge resources to check the information coming in from member banks.

All in all we are getting there and whether we get an independent credit bureau or some creature under the CIC we will be better off. The timetable should be within this year.

Bankruptcy laws

Being state owned and unable to pay off your debts means getting off scot free in Vietnam. Real reform can take place only when SOEs have the same legal status as private enterprises. In other words they must be subject to the same rule of law, especially bankruptcy law.

Bankruptcy law must be enforced when either enterprises or lenders request the courts to intervene. The courts must have real authority to exercise its power by temporarily taking over the ownership of the insolvent enterprises and either giving them time to find resources to pay off debts or liquidating the enterprises altogether.

At present, the SOEs continue to operate while mounting unpaid debts to other enterprises and banks are simply ignored. To make matters worse, in many cases they are provided with more bank loans to pay off old loans. As a result, the SOCBs' capital has in the past been seriously eroded, permitting them to provide only short term loans to borrowers. Now that their capital position has improved, they are naturally reluctant to repeat the experience.

Vietnam's current bankruptcy law is no friend to creditors. Its main objective is to protect and save companies, particularly distressed SOEs. For example, in Ho Chi Minh City, seven years after the bankruptcy law was enacted, there have been 21 applications for bankruptcy, and 11 of them were accepted because all requirements were satisfied. The court has issued only three settlements and not a single one has been implemented. Ooops!

Improving management and governance in the banking sector

Independence in management is one of the most crucial factors in the reform of the SOCBs, but no less important is an immediate improvement in the SOCBs' efficiency. The central bank's role in approving and appointing directors in the state sector is a practice that must come to an end soon. As must the interference of the regional central bank branches in local lending decisions. Once the incestuous relationship between the SBV and the state-owned sector has been replaced by the discipline of the marketplace we believe corporate governance in the banking sector will improve markedly.

There are two other issues relating to management: one is the reduction of operating cost and the other is the adoption of international standards and transparency. Bank margins have been quite low as a result of reliance on the low margin lending business and the high percentage of non-commercial loans made in the past. As banks answer to shareholders they will have to focus more on profitability and expand their product base to increase margins. At the same time the adoption of Basel 2 standards and the technology transfer from future strategic partners should enable Vietnamese banks to improve their transparency as they adopt more international standards for reporting and accounting.

Secondary market for bad debt disposal

Vietnam has yet to develop an efficient market mechanism to dispose of the bad debt weighing down the banking system. Back in 2000, the government issued regulations to allow commercial banks to set up vehicles called Asset Management Companies (AMC) to aid in the collection and disposal of long term bad debt. The state-owned banks went through the motion of setting up their own AMCs, with each bank kicking in VND30 billion in capital, a tiny amount. Not surprisingly, no transactions have yet taken place.

So far about ten commercial banks followed suit with their own AMCs. The idea is to transfer the NPL from the parent bank and for the AMC to manage the mortgaged asset until it can be realised or disposed of. The problem lies in the fact that as yet there is no secondary market to trade these distressed assets and few transactions have in fact taken place. The second is that the banks do not have the capital to write off the loans in order to be able to dispose of them in the secondary market.

In addition the government itself set up the Debts and Asset trading Company (DATC) in June 2003 under the Ministry of Finance with a charted capital of VND 2 trillion (US$130 million) with a mandate to help SOEs dispose of their NPLs and NPAs. The DATC started operating in 2004, working to resolve bad debts at 20 enterprises nominated by the government. Oddly though, the DATC purchases/receives the assets/NPLs directly from SOE's themselves, not from banks. The DATC has recently set transaction and consultation center for debt and asset trading in a bid to get things moving. It has also signed a cooperation agreement with the BIDV in order to create the framework for an asset trading market. So far things have gotten off to a slow start. One issue is that the DATC has a dual mandate, a social mandate to help SOEs clear up bad debts, and a profit mandate to earn a few dollars in the process. This is a clear conflict of interest.

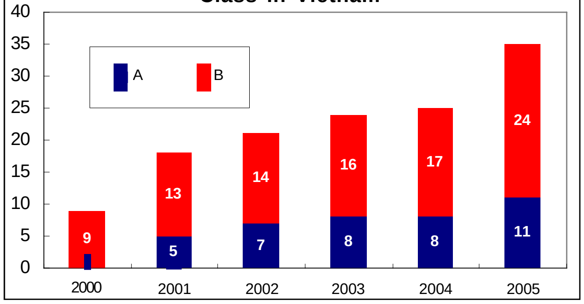
Both the AMCs and the DATC have so far demonstrated one thing clearly: without a secondary market for distressed debt they can do little to resolve the remaining NPL problem. That market requires a clear framework with legal backing for recovering collateral and participation from foreigners who have experience in debt trading and disposal. A lack of trained personnel and limited experience in packaging and pricing debt is also hampering the process.

The Ministry of Finance is dealing with the banks' NPL headache at arm's length, preferring to take the point of view of the SOEs. It would be far more efficient for the DATC to deal directly with the banks who after all own the debt (and can lay claim to the underlying assets) rather than take over the loan from the SOEs.

The whole merry go round turns on a single point. Who takes the loss? Currently only the government has the resources to bite the bullet. Having recapitalised the state-owned banks with a US$670 million injection in 2004, the government hates to admit that it might have to do the same again. Nonetheless the SBV has circulated a draft suggesting a further VND12-13 trillion (US$750-810m) government bailout next year before banks such as Incombank, BIDV and MHB are equitised.

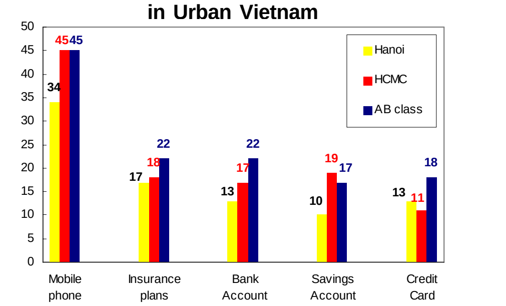
NEW GROWTH OPPORTUNITIES

Chart 62 - Growth of the AB Urban Middle Class in Vietnam



Source - CI Electronic Monitor

Chart 63 - Penetration of Banking Services in Urban Vietnam



Source - CI Electronic Monitor

Retail banking and the SME market

Retail banking in Vietnam is rather like a new born infant. Only a fraction of the nation's 83 million are utilising modern bank services. The number of private bank accounts still numbers only five million and only two million ATM cards have been issued. The ratio of cash payments to bank transfers is 22.8% which is still very high.

That said retail banking is the future of the Vietnamese banking industry. The profitability and growth rate of most Vietnamese banks will depend on how successfully they can penetrate the consumer and SME lending markets. Given the growth of the AB middle class and the number of SMEs in Vietnam the potential for this market is unquestioned. Banks such as Vietcombank, Sacombank, and ACB which already focus on these two segments, enjoy a higher than average profit margin and superior returns on equity. However, entry requires fairly heavy capital investment in branch networks and IT in order to create the infrastructure necessary to support a retail banking platform. This has been lacking and poor distribution along with limited consumer information are the biggest barriers to entry in these two key segments. In other words the capital costs are heavy and subsequent fixed costs are also high. The administration costs involved in making thousands of small individual loans have put off some banks. Economy of scale is the key.

Some SOCBs we talked to tell us they have little interest in retail banking or SME lending going forward. This is a viable strategy for the leading industrial bank in Vietnam as there is plenty of money to be made providing loans for infrastructure projects and large scale corporations. However, given the commoditised nature of this type of lending and the huge amount of capital required, it is not a viable strategy for most Vietnamese banks. And the margins are small and falling as large corporations will turn to the bond market instead. For the smarter banks, it's a case or retail or fail.

Chart 64 - Urban consumer market model

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total population (m)	81	81	82	83	83	84	85	85	86	87	87	88	88	89	89	90
Urban %	0.28	0.29	0.30	0.31	0.32	0.33	0.34	0.35	0.36	0.37	0.38	0.39	0.4	0.41	0.42	0.43
Urban population	23	23	25	26	27	28	29	30	31	32	33	34	35	36	37	39
AB urban middle class %	0.34	0.37	0.40	0.43	0.46	0.49	0.52	0.55	0.58	0.61	0.64	0.67	0.70	0.73	0.76	0.79
AB urban middle class (m)	7.71	8.69	9.84	11.06	12.22	13.58	15.03	16.36	17.96	19.64	21.16	22.99	24.64	26.64	28.41	30.57
Bank account penetration %	0.22	0.26	0.30	0.34	0.38	0.42	0.46	0.50	0.54	0.58	0.62	0.66	0.70	0.74	0.78	0.82
Number of urban bank accounts (m)	1.70	2.26	2.95	3.76	4.64	5.70	6.91	8.18	9.70	11.39	13.12	15.18	17.25	19.71	22.16	25.07
Growth rate year/year		33%	31%	27%	23%	23%	21%	18%	19%	17%	15%	16%	14%	14%	12%	13%
Credit/debit card pentration	0.18	0.21	0.24	0.27	0.3	0.33	0.36	0.39	0.42	0.45	0.48	0.51	0.54	0.57	0.6	0.63
Number of credit cards (m)	1.39	1.83	2.36	2.99	3.67	4.48	5.41	6.38	7.54	8.84	10.16	11.73	13.31	15.18	17.05	19.26
Growth rate year/year		31%	29%	26%	23%	22%	21%	18%	18%	17%	15%	15%	13%	14%	12%	13%

Source: Asia demographics, CI, VinaCapital

The consumer lending market

According to market research the size of the AB urban middle class (those with monthly income over US$500 living in the six major cities) has grown from 9% of the population to 34% since 2000. With an urban population of about 23 million (29% of the population) that amounts to an urban middle class of about 8.1 million people. Only about 22% of them currently have a bank account. That's 1.7 million urbanites with a bank account as of 2005. Overall there are about five million bank accounts in the whole country. The balance would be accounted for by small town inhabitants or the large rural population.

Let's focus on those urbanites. We have built an urban consumer model to estimate the growth of the retail banking market in the large cities. Using a population growth model from Asian Demographics and known penetration rates for banking services we have projected forward until 2020. We believe that the penetration rate for bank accounts is increasing by about 400 basis point a year and by about 300 basis points a year for credit cards. This gives us a current growth rate of about 33% right now in new urban bank account holders, and about 31% for debit/credit cards. This model is fairly conservative and penetration rates may in fact expand exponentially but for the time being we assume fast linear growth.

The growth is rapid for several reasons. The urban population is increasing by about 800,000 (1%) a year. The percentage weight of the AB urban middle class compared to the overall urban population is also increasing by an average of 300 basis points per year.

I hope this illustrates the potential of this new retail market. Of course, not all banks are focusing on this market. Even amongst those that are, some have adopted a niche strategy of focusing on one product, such as car loans.

Consumer banking products fall into five broad categories:

1. Personal loans – car loans, home improvement loans, small business loans
2. Credit/debit cards
3. Other products such as insurance or real estate broking
4. Investment products – securities investment
5. Mortgages

(1) Personal loans

Personal loans are a new thing in Vietnamese banking circles. In theory anyone can get a personal loan to buy a house, car or motorbike, or to repair their home, provided they can meet the banks' strict collateral requirements. The SBV has recently issued a new regulation that allows commercial banks to provide unsecured loans to employees of state-owned companies and organisations. A start, but it's not much good to the private sector employees who make up the bulk of the AB class.

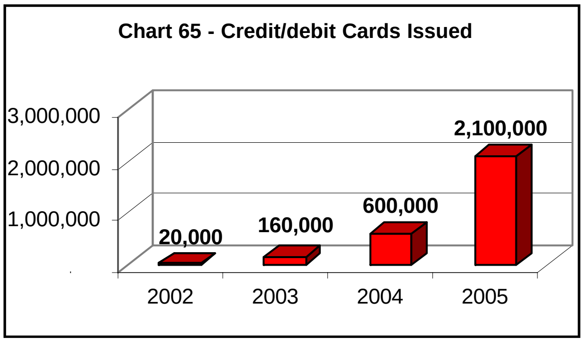
ACB, always in the forefront has launched a pilot unsecured loan program, totaling VND200 bn (US$12.5 million) to a total of 11,000 customers. The loan limit is being raised to VND200 million (US$12,500) from VND100 million (US$6,250). Vietnam International Bank (VIB) is happy to lend VND150 million (US$9,335) without security to government employees with a monthly income in excess of VND6 million (US$380). But these are exceptions to the norm.

The majority of personal loans are medium to long term secured loans. Up till now even with collateral it was hard to get a personal loan of more than VND10 million. Now banks are happy to hand over VND30-50 million in personal loans. The Mekong Delta housing Bank (MHB) has increased its personal loan ceiling to VND50 million (to be paid within 36 months). Vietcombank will happily lend you VND50 million for five years. Most of these loans can be cleared within 3-7 days.

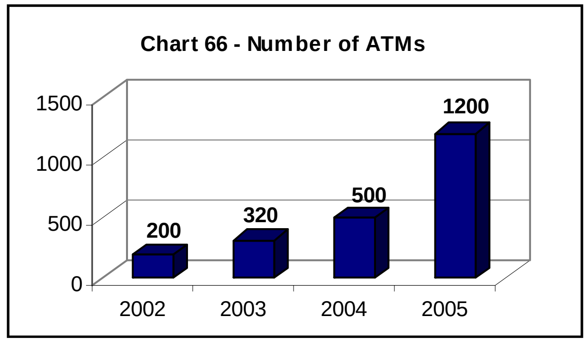
Some banks such as EAB and Eximbank target employees of existing corporate customers as potential borrowers. Others such as ACB and Vietcombank target Visa and MasterCard credit card holders. Foreign banks such as HSBC will give secured loans up to a value of VND40-200 million for one to three years to its customers.

In general, due to credit history constraints, this market is embryonic. The potential for both the unsecured and secured markets are huge. Growth in the retail markets is closely tied in to the growth in the number of bank accounts, and the shift towards payment by bank transfer instead of cash.

(2) Credit, debit cards and ATMs



Source - VinaCapital



Source - VinaCapital

The era of ATMs, credit cards and electronic payment is arriving in Vietnam. Banks have now issued only 2.1 million debit and credit cards, and installed a mere 1,200 ATMs nation wide, but the rate of growth is impressive. Revenue from bank card transactions issued through 17 Vietnamese commercial banks surged by 300% in 2005. 500 additional ATMs were installed nationwide last year, 125 of these in the Ho Chi Minh City area.

Lack of distribution is the key hurdle. Only 10,000 outlets accept card payments, concentrated in big cities like Hanoi and Ho Chi Minh City and other major tourism sites. 15 banks are allowed to issue payment cards, and almost 80% of issued cards come from domestic institutions.

There are three ATM/card alliances in Vietnam; the Vietcombank alliance, VNBC and BankNet. Vietcombank has an alliance with 17 other banks called Connect24. VNBC, is an ATM network founded by EAB in January 2005 along with the Sacombank and ANZ. The VNBC alliance is being expanded to include two overseas banks, ChinaUnionPay and United Overseas Bank from Singapore. BankNet is the national funds transfer system operated by BIDV. The big problem lies with the fact that the three systems do not talk to each other. This is typical of developing countries but one nationwide system would be a major breakthrough. We expect Vietcombank to win this one.

The VNBC Unicard is accepted at over 300 ATMs and 1,000 locations nationwide. Customers can use their Unicard to perform many banking functions including withdrawal, funds transfer and paying bills at ATMs. VNBC had already issued over 500,000 credit and debit cards. The network is also linked with China Unionpay, which enables customers to use their card at even more locations in China, Hong Kong and Macao.

Vietcombank (VCB), ACB, and Eximbank all offer international payment cards with 125,000 cards issued since 1996. Of this number, Visa-member banks had the largest share with 62,000 issued by the end of last year, a year-on-year growth of 67%. Other international brands such as MasterCard, American Express and Maestro also saw strong growth. VCB is currently the only issuer of MasterCard, Visa and American Express cards in Vietnam, with more than 50,000 cardholders in its client base. VCB is also the acquirer bank for MasterCard, Visa , American Express, JCB and Diner's Club, with 5,000 point-of-sale (POS) terminals and 400 ATMs nationwide.

Visa obtained a license from the SBV last month to open the first representative office in Vietnam, and the company expects the number of Visa cards issued in the country to hit 500,000 by 2010. However, 89% of merchant sales volume via Visa cards in Vietnam is still generated by foreigners, mostly in Hanoi and Ho Chi Minh City. Retail purchases and cash withdrawals made by domestic card issuers in 2004 topped US$72 million, a relatively small amount compared with the US$237 million worth of purchases and cash withdrawals in Vietnam by international visitors.

Credit card fraud is an ever present problem in Vietnam. Visa Asia-Pacific's statistics show that the fraud rate of Visa cards in Vietnam is approximately 0.15%. The normal global rate is about 0.06%. Magnetic strip cards in particular are vulnerable to counterfeiting and abuse. And because banks update credit card transactions only once every few weeks, the window of opportunity is much wider than it would be for either debit cards or ATM cards which are updated daily. Banks' liability in these cases has yet to be determined but so far little has been paid out by way of compensation. This is clearly a case of cardholder beware.

Eastern Asia Bank (EAB), one of the many second tier JSCBs have experimented with hybrid cards using a chip based infrastructure instead of magnetic strips. They are about to issue 5,000 such cards and tie-up with Petrolimex to issue cards for fuel purchases.

The mortgage market

Then, of course, there is the mortgage market. The growing AB middle class is very keen to become house owners. The favorable demographics picture is further amplified by the 57% of the population that is under 30 years of age. Young adults want to move out and buy their own house or apartment. This concept of ownership sets this generation apart from their parents and is now backed by a solid array of legislation. The legal framework has been put in place for the growth of a mortgage market.

One issue is that affordable housing has been hard to come by with spiraling property prices. Mortgages are a necessity for most young couples starting off on the property ladder. The mortgage market has grown hand in hand with the explosion in the urban condominium market which has brought affordable housing within reach of many in the AB middle class.

The mortgage market is new to Vietnam and currently accounts for only 10-15% of the total housing finance market. So far banks have approved mortgage loans of about US$1.2 billion, around 12.7% of their total lending. Most property purchases are financed informally through family networks (or friends) who typically advance sums at no interest. Nonetheless the professional finance sector has a stronger grip on the condominium market partly as a result of tie-ups between developers and financial institutions.

Prices for apartments in major urban areas in Vietnam range from about US$320-2,500 per square meter. The underdeveloped mortgage market has been the biggest constraint for the housing market. As loan terms are extended to 15 years or more demand will explode. Typical mortgages can be worth up to 70% of the value of the home, have a duration of seven to ten years and carry a rate of about 12%. Some banks are testing marketing longer terms – very positive news for demand. Most households can only afford to spend about 30% of their income on housing. This is the affordability threshold.

Normally a bank will lend only up to 70% of the value of a house for up to 10 years. The interest rate is around 12% currently. With such a short repayment schedule, high monthly repayments are a huge constraint on mortgage demand. As elsewhere in Asia, banks have been slow to move into the personal or household lending markets.

This is now changing. Sacom Real Estate, a division of Sacombank, has begun to offer mortgages with a term of 20 years as a pilot program. Vietcombank and Techcombank have extended the repayment time to 15 years. ACB is attempting to follow suit and for now can offer up to ten-year mortgages.

Over leaf we have shown a demand model for the mortgage market in Vietnam. As can be seen longer tenors are the key determinant in increasing demand as repayment becomes more affordable. If a typical life is increased from 10 to 15 years for a US$13,440 mortgage, monthly replayments drop by 15%. Minimum monthly repayments in our model from $263 to $228 in the first year of repayment. As servicing costs drop down towards $200 housing starts to look affordable for many in the B socioeconomic class. It is this equation that has bankers so excited.

Chart 67 - Aggregate Mortgage Demand Model for Urban Vietnam

Typical mortgage for a low to mid end apartment

Minimum size	price per sq meter	Total cost USD	30% Deposit	Loan Amount	Interest Rate	Loan Term
60 sq m	$320-440	19,200-26400	5760-7920	13440-18480	12%	10

Current repayment on a 10-year loan of $13440 at 12%

	Principal Repayment	Balance at year-end	Interest Payment	Total payment	Per month
Year 1	1344	14406	1809	3153	263
Year 2	1344	13062	1648	2992	249
Year 3	1344	11718	1487	2831	236
Year 3	1344	10374	1326	2670	222
Year 4	1344	9030	1164	2508	209
Year 5	1344	7686	1003	2347	196
Year 6	1344	6342	842	2186	182
Year 7	1344	4998	680	2024	169
Year 8	1344	3654	519	1863	155
Year 9	1344	2310	358	1702	142
Total	13440			24276	

Source: Vina Capital

Latent demand for mortgages in urban areas in Vietnam

	Number of urban Households	Urban Pop. Growth Rate	Class A % of total	Ann. Growth in Class A	Total Market	Annual new Mortgage dermand
2003	5,103,000	2.90%	5.0%	11%	255,150	
2004	5,250,987	2.90%	5.6%	11%	291,430	36,280
2005	5,403,266	2.90%	6.2%	11%	332,868	41,438
2006	5,559,960	2.90%	6.8%	11%	380,199	47,331
2007	5,721,199	2.90%	7.6%	11%	434,259	54,060
2008	5,887,114	2.90%	8.4%	11%	496,006	61,747
2009	6,057,840	2.90%	9.4%	11%	566,534	70,527

Source: Asia Demographics, World Bank, TNS Vietcycle, Vina Capital

Affordability threshold

	Term	Max.mnthly repayment	Threshold level	Minimum mnthly income
	10 year mortgage	263	30%	877
	15 year mortgage	228	30%	760

What if loan terms are exended to 15 years?

	Principal Repayment	Balance at year-end	Interest Payment	Tot.paymen	Per month
Year 1	896	14854	1836.24	2732	228
Year 2	896	13958	1728.72	2625	219
Year 3	896	13062	1621.2	2517	210
Year 3	896	12166	1513.68	2410	201
Year 4	896	11270	1406.16	2302	192
Year 5	896	10374	1298.64	2195	183
Year 6	896	9478	1191.12	2087	174
Year 7	896	8582	1083.6	1980	165
Year 8	896	7686	976.08	1872	156
Year 9	896	6790	868.56	1765	147
Year 10	896	5894	761.04	1657	138
Year 11	896	4998	653.52	1550	129
Year 12	896	4102	546	1442	120
Year 13	896	3206	438.48	1334	111
Year 14	896	2310	330.96	1227	102
Total	13440			29694	

Source: Vina Capital

Electronic payments

Electronic payments are also making steady inroads into a country once ruled by cash. Cash payments in Vietnam accounted for 21% total financial transactions in 2005, down from 24% in 2004. The SBV and tax authorities are all cheering from the sidelines. In fact the SBV has completed draft decrees on electronic and non-cash payment systems including cheques and bank draft circulation systems. Fewer cash payments means less tax evasion, corruption and money laundering, and lower minting charges. The decrease in the cash payment rate last year was the result of a sharp increase in bank payment transactions, and particularly those performed with payment cards.

To limit cash payments, Vietnam needs to encourage intra-account payments for utility, internet, and cable television bills. Cash payments continue to account for the greater number of daily transactions in Viet Nam, where only large supermarkets and hotels use point of sale (PoS) payment systems. 2,450 PoS card-reading machines were installed last year.

As cash cannot be king forever more and more consumers will eventually be driven to open bank accounts as the utility of paying bills by direct debit becomes clear.

Current Business Environment

Credit loan market

The credit loan market has come a long way but still remains underdeveloped compared to other Asian countries. In 1990, the credit ratio was only 4.7% of GDP. This ratio has been improved to 44.8%, 52% and over 60% in 2002, 2003 and 2005 respectively. Credit has been growing at an average annual rate of 25% over the past five years. While many economists believe that the optimum relationship between credit growth and GDP growth is a 2:1 ratio, this does not really apply to a developing country where the credit to GDP ratio tends to be low. Currently, lending at commerical banks amounts to about 60% of deposits and has lagged behind the sharp rise in deposits this year.

By the end of June banks in Ho Chi Minh City had deposits of more than VND227 trillion (US$14.2 billion) up more than 20% so far this year. Over the same period total outstanding loans grew by only 9.2% to VND192 trillion (US$12 billion). For the country as a whole, deposit taking was up around 30% in the 1-H while lending growth lagged behind at about 15%.

Dong deposit rates are hovering at the 9-9.5% level for many private sector banks. Current lending rates for dong loans are between 10-14%, which are turning off borrowers. If the credit market is to grow at the 20-25% target forecast set for this year, banks will have to look more aggresively for new borrowers, perhaps in the retail market. The corporate sector seems to have reached the limit of its ability to expand credit at the current high rates.

Another reason for the cautious lending stance is the funding mismatch between largely short term deposits and the largely medium/ long term loans. Currently medium and long term loans account for about 42% of total loans. The problem is that up to 50% of short term deposits are being used to offer medium and long term loans. Such imbalances are long standing and a bit worrying. However, once the corporate bond market takes off banks should be in a position to do more long term financing and reduce this dependency.

Long term project finance

One good example of the type of medium to long term financing provided by the SOCBs is the recent deal signed with Electricity of Vietnam (EVN). The syndicate is to provide a credit line of US$2.7 billion to EVN over the next four years at an interest rate pegged to the average 12-month deposit rate and a 3% fee. These kinds of projects are becoming more and more frequent as the government and large SOEs tap private sector banks for large infrastructure-type syndicated loans.

As the corporate bond market takes off, companies will have the option of raising money there instead, but the main purchasers will still be the banks and insurance companies.

Property Sector Loans – A note of caution

According to recent statistics quoted by VietnamNet, commercial banks have outstanding loans of about VND50 trillion (US$3.15 billion) to the property sector. As a percentage of total loans this amount to a 10% exposure to the property market, or 24% of all medium to long term debt. By city, 15% of all outstanding loans in Ho Chi Min City are exposed to the property sector, a total of VND29 trillion (US$1.8 billion). In Hanoi the figure is 10% or VND9 trillion (US$562 million).

Some individual banks of course have a far higher exposure, particularly amongst the joint stocks banks. BIDV for example accounts for about 10% of outstanding loans to property developers, an exposure of about VND2.8 trillion (US$176.1 million). However the government has been tightening lending by ordering banks to check the credit quality of loans to the property sector. Loans must not exceed 70% of the value of a mortgaged property.

Given the fact that few real estate transactions have taken place in the past few years there is concern that the frozen state of market might jeopardize the quality of lending to the sector. Transactions in Hanoi and Ho Chi Minh City fell 60% year/year in 2005. Last year only 113 projects (down 40% year/year) were being developed in Ho Chi Minh City, covering about 175 hectare of land.

The hurt has spread. BIDV has had to reschedule about VND1 trillion (US$65.7 million) in loans to Vietnam's top seven developers. These are Song Da, Vinaconex, Housing and Urban Development Corporation, Hanoi Construction Corporation, Viglacera, Cienco 5 and Contrexim Holdings. These amount to about a fifth of BIDV's total exposure to the property sector. Two years has been added to the debt schedule and short term loans have been reclassified as long term debt under the new arrangement. About 17 projects are involved, five of them behind schedule. Housing and Urban Development Corporation seems to be one of the main concerns with 11 of its projects facing capital shortages.

BIDV has recently pleadged VND1 trillion in short term lending and VND9 trillion in medium term financing to Song Da over five years. No word on rates.

The true level of exposure to the property market is far higher than that. The number critically only includes direct loans to property developers for the purpose of project development. Loans to manufacturing companies that have large land banks or who develop real estate projects as a sideline are not properly accounted for. Nor is the fact that the vast majority of loans are collateralised by land or property.

Therefore a sharp drop in property values would expose the entire banking sector to serious difficulty more through the deterioration in the value of collateral than through direct exposure. What are the chances?

We don't fear a collapse in property prices based on an internal crisis. High as prices may be, few actual transactions take place and with inflation and GDP growth both high, prices are set to rise in the good years and simply stay flat in the bad years. In our book, any collapse would come as a result of an external shock, leading to a general and perhaps sudden deflation in asset values across all classes. That is what keeps us up at night.

Existing SME lending

There are about 240,000 SMEs in Vietnam and the government believes this number will double by 2010-11. The sector accounts for about a third of GDP and employs about 25% of the workforce. Less than a fifth of SMEs currently have access to the bank lending market. The rest make do with loans from family, friends or other private sources. Even those that do borrow money from banks usually do so in a private rather than corporate capacity. In other words, the owner will pledge some personal assets, take out a personal loan and apply it to the business. Banks are generally wary of the SME market as many small companies have few assets to offer as collateral, accounts are frequently unreliable and they are usually the first to suffer in an economic downturn. Add to this the paucity of credit information and you can see the relationship between bank and small business can be rather fraught.

Generally loans of VND5 billion (US$315,000) and up are likely to be rejected, even though businesses may have sufficient collateral to borrow such amounts. Banks are typically afraid of the risks of lending capital over VND5 billion. The comfort zone for SME lending is about VND1 - 2 billion ($63,000-126,000), which is insufficient for most small businesses. The banking sector's hesitance is partly rooted in regulations on lending rates, under which banks are permitted to lend a maximum of 75% of their mobilised capital.

More than that, however, is a lack of credit information on most customers and a risk adverse lending culture that wants to spread the risk as widely as possible in this niche. Ironic considering that most Vietnamese banks concentrate their lending on a few large corporate customers.

The main problem of course is not only the size of available lending but also the short maturities of loans. Banks are not interested in medium term or long term loans to SMEs for project finance or business expansion. These kinds of loans require a good understanding of the business viability and potential cash flows from a new project. This is clearly beyond the current scope of a banking system that bases its credit decisions mainly on collateral.

Amongst the Vietnamese banks, Agribank and Sacombank have both made a strategic decision to focus on this market. Agribank's involvement speaks volumes; they are usually the lender of last resort, a bank with a largely social policy function. However ACB and Sacombank, the savviest private banks, has also entered this market niche. This should also tell you something. Namely, that there is money to be made. The SME lending market is multi-tiered and there are plenty of successful, fast growing mid-sized enterprises who have large appetites for funding and can afford to pay for it.

Consumer lending

Consumer lending is covered in more detail earlier in this report. This market is a new area for banks and overall accounts for less than 10% of total outstanding loans. However it is probably the fastest growing part of the lending market. Vietcombank, Sacombank and ACB are currently the major players offfering a full range of products such as credit cards, mortgages, life insurance and both unsecured and secured loans. Others such as VBARD say consumer loans currently amount to 10% of their loans and have a target of increasing that to 30% over the next few years following equitisation**.** Given that most consumer loans attract fees of one sort or another it is a high margin market and has enabled those banks that specialise in retail banking to enjoy far higher margins than the rest.

Remittances

Remittances are a lucrative source of fee income for Vietnamese banks, but most of the money is left on the table owing to the lack of a foreign presence by the Vietnamese banking industry. With 2.7 million Vietnamese living abroad (mainly in the US and France) sending home US$5-7 billion a year and being charged between 2-5% in fees for the privilege, the market size is very decent. About US$4 billion of this is routed through the banking system by wire transfer. The rest comes through the gold shops and is undocumented.

Currently the overseas portion of this market is dominated by foreign firms such as Western Union,which take the lion's share of the resulting fees. VIB bank has recently launched a home delivery service for remittance payments within 24 hours at no additional cost.

Stock Lending

One of the hidden triggers of the 1-H surge in the stock market has been the willingness of bank to lend against stocks, using the certicicates as collateral. Banks ahve told us they generally vaoue stocks at par, or close to book value but in some cases are prepared to lend more if the stock os listed or actively traded. This fairly new market is frowned on by the SBV which fears some banks lack the internal controls to balance these relatively high risk niche market.

Vietnam International Bank (VIB) reported its current loans to the sector accounted for roughly 5% of the bank's total loans. Instead of lending only against bank stocks, VIB now offers loans against 29 different types of stocks ranging from shares in hydropower plants to insurance and information technology stocks. Many other banks have joined in. ACB for example has about 1% of its total loans mortgaged by stock portfolios. The latest figures issued by commercial banks in May showed that 13 million shares worth VND751 billion ($47 million) on the market were used as collateral for loans.

Our impression is that these types of loans are fairly safe as the amount of collateral required provides ample protection against any but the most calamitous collapse in the market. However, the concern is that some of the smaller banks might be tempted to relax the rules a bit in future.

Chart 68 - FY05 Bank Earnings

	Revenues	y/y	EBT	y/y	Net profit	y/y	EPS	y/y	Par value
VCB	10,100,000 *	53.9%	2,666,667 *	109%	2,000,000 *	110%	-	-	
ICB	10,845,510 *	28.9%	717,333 *	184%	538,000	160%	-	-	
VBARD	21,980,330 *	30.1%	1,676,821 *	59%	1,257,616	59%	-	-	
BIDV	8,852,923	26.6%	295,878	33%	114,992	200%	-	-	
ACB	2,092,683	108.0%	385,071	39%	294,120	39%	298,806	-32%	1,000,000
Sacombank	1,208,643	44.5%	306,054	55%	234,390	55.1%	1,875	-8%	10,000
Eximbank	829,942	74%	28,557	100%	21,101	100%	30,144	100%	1,000,000
Techcombank	905,473	83%	286,067	167%	206,156	166.9%	1,670,632	79%	5,000,000
Habubank	488,911	57%	103,097	71%	75,190	64.7%	2,506	10%	10,000
EAB	943,163	49%	134,299	37%	96,696	37.00%	387	-100%	2,000,000

Source - VNExpress, Bank's financial statement

** Estimated*

Bank earnings

FY05 – A record year for bank profits

Vietnamese banks saw record profits in 2005, fuelled by strong credit growth and falling bad debt ratios. With strong economic growth, rising fee and remittance income and a stream of equitisations fuelling new loan demand, banks' profits are growing fast. Income from new products such as credit and debit cards is also growing.

Amongst the SOCBs Vietcombank obtained pre-tax profits of VND3,250 billion (US$203 million) and net profits of VND2,000 billion. Incombank also registered pre-tax profits of more than VND2,000 billion and net profits of VND538 billion. Agribank posted a profit increase of 59.3% year/year. Costs are also rising, with Agribank reporting that staff salaries increased by 40% on average during the year.

Prospects for FY06 and beyond

Banks issued rosy earnings forecasts for FY06, essentially following on from stellar results last year. Credit growth is forecast to conitnue at the 20-25% range The five state-owned banks have forecast a 52% year/year increase in net income to VND6.15 trillion (US$384 million).

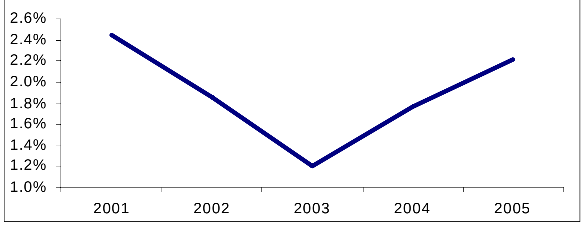
The top seven JSCBs have forecast a 75% increase year/year in net income to VND1.76 trillion (US$110 million) for FY06. Noteworthy is the ninefold increase in profits forecasted by Eximbank. If we strip this out of the calculations the overall average increase is a more modest 56%. Still very impressive though.

Overall profit growth rates are very similar to FY05, supported by the low penetration rate of banking services in the economy and strong GDP growth.

1-H results largely came in on or slightly ahead of forecast (see table 71). Sacombank exceeded its original forecast whilst Techcombank disappointed. State-owned banks don't usually publish half yearly results but we suspect that they are on plan.

We believe that banks can continue to grow profits by 30-50% every year until 2010 provided that GDP growth continues in the 8% range, 12 months deposit rates do not significantly exceed 9% and lending rates stay at or around current levels. The concern is interest rate spreads which have been narrowing of late. Accordingly we suspect that 2-H results may come in somewhat under forecast. Lending rates are high already and right at the limit of tolerance for many corporate lenders. Therefore narrowing interest rate spreads are the greatest threat to profit growth rates going forward.

Chart 69 - Interest rate Spread - BIDV (2001 - 2005)



Source - BIDV

Chart 70 - Selected Banks' Pre-tax Profit Margins

	2004	2005	2006	2007
VCB	19.43%	26.40%	29.01%	32.31%
ICB	3.62%	6.61%	7.01%	7.43%
VBARD	6.25%	7.63%	8.88%	10.33%
BIDV	3.86%	3.89%	3.52%	3.36%
ACB	21.31%	18.40%	22.10%	26.45%
Sacombank	23.68%	25.32%	25.00%	26.00%

Source - Banks' financial statements and forecasts, VinaCapital

Profit Margins

One of the most interesting facets is the stark contrast between banks that include margins as part of their growth metrics and those that don't. Profit margins in the Vietnamese banking system are a function of two things:

- The interest rate spread
- Fee based income

The IMF generally recommends a 3-5% spread between deposits and loans. In the Vietnamese bank system we believe the differential has ranged between about 1.2% and 2.5% over the last five years. Currently the spread is close to 2.5% at the top end of its recent range. In the chart below we use BIDV as a proxy for the whole market as the other banks regard this number as top-secret. BIDV to their credit has published it and we understand the number is close to the average for the market as a whole.

This spread has been narrowing alarmingly in the 1-H as the 30 basis point rise in deposit rates has not been matched by a commensurate rise on lending rates. The lag period is normally several months anyway and of course can only apply to floating rate loans.We have conducted a quick survey of corporate clients and all have told us that lending rates have remained steady in the last six months. While not conclusive, the result suggests that banks are reluctant to raise lending rates even as deposit rates have risen. The inevitable result: shrinking margins from the lending business in the 2-H.

Chart 71 - FY06 1-H JSB results summary

Banks	Net profit 1-H	FY06 Plan	% of plan
Sacombank	286.80	600.00	47.8%
ACB	280.50	555.00	50.5%
Eximbank	161.00	287.50	56.0%
Techcombank	141.00	572.00	24.7%
Habubank	150.00	182.00	82.4%
Southern Bank	91.83	175.00	52.5%
EAB	82.62	200.00	41.3%
Saigon Bank	79.63	130.00	61.3%
Oricom Bank	66.07	130.00	50.8%
An Binh	12.88	35.37	36.4%
Gia Dinh	7.52	18.00	41.8%
Total	***1359.85***	***2884.87***	***47.1%***

Source - SBV

To a great extent this problem can be offset by increasing operational efficiencies in the state sector and rising fee income for the better private sector banks. As higher margin businesses such as credit cards, mortgages, leasing and unsercured lending account for a greater proportion of lending over the next few years, pre-tax margins will have room to rise further.

As for the state sector only Vietcombank has optimised margins from the existing business model, others such as BIDV, Incombank and Agribank have considerable room for margin improvement over the next few years if they can improve operational efficiencies and reduce the amount of bad loans further.

Incombank or even BIDV, if it can clear its mountain of bad debt have the most to gain in terms of margin improvement. So what are the odds?

Actually quite low as long as their business model depends largely on earning interest income from lending to corporates and small businesses.

Overall much depends on the economic environment continuing to be as benign to the banking sector as it has been for the last five years. Assuming no downturn in the economy and the government comes through on its recapitalisation programme, margins should improve somewhat at the underperforming state sector banks. However this may well prove to be a temporary relief unless the quality of management and corporate governence is improved dramatically. We wouldn't bet on that.

For the quality banks such as ACB and Vietcombank the challenge lies in adding more high margin products and increasing the weight of exisiting high margin businesses. This is possible as the existing management has proved capable of expanding the range of services.

Overall we see two contrasting trends: narrowing interest rate spreads in the short term, and rising fee income and gains from operational efficiencies in the medium term to longer term. However, the easy gains in margins have already been acheived and further improvements will be harder to come by.

Chart 72 - Equitisation and Listing

(1) All state owned banks to be privatised by 2010
(2) Government will retain majority stake
(3) About 30% of the outstanding shares will be sold through auction
(4) Foreigners will be allowed to buy up to 30%, 10% for one investor
(5) Foreigners wanting to become strategic investors (hold 20%) have to keep their stake for three years

Source - SBV, VNExpress

Bank Shares – Monetising the potential

Equitisation and listing

Between the WTO and the bilateral trade agreement with the US, the Vietnamese government finds itself under pressure to open up the financial sector post haste. Equitisation of SOCBs in Vietnam would be largely complete by 2010, according to a recently approved plan on the restructuring of the banking system. Under the plan, all SOCBs except for the Agribank would be operating under the new banking system by 2010.

The equitisation plans aim for a further reduction in the amount of state capital at banks such as the Bank for Foreign Trade of Viet Nam (VCB), initially to 70% and then to 51% by 2010. However foreign shareholdings would be kept to a limit of 30%. The equitisation plan is several years behind schedule already and it is possible that the state may be forced to sell a larger stake up front.

International bodies have highlighted important obstacles to the equitisation plans. According to current regulations, the SBV has a responsibility to enforce the rights of the state shareholder at the banks, but this responsibility creates a conflict of interest with its supervisory role at the banks. Some critics have suggested SBV should transfer its shareholder role at the banks to the Ministry of Finance before equitisation takes place. This is unlikely before 2008 but the uncertainly has been one factor in delaying the whole process.

The current timetable calls for Vietcombank to come to the market in early 2007. BIDV and Mekong Housing Bank will follow in the second half of 2007. And Incombank will equitise in 2008. About 30% of the outstanding shares will be available for purchase, with the government keeping a stake of at least 51%. The size of these listings will vary, with Vietcombank likely to list at a market capitalisation of USD$1.5-2 billion, BIDV coming in slightly lower and Incombank slightly higher. In short each will inject USD$600 worth of new supply into the market if a 30% tranche is sold off.

As mentioned before in this report, in preparation for its listing Vietcombank issued VND 1.4 trillion worth of convertible bonds in December 2005, while BIDV followed up with a similar bond issue in March. Vietcombank plans to issue another convertible bond this summer but the date has yet to be decided.

How foreigners might invest in banks

Buying banks in Vietnam is no easy thing for a foreign institution. Regardless of whether the bank is currently a state- owned or a joint-stock bank the ownership rules are very tight. Under current regulations, namely SBV's decision 228, covering foreign investor participation in Vietnam's joint-stock banks, one institutional investor may hold up to 10% of a bank's shares, while total foreign ownership is capped at 30%.

The SBV's thinking on this mirrors the government's thinking in other sectors of the economy: strategic partners welcome, speculators not so welcome. And even with reform in the air and market opening coming soon the role of the foreign investor is still being seen in terms of long term strategic benefits rather than simply as a capital provider.

As part of its attempt to spread its wings the SBV has come with a comprehensive draft which also covers in some depth, foreign ownership in the banking sector. First, the good news. The SBV proposes to lift the 10% cap, but keep the total 30% limit effective by the end of the year. Then it gets trickier. According to the latest draft, any foreign investor wanting to invest 20% in a Vietnamese commercial bank has to be one of the top 500 banks in the world and be subject to SBV approval. They need to have a minimum of $20 billion in total assets in the year prior to purchase.

State equitised commercial banks are an even tougher nut to crack. To buy shares in these, any potential foreign investor would have to get the green light from the Prime Minister himself and be limited to a maximum 20% of a bank's chartered capital, and a maximum of two bank holdings per investor. If the investor is recognised as a strategic partner, they would be permitted to buy up to 20% stake. The draft regulations further stipulate that only Vietnamese commercial banks (including state-owned equitised commercial banks) that have VND500 billion or more in chartered capital, have strong and transparent finances and good management would be allowed to sell shares to foreigners.

Other foreign investors such as investment funds can only hold up to 10% of the chartered capital of a fund up to a maximum of four banks. More recently however investment funds have been allowed to hold up to 5% in a listed bank without any restrictions or need to inform the authorities. Of course this still leaves an apparent contradiction between the SBV which wants the 30% cap and the State Securities Commission (SSC) which has a 49% cap on foreign holdings in listed companies. Both agencies will coordinate to avoid confusion. This may give foreign investors a window to test the 30% cap in future.

The draft regulations state that foreign investors can sell their shares two years after purchase (three years if the foreign investor joins the management board). We consider this a rather sensitive matter that will certainly be reconsidered.

The draft is part of an SBV appeal to the government to give the central bank the responsibility to allow foreign banks to buy stocks of domestic credit joint-stock organisations instead of submitting proposals to the government. SBV said they would prefer foreign banks to be selected to take stakes in local joint-stock banks rather than investors from outside the banking sector.

he SBV believes if it had these rights, administrative procedures would be reduced, facilitating the involvement of foreign credit institutions. Another reason for SBV's desire to take the reins on this issue is that the central bank now applies international banking practices in terms of debt classification, accumulated risk reserve and safe ratios in banking operations.

But the debate is not over yet. The Vietnam Association of Financial Investors (VAFI) has responded with three counter proposals:

- Expand the type of buyers to include any foreign investor.
- Increase the maximum percentage a foreign investor can own to 25-30% of a Vietnamese commercial bank's chartered capital, and 35-49% of a bank's overall capital.
- The draft should also not include administrative regulations that restrict share transactions between foreign investors and Vietnamese commercial banks. Let foreign investors and Vietnamese banks buy and sell as they see fit.
- Don't restrict the share sales only to the strongest Vietnamese commercial banks. Weaker banks have a stronger desire to reform and grow and they need to be able to attract foreign capital.

The SBV has not budged much. In response they insist only the most powerful foreign institutions should be allowed to buy in and help the domestic banking sector grow. The two positions are clearly poles apart. Currently foreign investors have to approval from the Governor of the State Bank or the Prime Minister before they can buy shares in Vietnamese commercial banks.

Provision 3 of Article 12 of the Law on Credit Institutions states gives the final say to the Government regarding the sale of shares of credit institutions. In this light, the draft regulations propose that the government authorize the governor of the SBV to make decisions regarding the sale of shares in JSBs while the Prime Minister makes the final decision regarding the sale of shares of State-owned commercial banks. Rather complex stuff. Make you weep really.

Who has invested so far?

Four JSCBs – ACB, Sacombank, Techcombank and VB – have sold stakes to foreign banks in the past year, and ACB and Sacombank are now 30% owned by foreigners. In June last year, British-based emerging markets specialist Standard Chartered Bank took an 8.56% stake in ACB for US$22 million. ANZ Bank paid US$27 million for a 10% stake in Sacombank earlier in the year. HSBC agreed to pay VND275 billion (US$17.3 million) for its stake in Hanoi-based Techcombank, the country's third-largest joint stock commercial bank.

More recently Overseas-Chinese Banking Corp paid US$15.7 million to acquire 10% of Vietnam Joint Stock Commercial Bank for Private Enterprise (VP bank). With an option for a further 10% stake valid until the end of 2007. All these deals clearly fall into the strategic partnership category.

For example, as part of HSBC's alliance with Techcombank, its multinational clients in the country can undertake cash transactions at any branches of Techcombank.

The two banks also plan to cooperate in the money transfer service, which will enable overseas Vietnamese to remit money home through HSBC's branches worldwide, to be collected at any branches of Techcombank. HSBC will also transfer know-how and product information.

Chart 73 - IAS guidelines on classification of non-performing loans

Standard: Credit is sound and all principal and interest payments are current. Repayment difficulties are not foreseen under current circumstances and full repayment is expected.

Watch: Asset subject to conditions that, if left uncorrected, could raise concerns about full repayment. These require more than normal attention by credit officers.

Substandard: Full repayment is in doubt due to inadequate protection (e.g., obligor net worth or collateral) and/or interest or principal or both are more than 90 days overdue. These assets show underlying, well-defined weaknesses that could lead to probable loss if not corrected and thus risk becoming impaired assets.

Doubtful: Assets for which collection/liquidation in full is determined by bank management to be improbable due to current conditions and/or interest or principal or both are overdue more than 180 days. Assets in this category are considered impaired but are not yet considered total losses because some pending factors may strengthen the asset's quality (merger, new financing, or capital injection).

Loss: An asset is downgraded to loss when management considers the facility to be virtually uncollectible and/or when interest or principal or both are overdue more than one year.

Source - Vietnam Economic Times, VinaCapital

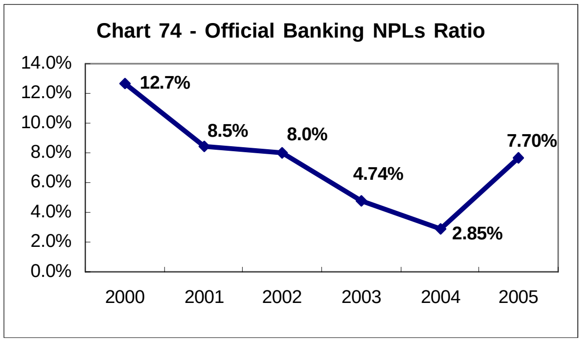
Non-Performing Loans – The elephant in the room

NPLs are a serious problem but not a crisis in Vietnam. The first wave of NPL's has been partly dealt with already. The low penetration of the banking sector has acted as a cushion given that four- fifths of small and medium sized enterprises have no access to the banking system. There are three areas of concern:

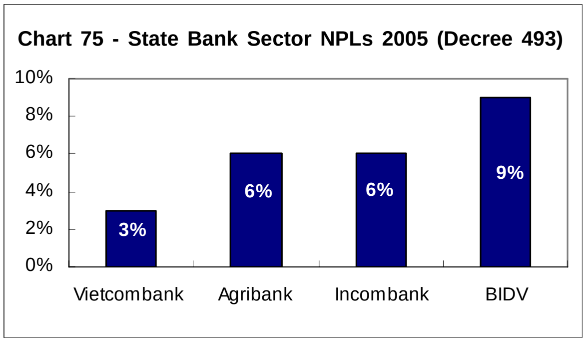
- The failure of the government to quantify the level of bad debt according to international standards.
- Preventing a sharp growth in the level of bad debts as credit growth exceeds GDP growth.
- Regulating the state owned sector to force companies to take their debt obligations seriously. Currently equitising companies are given a clean slate at the bank's expense.

The real concern is the conflicting claims of NPL ratios for the state-owned banks. The World Bank and the IMF estimate NPLs at approximately 15-20% of outstanding loans. Others have talked of a number as high as 30% of outstanding loans. This would amount to about VND 90 trillion (US$5.7 billion) which is 10% of GDP. Yet the SBV and the state owned banks claim that these estimates are exaggerated and that the true value is well below 10%. The issue stems from loose financial disclosure laws, over reliance on Vietnam Accounting Standards (VAS) and the resulting lack of transparency and accuracy.

The state banks have been slow to take steps to deal with this particular concern, but they are not acting as free agents. We believe that the majority of these issues must be dealt with swiftly as the upcoming liberalisation puts more pressure on the government and banks to overhaul their current legal and banking infrastructure.



Source - SBV



Source - BIDV

To tackle a problem you first have to admit to having one. The government is still sending mixed messages about the level of NPLs in the banking system. According to the Vietnam Development Report 2006, the repayment rate of credits is very high in Vietnam. Nice try, guys.

That the authorities can to a large extent paint a false picture is helped by a number of old tricks familiar to veterans of Asia's NPLs over the years. One particular favourite is not including rescheduled loans when calculating NPLs. But that's not all. For instance, Vietnam Bank for Agricultural and Rural Development (Agribank) does not count frozen loans as non-performing or overdue. And most banks only count the current due portion of a non-performing loan as doubtful. The balance of the loan is considered healthy. As a result bad loan ratios only cover a fraction of the true figure.

Admittedly, as the seizure of collateral is difficult in practice, the rescheduling of NPLs is at times the only alternative left to banks. The mere servicing of interest payments is a very poor indicator of their quality, especially if, the interest payment itself has also been advanced by the bank through a secondary loan. A golden oldie used by Japanese banks in the 90s. Not surprisingly differences in the treatment of rescheduled loans are one of the main reasons for the wide variance of estimates of NPLs in Vietnam.

Classification is improving gradually. One frequently used method now counts as non-performing any loan whose service is overdue by 90 days or more, as well as any loan which is overdue by less than 90 days but has been rescheduled. This was the basic approach underlying a series of independent audits conducted since the year 2000 on SOCBs, using international accounting standards (IAS). At the other end, VAS completely ignores rescheduling. The main consequence of this has been the widening gap between IAS and VAS estimates of NPLs.

Decision 493

The issuance of Decision 493 in April last year has been touted as an important step towards bringing Vietnam's loan classification and provisioning practices closer to international standards. Decision 493 marks the first attempt to bridge the gap between VAS and IAS, although it will take three years to move from quantitative assessments (based on the number of days the servicing of a loan is overdue) to more elaborate, qualitative ones. By all accounts its success has been mixed. According to this decision,

- Banks need to provide reserves of 5% of the value of loans which are not current but are less than 90 days overdue;
- The provisioning rate increases to 20% for loans which are overdue by 90 to 180 days;
- And then to 50% for loans overdue up to 360 days;
- Loans overdue more than one year have to be reserved 100%.
- Loans which are being properly serviced but have been rescheduled are treated as if they were 90 to 180 days overdue;
- Provisioning rates aim to capture the expected loss (in probabilistic terms) for loans in each category;
- In the absence of any real market for distressed debt the level of provisioning is simply guesswork backed up by international experience. But we suspect that the provisioning is overly optimistic given real problems recovering collateral in Vietnam.

In 2005 using the new method, the SBV estimated NPLs at 7.7% of total outstanding loans. Using IAS rules and acting for the World Bank, Ernst&Young estimated the total at 15% or almost double the amount. So while the share of NPLs is far higher than under the old VAS methodology, it's still significantly lower than the level of NPLs found under IAS rules.

Decision 493 may be a step in the right direction, but it is not the final solution. The SBV itself is somewhat divided in its opinions, the architects of the decree seem happy but others are less sure. Commercial banks admitted to us that the decree creates more loopholes for dressing up financial statements. All in all we expect revisions to the decree soon once an investigation into its effects has been completed.

Applied consistently, it should exercise some pressure on SOCBs to improve the quality of their lending. However there is little by way of qualitative assessment and the approach still relies too heavily on loan classification. This is a blunt tool and a work in progress.

Equitising companies' failure to repay debts

The other key factor is the failure of equitising SOEs to acknowledge their debts before coming to the market. In a document sent to the government, the SBV has complained about the difficulties in collecting loan repayments from SOEs, especially those about to be equitised. As the process of equitisation is speeded up there are fears that this issue will lead to increases in the bad debt ratios among SOCBs. Equitising SOEs tend to ignore loans in order to restructure their organisation, reclassifying those loans as bad debt.

The Ministry of Finance (MoF) has been strongly requested to change its regulations to include the treatment of state-owned corporations, which ignore their responsibilities and duties to repay loans to commercial banks. The suggestion comes following the failure of current regulations to deal with SOEs defaulting on loan repayments.

Reform of Decree No. 187, which controls the equitisation of SOEs and the government's decision on the merging, dissolving and the bankruptcy of corporations, is necessary. There is an underlying turf war going on with the MoF and local authorities trying to protect SOEs from the SBV's claws.

Domestic banks have been forced to deal with SOE equitisation and bad debts passively because a recent steering committee for corporate equitisation did not include any representatives from domestic banks.

According to the SBV there are no regulations on the responsibility of equitised corporations to repay overdue debts and loans borrowed by former corporations, and some provincial and municipal authorities simply cancel debts to maximise the value of corporations during the equitisation process.

If the SBV is worried, banks themselves are becoming more vocal. Incombank has urged the SBV to ask the government to have clear-cut debt policies regarding SOEs involved in the equitisation process, as banks are not informed which companies will be equitised, which makes it difficult to collect loan repayments and make on credit risk assessments.

Fixing the NPL mess

So how big is the mess and how much will it cost the government to clean it up?

The SBV estimate of 7.7% of outstanding loans at the state-owned banks having gone bad is clearly far too low. The World Bank estimate of 15-20% also comes with a health warning as the supporting data is weak. In other words this is a floor number. We think it's probably fair to think of bad loans in terms of 20-25% of outstanding debts for the whole financial system.

Most joint-stock banks exercise better credit control but on the other hand find themselves lending to smaller enterprises with weaker financial systems. Foreigners seem to have the best record on bad debt but their share of the market is still very low.

As in other Asian countries the taxpayer will eventually have to take on much of the remaining burden. We estimate the direct fiscal burden from NPLs as the gap between the real bad debt figure and the actual provisioning by state-owned commercial banks.

Lets assume that bad debts are 15-20% as the World Bank has suggested. Applying the provisioning rates established by Decision 493 to this estimated structure leads to an expected loss equivalent to about 12-13% of outstanding credit.

This reflects the expectation that not all NPLs will be a total loss. This average provisioning rate was also applied to off-balance sheet items, assuming that such items amount to 15 per cent of the figures captured by the IAS audits. Erring on the side of caution, the total provisioning (including both balance sheet and off-balance sheet items) was increased by 50%.

This is a considerable sum, and will take several years to clear even under a determined effort to reform the banking system. The government will have to issue bonds and transfer the resources to the SOCBs as they restructure. This in turn, would increase Vietnam's public debt. How much?

A debt sustainability assessment jointly conducted by the IMF and the World Bank tried to estimate by how much. It assumed that the issuance of government bonds to support SOCB reform would be spread over a five-year period. The assessment also considered that the economy would continue growing as it did in recent years, at about 7.5% per year.

Macroeconomic management was supposed to remain prudent, with the budget deficit being gradually brought down, until reaching 1.5%of GDP by 2010. Under these assumptions, public debt would increase from 41.2% of GDP at present, to 48.7% in 2010. By contrast, if SOCBs had been performing well, and not generating fiscal liabilities, the stock of public debt would remain almost stable, reaching 42.4% of GDP in 2010.

These numbers are to some extent deceiving, because a considerable portion of Vietnam's public debt is in concessional terms. This means that the net present value (NPV) of the long term obligations faced by the government is considerably less than its face value. On a present-value basis, the burden of SOCB restructuring would increase public debt from 28% of GDP at present to 35.2% in 2010. This figure is high, but very manageable.

Delaying SOCB reform, on the other hand, will result in a much heavier burden. Even maintaining a stable share of NPLs in total credit would translate into an increasing fiscal liability, because credit is growing much faster than GDP. The bottom line therefore is that the Vietnamese NPL problem is manageable given the current level of NPL's and public debt. Provided the process is completed over the next two to three years.

The Chinese example

To envisage how is might be done it is instructive to look at the Chinese case. Standard&Poor's has estimated that at least half of the PRC's banking system's RMB11.3 trillion of loans were non-performing when graded by international standards. If this were true, this would amount to US$680 billion or around 60% of current GDP. Whilst the exact level of NPLs is unclear, the PRC government recognised that NPLs posed serious risks to the continued growth of the economy. The response was to restructure the big-four commercial banks in 1999 to separate the worst of the historical NPLs from the ongoing operations of the banks.

Firstly the government set up four asset management companies to purchase NPLs from four main banks. The government provided the seed capital and the debt was bought using IOUs issued by the government. After some dithering earlier in the decade the AMCs have recently made enormous progress in repackaging and selling NPLs in the secondary market to various foreign investors.

These AMCs acquired RMB1.39 trillion (US$170 billion) of NPLs, which amounted to approximately 20% of the then gross loan books. The AMCs were given ten years to recover what they could from the portfolios. However, progress in the beginning was extremely slow and only 16% of loans were reported as dealt with in the first two years to 31 December 2001.

Since then however the pace has picked up in the last two years and large scale disposals have taken place in the secondary market. The lessons to be learnt are simple:

(1) Set up an easy mechanism to transfer debt from bank balance sheets to a special purpose vehicle;

(2) Use this vehicle to pay the banks the accepted rate;

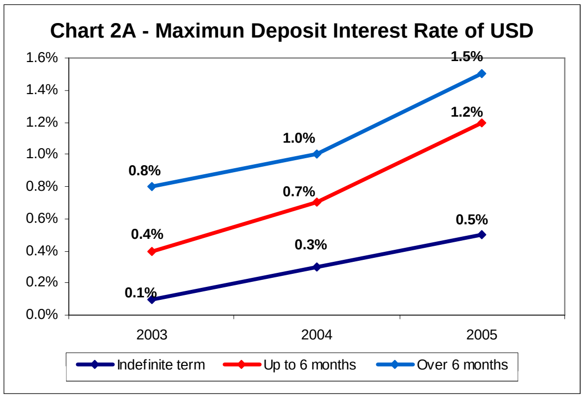
(3) Let the special purpose vehicle then repackage and sell on the debt.

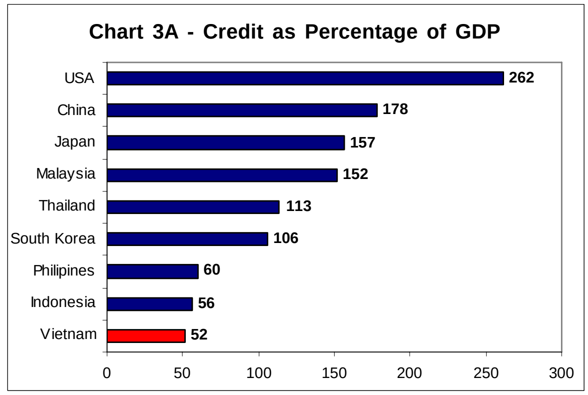
Banks can quickly return to the banking business and the vehicle can concentrate on managing the disposal process.

APPENDIX

Chart 1A - Standard & Poor's Sovereign Long Term Debt Rating (as at January 2004)	Vietnam	Thailand	Singapore
Foreign currency	BB-	BBB	AAA
Domestic currency	BB	A	AAA

Source - The IMF





Source - The State Bank of Vietnam

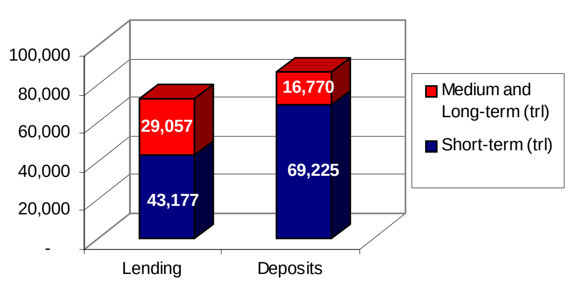
Chart 4A - Compulsory Deposit Reserve Ratios

Compulsory Deposit reserve Ratios	2003	2004	2005
VND			
- Indefinite term and definite term under 12 months			
+ Others	2%	5%	5%
+ VBARD	1%	4%	4%
- From over 12 months to 24 months	1%	2%	2%
Foreign currency			
- Indefinite term and definite term under 12 months	4%	8%	8%
- From over 12 months to 24 months	1%	2%	2%

Source - The State Bank of Vietnam

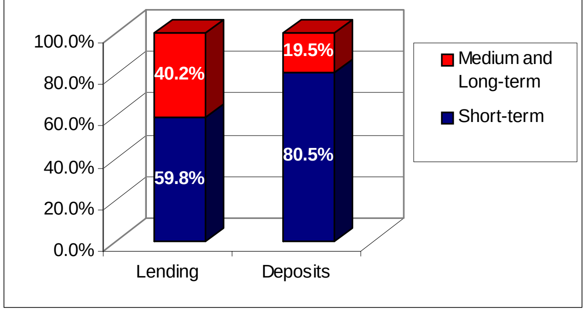
APPENDIX

Chart 5A - Deposit and Lending Struture Value (2005)



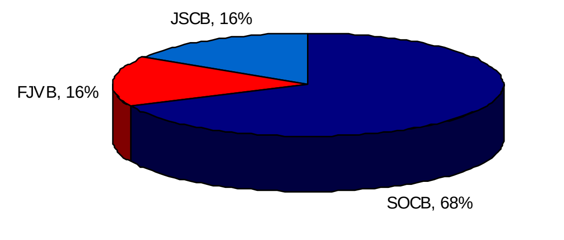
Source - VinaCapital

Chart 6A - Deposit and Lending Structure (2005)



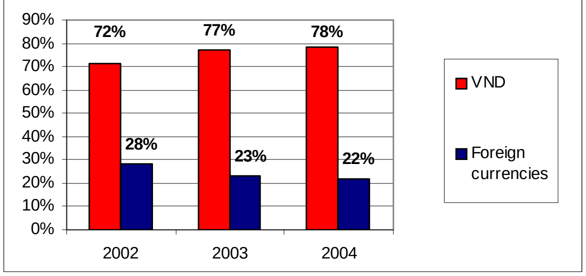
Source - VinaCapital

Chart 7A - Banking Lending Market Share (2005)



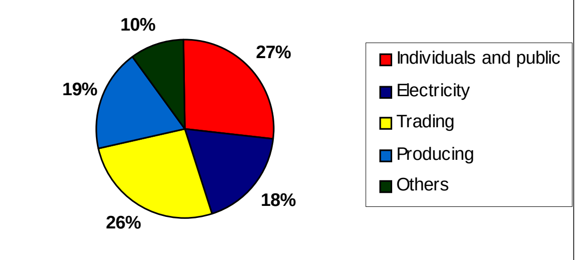
Source - VinaCapital

Chart 8A - ICB Deposits by Currency



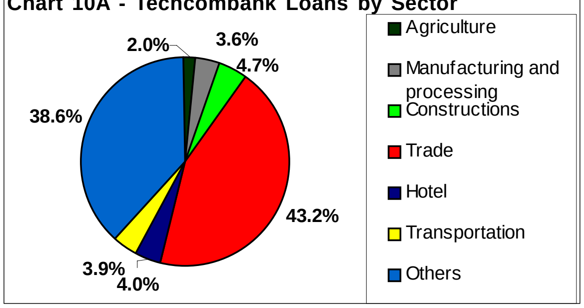
Source - ICB Annual Reports

Chart 9A - Eximbank Loan Book by Sector



Source - Eximbank Annual Reports

Chart 10A - Techcombank Loans by Sector



Source - Techcombank Annual Reports

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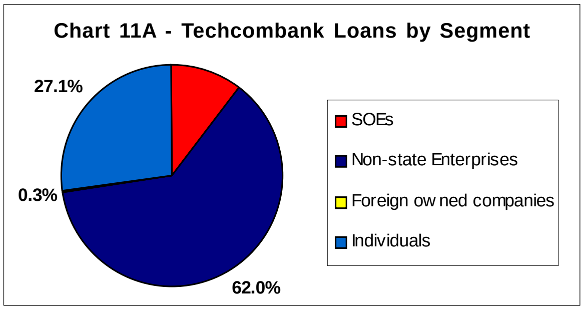
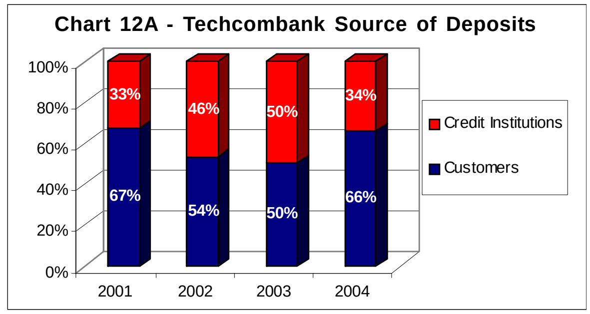
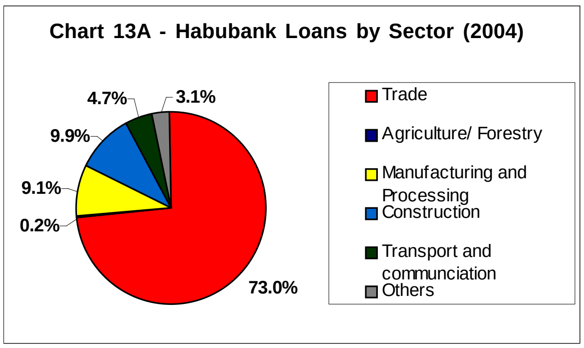


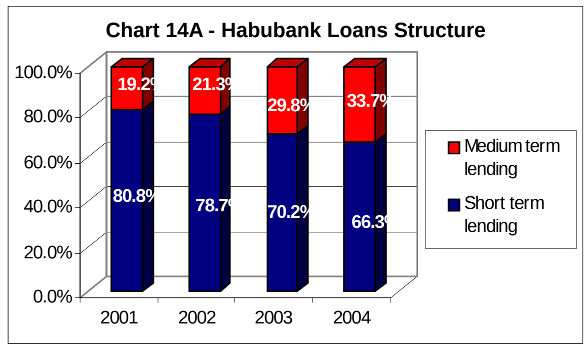
Source - Techcombank Annual Reports



Source - Techcombank Annual Reports



Source - Habubank Annual Reports



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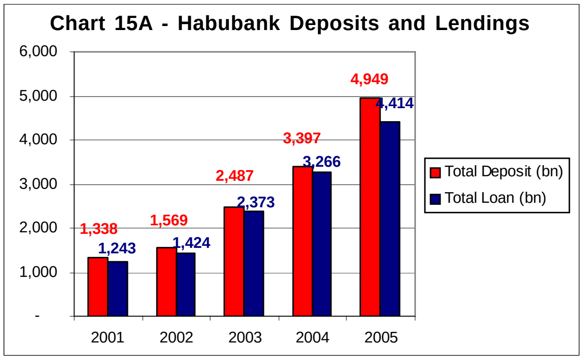

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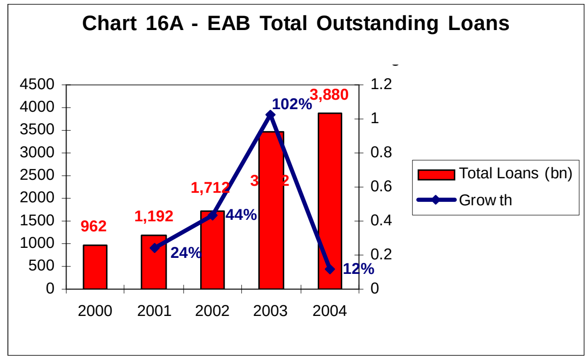
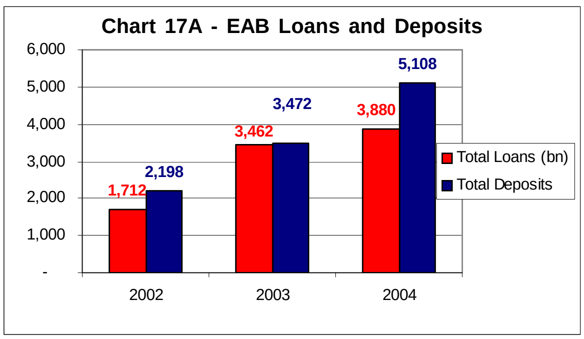
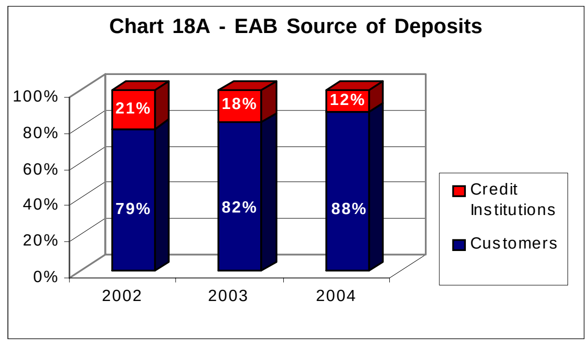


Source - EAB Annual Reports



Source - EAB Annual Reports



Source - EAB Annual Reports

APPENDIX

Vietnam Financial Sector

Formal financial system

Banking financial sector:

- 5 state-owned commercial banks, including:

  4 large state-owned commercial banks:

  - Bank for Foreign Trade (Vietcombank)
  - Industrial and Commercial Bank (Incombank)
  - Vietnam Bank for Agriculture and Rural Development (Agribank)
  - Bank for Investment and Development (BIDV)

  1 small state-owned commercial bank:

  - Housing Development Bank for the Mekong River Delta
- 1 Social Policy Bank
- 29 foreign banks branches
- 6 foreign bank sub-branches
- 45 foreign credit institutions representative offices
- 5 joint venture banks
- 37 domestic joint-stock commercial banks
- Central People's Credit Fund System and 23 branches
- 888 local credit funds
- 7 Finance Companies (of which 5 are affiliates of General Corporations)

Non-banking financial sector:

- 18 insurance companies
- 8 finance leasing companies, 3 of which are joint ventures with foreign investors or wholly foreign owned: 5 are subsidiaries of state-owned commercial banks
- 1 Postal savings system, the Vietnam Postal Savings Service Company (VPSC)
- 2 Stock Exchanges: Ho Chi Minh Securities Trading Center and Hanoi Securities Trading Center
- 8 Investment funds
- 1 Debts and Assets Trading Company (DATC) established in 2003 belong to Ministry of Finance

Informal financial system

- Moneylenders, relatives and friends
- Rotating Savings and Credit Associations (ROSCAs)