Overview of the Capital Markets in Vietnam and Directions for Development

May 2006

This report reflects the state of Vietnam's capital markets as of the end of October 2005. The report disseminates the findings of work in progress to encourage the exchange of ideas about development issues. The report carries the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

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Abbreviations and Acronyms

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
CBs	Convertible bonds
CDs	Certificates of deposit
CLF	Central Liquidity Facility
CSD	Clearing, settlement and depository system
DAF	Development Assistance Fund
DVP	Delivery versus payment
EBRD	European Bank of Reconstruction and Development
EFT	Electronic funds transfer
FDDMP	Financial and Domestic Debt Management Policies
FDI	Foreign Direct Investment
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office of Vietnam
HASTC	Hanoi Securities Trading Center
HCMC	Ho Chi Minh City
HOSTC	Ho Chi Minh City Securities Trading Center
IAS	International Accounting Standards
IFC	International Finance Corporation
IPO	Initial public offering
IMF	International Monetary Fund
JSC	Joint stock company
LLC	Limited liability company
MBO	Management buy out
MEBO	Management employee buy out
MOF	Ministry of Finance
MOJ	Ministry of Justice
MPI	Ministry of Planning and Investment
MTN	Medium- term note
NBFIs	Non-bank financial institutions
NCDs	Negotiable certificates of deposit
NPLs	Non-performing loans
NSCERD	National Steering Committee of Enterprise Reform and Development
ODA	Official Development Assistance
OTC	Over-the-counter
PVP	Payment versus payment

RTGS	Real time gross settlement
SBV	State Bank of Vietnam
SOCBs	State-owned commercial banks
SOEs	State-owned enterprises
SCC	Securities Custody Center
SCIC	State Capital Investment Corporation
SSC	State Security Commission of Vietnam
ST	State Treasury
STC	Securities Trading Center
STP	Straight-through processing
TBs	Treasury Bills
VND	Vietnam dong
WB	World Bank
WTO	World Trade Organization

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Executive Summary

5. Vietnam's domestic capital markets appear to be at a critical juncture where the country's continuous rapid economic growth may be constrained unless the markets are developed in parallel. Aside from the fiscal resources (including external borrowing), bank loans have been a key domestic source of finance for investment. As a result, Government bond issuance has been less than 10% of GDP ($4.4 billion total during the period 2000-2005), corporate bonds and municipal bonds were just 1% of GDP ($600 million), and the formal equity market capitalization stood at about 2% of GDP at the end of 2005. On the other hand, bank loans, while having rapidly grown, only represented about 60% of companies' financing needs. With short-term liabilities, banks cannot meet the growing demand for medium to long term finances without increasing term mismatch risks. This gap in the availability of medium to long term funds needs to be filled in order for Vietnam to achieve the 8% growth target in next five years. It also needs to be filled in a financially sustainable manner, which requires development of the domestic capital markets. This document provides and in-depth analysis and recommendations for further development of Vietnam's capital markets.

6. The country has been running modest current account and budget deficits, maintaining its external debt at a sustainable and stable level. However, the budget deficit may grow because the Government may have to increase capital expenditure in order to support and manage its fast economic growth. If some of the capital expenditure is delegated to the provincial and municipal level, sub-national debt will increase instead of government debt. In either case, **the domestic government debt market will have to be enhanced substantially** because the pricing of sub-national debt will depend on the availability of reliable sovereign benchmarks. The sub-national debt should also be captured by appropriate public debt management radar as contingent liabilities of the Government.

7. **Capital market development should facilitate the on going banking sector reforms.** Vietnam's banking sector has expanded rapidly in recent years mostly by supplying loans to the private sector. Four large state-owed commercial banks (SOCBs) still account for about 70% of all credit. Institutional investors and non-bank financial intermediaries are still embryonic. Despite the sector reform underway, the banking sector remains financially weak and requires reinforcement of its capital base to enhance its stability and lending capacity. To do so, equity and subordinated debt instruments will be useful. SOCBs' public issuance of equity or subordinated debt should follow the principles of securities regulation even if the current Vietnamese law does not specifically require it. The banking sector may also benefit from greater competition to accelerate its current reform. Finally, the diversification of the financial sector will become increasingly critical because underdevelopment of the capital markets and institutional investors intensifies banking sector risk (due to over-reliance on bank credit) and reduces prospects for improved corporate governance.

8. **The equitization of SOEs needs to be more closely aligned with the policy to develop the domestic capital markets.** Only SOEs that potentially qualify for public offering and trading should be allowed to place their shares with non-strategic, public investors including employees. It may be worth considering legislation that grants a certain number of minority shareholders a right to audit and force their former SOE to list its shares. More centralized decision making for the equitization may accelerate that of high quality SOEs which qualify for listing. Line ministries' continuous holding of controlling shares in equitized SOEs discourages entry of private companies into industries in which such SOEs operate. A further reduction of line ministries' shareholdings in equitized SOEs may help forge the public confidence in the securities market. Beyond strategic industries, it is generally advisable to limit the State's controlling share holding only to natural monopolies.

9. The unlisted stock market is much larger than the formal stock trading centers (STC), indicating the potential of the market to grow. Trading in the unofficial, over-the-counter market exceeds the official trading on Ho Chi Minh Securities Trading Center, the main trading market, by more than three times with all bond transactions taking place over the counter. While it is encouraging

that an active market exists, it is advisable to entice the players in the unregulated market into a regulated framework to enhance transparency, investor protection, and market surveillance. At the same time, Vietnam's broad capital market strategy should rely more on private-sector initiatives. HOSTC and the HASTC should be reformed to be privately-owned exchanges. The introduction of a securities registration system, an integrated securities depository system, and an individual securities broker/dealer registration system will also help put securities intermediation outside the STCs under control. In particular, the securities registry and depository systems should be designed to serve for not only all listed securities but all publicly tradable ones. The broader scope of regulated market will require enhanced financial statistics supported by appropriate information technology. IT infrastructure development will be required also at the State Securities Commission (SSC) to put the current unregulated market activities under regulatory supervision.

10. The nascent government securities market and the small primary market are core impediments to Vietnam's capital market development. Trading in the government securities market has been modest and holdings are concentrated in commercial banks. It is advisable to review the current debt management and debt issuance policies against World Bank/IMF guidelines and develop and implement market development policy measures in line with the World Bank/IMF Handbook on Developing Government Bond Markets. Those may include, among other things, enhancement of the government cash management and monetary policy framework, reinforce the judicial system for financial contracts with a view to adopting a standard master repurchase agreement, accelerate the listing of state-owned commercial banks, enhance contractual savings and expedite setting up pension schemes for the private-sector. Thus, achieving the government debt market development will require coordinated efforts between key departments of MOF (including SSC), SBV and key market participants.

11. **Corporate governance, transparency, and the judicial system need further enhancement.** It is recommended to establish robust, efficient and equitable accounting, auditing and corporate income tax collection systems; streamline banking supervision to keep banks' maturity mismatch at a modest level; review intermediaries' license categories and criteria to alleviate the concentration of market power of the SOCBs' subsidiary securities firms. There is also a need to review and reinforce the judicial system for not only public, but also private enforcement of financial contracts to protect the interests of investors. Finally, consideration should be given to the establishment of an investor protection fund as an incentive for investors to trade through regulated brokers.

12. **Vietnam's regulatory framework for capital markets is at an early stage of development.** The current governing regulations for the securities market is Decree 144, which narrowly defines securities markets in the scope of institutions, activities, and products offered in the STCs. In addition, the SSC was moved from an independent position to the Ministry of Finance, which may have compromised the SSC's ability to act in an independent fashion. However, the new Securities Law that has been drafted and is scheduled for passage in 2006 aims to more broadly define the scope of the public trading of securities as well as the SSC's mandate to regulate it. It is also expected to provide for the SSC's operational independence. These are encouraging steps which should help forge public and private sector confidence in the capital markets.

13. However, the regulatory framework of the financial industry as a whole is not well-defined and has created room for regulatory arbitrage. Vietnam's financial industry is already operating in a conglomerated form, which may be inevitable to meet the mounting global competition expected from the prospective WTO accession. However, the industry's current regulatory framework is based on entity regulation, whereby a regulatory agency only supervises a particular type(s) of institutions instead of a particular type(s) of business functions. For example, the SSC regulates a brokerage subsidiary of a bank, but not the bank itself which may also be engaged directly in securities activities. To minimize the room for regulatory arbitrage, the regulatory framework needs to be reformed with respect to business functions instead of type of institutions. Regulation should also ensure provision of sound rules for prudential management, governance, transparent trade and fair competition within and between the conglomerates. Policymakers may also be faced with the

choice between a unified model (unified regulatory agency) and a specialist and separatist model (specialist agencies) in near future.

14. The Government should forge a vision for the financial sector that includes the prospective regulatory framework more conducive to Vietnam's economic development. To do so, policymakers and the Government must be able to see a clear, updated and comprehensive picture of the financial industry. It thus requires enhancement of the financial statistics and its supporting information technology infrastructure. Capital market development requires political support as well as orchestrated efforts across multiple branches of the Government and the private sector. A master plan should give priority to addressing the policy and institutional problems over operational issues. It may help for the Government to set key milestones and standard indicators for capital market development and to measure progress.

15. The SSC must lead the Government's efforts in taking specific policy actions to accelerate capital market development over the next five year period. It is recommended that the 2006-2010 five-year plan of Vietnam's capital market development include four groups of policy actions as follows:

(i) Private-sector securities markets

Comprehensive regulatory and supervisory framework for the SSC;

Listing process for SOEs to eliminate owner-regulator conflicts;

Upgrading of the judicial system for financial transactions; and

Improved accounting, auditing and tax collection systems.

(ii) Public debt management and government securities market

Comprehensive regulatory and supervisory regime for the SSC;

Modern reserve management, consistent monetary policy framework;

Best practice debt management and debt issuance policies; and

Contractual savings development and implementation.

(iii) Master plan for a coherent financial sector structure

Analyze the current and forecast the future structure of the financial sector;

Formulate objectives for regulating the financial sector in the future; and

Design and implement a new financial regulatory structure.

(iv) Statistical capacity building and setting an information sharing regime.

Establish a standard set of market indicators;

Develop data sharing networks and safeguard protocols with market operators and participants and across the Government; and

Build capacity for data analysis for market surveillance and policy making.

1 Introduction

16. At the request of the SSC, the World Bank undertook a study project on Vietnam's capital markets and sent a mission to Vietnam from May 15 to May 27, 2005. This report is the result of the study project. The World Bank's suggestions and comments have been delivered to the SSC separately as well.

1.1 <u>Objectives</u>

17. The objectives of the Project were:

To review, analyze and evaluate the situation of Vietnam's securities markets in terms of their internal factors (regulatory framework, market infrastructure, operational capacity, etc.) as well as their external factors (economic reform progress, private sector development, etc.) in reference to experiences in other developing countries including transition economies ;

To work with the officials of the State Securities Commission (SSC) to make specific recommendations for a five-year plan of Vietnamese capital market development in light of policy implementation sequence and priorities;

To make suggestions on the draft of the Action Plan for Securities Market Development for the period of 2006-2010; and to comment on the Prime Minister's Decision No 163 on the Strategy for the Development of Vietnam's Securities Market up to year 2010; and,

To identify desirable capital market-related projects and programs to be administered by the Bank in line with Vietnam's overall economic development strategy.

1.2 <u>Methodology</u>

18. This study project was carried out according to the following methods:

Desk research using (i) reports and data on Vietnam compiled by the World Bank and the IMF; (ii) laws, regulations and rules on banking and capital markets provided by the SSC, and other Vietnamese authorities; (iii) reports provided by the SSC, and other Vietnamese authorities; and (iv) annual reports, prospectuses, and other reports provided by intermediaries, issuers, investors, accountants and lawyers in Vietnam;

Interviews and electronic inquiries with about one hundred officials (i) of the SSC, and other Vietnamese authorities; and (ii) intermediaries, issuers, investors, accountants and lawyers in Vietnam in May 2005; and,

Discussions with and reviews by officials of the World Bank and the IMF who were well versed in the subjects and/or the region.

1.3 <u>The Structure of the Report</u>

19. This report is organized as follows: Sections 2 and 3 will overview Vietnam's macroeconomic situation and the financial markets in Vietnam, respectively. Section 4 will examine SOE equitization, foreign direct investments, and private sector development, which have been considerably influencing capital market development process in the country. Section 5 will review the operation of Vietnam's capital markets in terms of their regulatory framework and activities, examining key issues to find ways to enhance the robustness and efficiency of the markets. Section 6 will explore two principal impediments to Vietnam's capital market development, namely its nascent government securities market and its inactive primary market. Section 7 will discuss the policy and institutional problems that have been adversely affecting the whole financial sector in Vietnam. Finally, Section 8 will recommend policy actions to be implemented under the five-year plan of Vietnamese capital market development.

2 Macroeconomic Overview

20. This section will overview Vietnam's macroeconomic situation and relate their issues to the financial markets.

2.1 Current Situation and Discussion

21. **Vietnam's economy growth has been robust, although it is still catching up to its fast growing neighbors.** In 2004, Vietnam achieved a growth of 7.7 percent, which was the second highest growth rate among ASEAN+3 countries from 2000 to 2004, though its GDP per capital registered at US$ 482 in the tenth place in 2003. (Table 1) The industry and construction sectors, which comprised about 40 percent of GDP, have maintained the annual growth of approximately ten percent since 2000 and pulled the Vietnamese economy. During the same period, the annual growth rate of the services sector, which also comprised about 40 percent of GDP, has increased from 5.3 percent to 7.5 percent, while growth in the agricultural sector has remained relatively low between 2.8 percent and 4.6 percent. These data indicate that Vietnam has been industrializing its economy..

22. Vietnam's effort to join the World Trade Organization (WTO) has successfully increased its international trade and foreign investment. Encouraged by China, Vietnam has gradually liberalized international trade through deregulations that resulted from negotiations in view of the WTO accession. Tariff reductions have contributed to the expansion of imports. Export has also increased by price hike of some commodities and quota-free trade gained through negotiations noted above. High foreign direct investment (FDI) commitments were observed in 2004, which reached US$ 4.2 billion, as well as in the first four months of 2005, which amounted to US$ 2.1 billion. (Table 2) Thus, Vietnamese economy has been increasingly integrated to the world economy

Table 1: GDP Data of ASEAN+3 countries

		2000	2001	2002	2003
Burnei	GDP (current US$ million)	n.a.	n.a.	n.a.	n.a.
	GDP per capita	n.a.	n.a.	n.a.	n.a.
	GDP growth (annual %)	n.a.	n.a.	n.a.	n.a.
Cambodia	GDP (current US$ million)	3,583	3,706	4,000	4,228
	GDP per capita	282	287	304	315
	GDP growth (annual %)	7.0	5.7	5.5	5.2
China	GDP (current US$ million)	1,080,741	1,175,716	1,271,000	1,417,000
	GDP per capita	856	924	993	1,100
	GDP growth (annual %)	8.0	7.5	8.3	9.3
Indonesia	GDP (current US$ million)	150,196	143,034	172,971	208,312
	GDP per capita	728	684	817	970
	GDP growth (annual %)	4.9	3.5	3.7	4.1
Japan	GDP (current US$ million)	4,746,068	4,162,363	3,972,485	4,300,858
	GDP per capita	37,409	32,738	31,181	33,713
	GDP growth (annual %)	2.8	0.4	-0.4	2.7
Korea, Rep.	GDP (current US$ million)	511,928	481,969	546,713	605,331
	GDP per capita	10,890	10,180	11,476	12,634
	GDP growth (annual %)	8.5	3.8	7.0	3.1
Lao PDR	GDP (current US$ million)	1,711	1,750	1,719	2,122
	GDP per capita	324	324	311	375
	GDP growth (annual %)	5.8	5.7	5.0	5.0
Malaysia	GDP (current US$ million)	90,320	88,001	95,164	103,737
	GDP per capita	3,881	3,697	3,915	4,187
	GDP growth (annual %)	8.9	0.3	4.2	5.3
Myanmar	GDP (current US$ million)	n.a.	n.a.	n.a.	n.a.
	GDP per capita	n.a.	n.a.	n.a.	n.a.
	GDP growth (annual %)	n.a.	n.a.	n.a.	n.a.
Philippines	GDP (current US$ million)	75,913	72,043	77,954	80,574
	GDP per capita	991	920	975	989
	GDP growth (annual %)	6.0	3.0	4.4	4.5
Singapore	GDP (current US$ million)	91,476	84,871	88,275	91,342
	GDP per capita	22,767	20,545	21,200	21,492
	GDP growth (annual %)	9.4	-2.4	3.3	1.1
Thailand	GDP (current US$ million)	122,725	115,536	126,770	142,953
	GDP per capita	2,021	1,888	2,058	2,305
	GDP growth (annual %)	4.8	2.2	5.3	6.9
Vietnam	GDP (current US$ million)	31,173	32,685	35,058	39,164
	GDP per capita	397	411	436	482
	GDP growth (annual %)	6.8	6.9	7.0	7.2

Source: World Bank

23. The country has been running **modest current account and budget deficits, maintaining its external debt at a sustainable level.** Its current account has been in deficit since 2002 due to rapid import growth. In 2004, the deficit moderately declined to around 4.0 percent of GDP as net exports grew, partly due to the increased export prices for crude oil and rice. The current account deficit has been financed mainly by official development assistance (ODA) and FDI inflows in capital account. Similarly, the fiscal balance, which had been long in deficit in a range of 4 to 5 percent of GDP, slightly improved in 2004 (Table 2) by controlling current expenditure.

24. A more explicit regulatory framework, a more robust market infrastructure and the availability of more instruments would help the State Bank of Vietnam (SBV) to effectively rein in growing inflationary pressures. Credit growth of 28.4 percent and 41.6 percent in 2003 and 2004, respectively, appear to be inconsistent with objectives for low inflation. In addition, price increases for imported products and foods, caused respectively by the price appreciation of petroleum products and by the shock to farmers of the avian flu and the drought, imposed inflationary pressures on the economy. It seems that the SBV's ability to manage monetary policy has been considerably constrained by the state-owned commercial banks' (SOCBs') conventional operations that are often influenced by non-commercial objectives. The lack of independence has also restrained the central bank from more effective monetary management.

Table 2: Selected Macroeconomic Data of Vietnam

	2000	2001	2002	2003	2004	2005 Q1
Total GDP (percentage change)	6.8	6.8	7.0	7.2	7.7	7.2
Agriculture (percentage change)	4.6	2.8	4.1	3.2	3.5	4.1
Industry & Construction (percentage change)	10.1	10.3	9.4	10.3	10.2	8.5
Services (percentage change)	5.3	6.1	6.5	6.6	7.5	7.0
Export Value Growth (percentage change)	25.2	4.0	11.2	20.8	31.4	-
Import Value Growth (percentage change)	34.5	2.3	22.1	27.8	26.7	-
FDI Commitments (USD billion)	2.7	3.2	3.0	3.1	4.2	2.1
FDI Disbursement (USD billion)	2.4	2.5	2.6	2.7	2.9	-
Saving-Investment Balance	2.1	2.1	-1.2	-4.7	-4.0	-
Gross National Saving	31.7	33.2	32.0	30.4	-	-
Gross Investment	29.6	31.2	33.2	35.1	-	-
ICOR[2]	4.1	4.2	4.4	4.5	-	-
Current Account Balance (percent of GDP)	2.1	2.1	-1.2	-4.7	-4.0	-
Trade Balance (percent of GDP)	1.2	1.9	-2.5	-6.4	-5.0	-
Total Revenue and Grants (percent of GDP)	20.5	21.6	22.2	23.4	23.4	-
Total Expenditure and Net Lending (percent of GDP)	25.5	26.6	26.8	28.4	26.7	-
Fiscal Balance (percent of GDP)	-5.0	-5.0	-4.5	-5.0	-3.3	-
Credit to the Economy (percentage change)	-	21.5	22.2	28.4	41.6	-

Source: GSO, GDC, MPI, IMF and World Bank

[1] The first four months of 2005
[2] Incremental Capital-Output Ratio

25. **Vietnam needs to improve the efficiency of the financial sector by intensifying structural reform efforts**. In order to satisfy the increasing demand for capital in both the public and private sectors to support a high economic growth, financial resources need to be not only expanded but also allocated more efficiently. The WTO accession will expose Vietnamese economic actors to a highly competitive world. An improved financial sector will encourage investors to invest more in Vietnamese industries. The attendant reduction of financial costs and robustness of financial systems will make Vietnamese industries resilient to the international competition and shocks.

2.2 Conclusion and Recommendations

26. **The Vietnamese economy has been one of the best performers among the ASEAN countries.** Its accession to the WTO is expected in 2006. A better FDI environment, an efficient

Government debt issuance system, and a clear monetary policy appear critical for managing the rapid economic growth with inflationary pressures under control.

27. The Government is recommended to:

 Organize its debt issuance program as much in line with international standards for public debt management as possible; and,

 Clearly establish a monetary management framework.

3 Financial Market Overview

28. This section will overview the financial markets in Vietnam, relating their issues to the capital markets.

3.1 Current Situation and Discussion

29. **Vietnam's financial sector has expanded rapidly in the recent years, mostly supplying banking loans to the private sector.** In the banking sector, the credit to the economy rose from VND 156 trillion in 2000 (35 percent of GDP) to VND 420 trillion in 2004 (59 percent of GDP). The ratio of bank deposits to GDP stands at 57 percent. In the securities market, which includes stock, bond and investment funds, total listing value was VND 27.0 trillion in 2004 (4.0 percent of GDP), while it was just VND 1.5 trillion in 2000 (0.3 percent of GDP). The insurance market has also been growing; the penetration rate became 2.0 percent of GDP in 2004 from 0.4 percent in 1993, although it is still relatively low.

30. Commercial banks, especially SOCBs, dominate Vietnam's financial sector, deterring market-

Table 3: Selected Financial Sector Data of Vietnam

	2000	2001	2002	2003	2004	2005*
Banking						
Credit to the Economy (VND tril.)	156	189	231	297	420	
Credit to the Economy (Growth rate)		21%	22%	28%	42%	
Credit to the Economy (% of GDP)	35%	41%	44%	50%	59%	
Claims on SOEs (% of total credit)	45%	42%	39%	36%	34%	
Claims on SOEs (% of GDP)	16%	17%	17%	18%	20%	
Securities						
Stocks						
Listed companies (companies)	5	11	20	22	26	30
Market Cap (VND tril.)	n.a.	n.a.	n.a.	2.3	3.8	5.9
Market Cap (% of GDP)	n.a.	n.a.	n.a.	0.4%	0.5%	0.5%
Bonds						
Listed bonds (issues)	4	18	41	103	207	281
Listing value (par value) (VND tril.)	1.2	2.9	4.3	11.9	23.9	33.7
Listing value (% of GDP.)	0.3%	0.6%	0.8%	2.0%	3.4%	
Investment Fund						
Listed fund (funds)	0	0	0	0	1	1
Listing value (par value) (VND tril.)	0	0	0	0	0.3	0.3
Listing value (% of GDP.)	0.0%	0.0%	0.0%	0.0%	0.1%	
Insurance						
Revenues from premium (VND Tril.)	n.a.	n.a.	7.0	10.4	12.4	
Revenues from premium (% of GDP)	n.a.	n.a.	1.30%	1.72%	1.73%	
Non-life insurance (% of GDP)	n.a.	n.a.	0.49%	0.63%	0.66%	
Life insurance (% of GDP)	n.a.	n.a.	0.82%	1.09%	1.07%	
Revenues from investment (% of GDP)	n.a.	n.a.	0.16%	0.16%	0.26%	
Total assets (VND tril.)	n.a.	n.a.	12.5	18.3	26.7	
Total assets (% of GDP)	n.a.	n.a.	1.6%	2.2%	2.6%	

Source: HOSTC, MOF, IMF and World Bank
* As of October 21, 2005. GDP for 2005 is an IMF projection

based credit allocation as well as equity base reinforcement of Vietnamese industries. Historically, Vietnam's financial system depended heavily on the SBV and two SOCBs, which provided almost all financial services in the country. In 1988, two years after the introduction of Doi moi, the Government established additional SOCBs so that the SBV could specialize in the monetary policy and financial supervision as the central bank. While allowing the private sector to set up joint-stock commercial banks in 1991 and foreign banks to open local branches in 1992, the Development Assistance Fund (DAF), which was intended solely for policy finance, was added to the state-owned financial facilities in 2000. The SOCBs currently account for nearly three-quarters of total bank credit in Vietnam. They are still engaging in non-commercial or politically-preferred lending, especially in rural areas.[1] Market capitalization of all listed stocks is merely VND 3.8 trillion as of the end of 2004, as compared to VND 420 trillion in overall credit to the economy.

31. **Vietnam has been actively developing the insurance industry.** The new Insurance Law, enacted in April 2001, allowed foreign joint venture insurance companies and wholly foreign owned subsidiary branches to operate in Vietnam. As a result, there were two state-owned companies, 11 joint stock companies, and 15 foreign subsidiaries operating in the country's insurance sector as of mid-May 2005.[2] In addition, two out of four state-owned insurance companies have been converted to equitized companies. Vietnam's insurance penetration rate stood at 1.72 percent and 1.73 percent in 2003 and 2004. In Vietnam, unlike most other developing countries, life insurance market is larger share than non-life one. (Table 3) The life/non-life ratio is likely to reverse as motorization intensifies in the country. The Government set a goal of the insurance penetration rate at 4.2 percent – VND31 trillion (US$2 billion) for life insurance and VND9 trillion (US$562 million) for non-life insurance – by 2010.[3 4,] However, the government's goal of insurance industry development is overshadowed by the creeping inflation.[5] Penetration rate growth almost stopped in 2004. (Table 3) In addition, the regulatory and supervisory framework for the industry is fledging. Finally, capital market development has been slow, which limits the availability of high-quality assets and risk management instruments.

32. **Other institutional investors and non-bank financial intermediaries are still embryonic**. In contrast to the insurance industry, the pension fund industry lags behind with one state-managed pension fund (the State Social Insurance Fund) for public servants but no pension funds for private sector workers. The absence of pension funds for private sector workers presumably may be interfering with the development of not only the capital markets but also the private sector by discouraging workers' migration from the public sector to the private sector. There is only one investment fund listed on the Ho Chi Minh City Securities Trading Center (HOSTC). Regarding the leasing business, there were nine companies at the end of 2004; some of them were subsidiaries of SOCBs and others were joint companies with foreign capitals.

33. Despite various sector reforms underway,[6] the banking sector remains financially weak and may benefit from more competition to accelerate its current reform agenda. NPLs of SOCBs were estimated at approximately 15 percent of total credit as of May 2005, which was about eight percent of GDP.[7] Assessments based on International Accounting Standards (IAS) audits suggest that the overall

1 World Bank (2005), Taking Stock – An Update on Vietnam's Economic Developments and Reforms.

2 http://www.vneconomy.com.vn/eng/index.php?param=article&catid=0403&id=050511111500

3 The Prime Minister's Decision No. 175/2003/QD-TTg

4 The Ministry of Finance of Vietnam, 2005, *Vietnam's insurance market in 2004,* and http://www.vneconomy.com.vn/eng/index.php?param=article&catid=0403&id=050511111500

5 Inflation would generally depress the public's demand for insurance policies.

6 World Bank (2005), *Taking Stock – An Update on Vietnam's Economic Developments and Reforms.* The reforms include the improvement of payments system, the development of accounting rules aligned with International Accounting Standards, enhancement of procedures for the collection and sharing of credit information, an establishment of legal framework for modern financial products and services, and the implementation of risk-based prudential supervision of banks.

7 World Bank (2005), *ibid.*

quality of the SOCBs portfolio is not improving. On the contrary, according to the judgment of external auditors analyzing the limited information, the SOCBs have already suffered from capital shortfall.[8] Despite improvements in some individual financial issues, it seems that Vietnam has yet to address problems fundamental to the financial sector. In addition to potentially positive effects of competition from foreign banks, the capital market will also possibly help SOCBs lessen NPLs by providing indebted companies and SOCBs with additional equity cushion and/or second-tier capital.

34. **The banking sector reform has been inadvertently creating a funding gap in the medium- and long-term segments.** In order to rein in the recent sharp credit growth as well as maturity mismatch, the SBV issued an ordinance to commercial banks in April 2005 to limit medium- and long-term lending to 40 percent of their short-term funds.[9] On the other hand, the capital markets, which are aimed at supplying the economy with medium- and long-term risk capital, remain underdeveloped. A total of 30 companies with market capitalization of $371 million[10] are listed on the HOSTC five years after its inception. In addition, the government debt market and especially the corporate bond market are still in an early development stage. Consequently, the banking reform underway leaves a funding gap in the medium- and long-term segments.

35. The reinforcement of shareholders' equity capital is also vital to a successful banking sector reform as equity capital enhances the stability of the banking system as well as banks' lending capacities. SOCBs have been plagued with capital shortfalls. The high-growth economy has been causing banks to expand their loan portfolios. Meanwhile banks' credit analyses are said not to be scrupulous enough under a lasting effect of non-commercial based lending.[11] For example, by allowing the Government, the People's Committees and other authorities to intervene in bank management and operations,[12] the SBV laws and the Credit Institutions Law leave room for potential non-commercial based lending. Given this incomplete state of the reform, the capital markets may help commercial banks streamline their operations and provide indebted companies and SOCBs with additional equity and/or second-tier capital.

3.2 Conclusion and Recommendations

36. **Though Vietnam's financial sector has been expanding rapidly, the delayed SOCB reform is a bottleneck.** An unintended financing gap for medium- and long-term debt appears widening. Strengthening of the equity base of borrowers as well as lenders could complement reforms in the banking sector.

37. The Government is recommended to:

- Accelerate and deepen the banking sector reform; and,
- Continue to develop well-functioning capital markets – both equity and debt markets – to facilitate the banking sector reform.

8 IMF (2004), Vietnam: Selected Issues
9 World Bank (2005), *ibid.*
10 As of October 21, 2005.
11 World Bank (2005), *ibid.*
12 Articles 6 to 8 of the Law on the State Bank and Article 116 of the Law on Credit Institutions

4 Capital Market Environment

38. This section will examine the equitization of state-owned enterprises (SOEs), foreign direct investments, and private sector development, which have been considerably influencing capital market development process in the country.

4.1 SOE equitization

4.1.1 Suggested improvements of equitization

39. Some improvement of the current equitization process and requirements would help materialize economic and capital market development effectively. Equitization is the very first step for economic development in general and for capital market development in particular in Vietnam. Of 30 joint stock companies listed on the HOSTC as of October 21, 2005, 29 were former SOEs. Of more than 2,000 equitized SOEs, approximately 400 companies are said to qualify for listing. The equitization framework prescribed in the three decrees stop short of accelerating the equitization and subsequent listing of well-performing SOEs.

40. **A more centralized decision making mechanism may accelerate the equitization of potentially listing-qualified SOEs.** The decentralized nature of the current equitization framework is likely to delay the equitization of SOEs by allowing decisions on equitization to be inconsistent. Professional skills are vital to warrant the quality of an SOE-converted joint stock company and to prevent unnecessary delay in equitization and listing. In centralized evaluation, it may be desirable for the centralized decision making body to consult the line ministry and the people's committee concerned so as to reasonably adjust the equitization plan to the factors specific to the SOE. Under the current arrangement, however, the evaluation is left solely to the line ministry and the people's committee that regulates and supervises the SOE. Not every line ministry and people's committee may have evaluation skills sufficiently. Some line ministries and people's committees may try best to defend their interests vested in the SOE. The decision makers with vested interests may see benefits in delaying equitization and listing.

41. Only SOEs that qualify for and commit to listing or public offering should be allowed to place their shares with minority shareholders such as employees, and non-strategic investors. Many SOEs that are large and financially attractive to the investing public are likely to fall under this category. The current equitization regulations do not require every SOE that chooses to sell its shares to employees, and/or non-strategic investors to list its shares on a stock trading center. In most jurisdictions[13], when a privatization takes place, investors are entitled to know before subscribing whether there will be a trading market for their shares and what information will be available subsequently.[14] With the current weaknesses in the legal and regulatory framework for publicly traded securities and companies, mandatory listing of equitized SOEs eligible for listing may be considered. Listing will enhance the transparency of an equitized SOE's operations and the accountability of its management as well as the liquidity of its shares. It should also make "closed" transactions involving no outsiders difficult.[15] Those equitized SOEs that are not ready for listing should not be allowed to sell their shares to their employees and non-strategic investors.[16] The absence of the mandatory listing requirement for listing-eligible equitized SOEs may be partly responsible for the burgeoning

13 with an exception of some former socialist countries which adopted a mass privatization program.

14 Some minority shareholders, who are not familiar with securities markets, may not understand well the economic implication of listing or unlisting of the shares that are offered to them.

15 On average, employees have bought about 55 percent of the shares. P. 19, the World Bank, June 2-3, 2005, *Taking Stock – An Update on Vietnam's Economic Developments and Reforms.*

16 The flip side of this qualified mandatory listing requirement will be that it may implicitly encourage a whole equitized SOE to be sold to strategic investors. This is not necessarily a bad policy for job creation and economic development as long as the fairness of an SOE sale transaction is assured and is balanced with a set of counter-balancing policy measures. The counter-balancing policy measure includes certain restrictions of the sale of the strategic investors' holdings and tax holidays for listed companies.

unregulated market of shares. If the prospective Securities Law adequately addresses the issue of public offering of securities and publicly held companies, the idea of mandatory listing may be revisited, however.

42. A legislation that grants a certain number of outsider minority shareholders a right to audit and force their former SOE to list its shares is also likely to strengthen minority shareholders' rights. Approximately 400 former SOEs that qualify for listing under the current listing criteria have are hesitant to list their shares. This means that for each of such SOEs, at least 50 minority outside shareholders holding at least 20 percent of the stake[17] are deprived of an opportunity to realize market value of their shares while insiders of the company may be enjoying superfluous benefits from inside dealings. The strengthening of minority shareholder rights tends to increase outsider investor enthusiasm resulting in more share sales to outsiders and higher equitization proceeds. Equity sold to outsiders accounted for no more than nine percent in 2004.[18] It means that many of the 400 hundred companies are considered to have at least several hundred shareholders.

43. Liquidating or substantially cutting back on line-ministries' holdings in equitized SOEs may help forge the public's confidence in the securities markets, eliminating owner-regulator conflict of line-ministries.[19] Of 30 former SOE companies listed on the HOSTC, 27 companies were still owned by the State. The State holdings in the 27 companies averaged 21.7 percent as of the end of June 2006. Of approximately 1,500 SOEs that were equitized (transformed into joint stock companies) as of December 2004, 909 companies[20] or 60 percent were 35 percent or more owned by the State. Most line-ministries holding substantial shares of equitized SOEs are the regulators of the industries in which the equitized SOEs do business. In an owner-regulator conflict situation, the investing public is not sure if the management of a company with a serious owner-regulator conflict is pursuing the best possible interest or the maximum possible profit for minority shareholders of the company. Otherwise, an owner-regulator conflict in an equitized SOE discourages other companies from entering the same market or industry that the equitized SOE is doing business, interfering with private sector development.

44. The manner in which SOE's assets and liabilities are separated from the State should be made more transparent. The transparency will help make the evaluation of an equitized SOE easier and create a well-informed demand for shares auctioned by an SOE, enhancing the confidence in the country's stock market. The current equitization appears ambiguous in separating an SOE's assets and liabilities from the State. For example, the State's proceeds from the sale of its stake may be partly used for compensating retrenched workers and may be "used" for the partly sold SOE's operations. (Article 35-1 of Decree 187 on transformation of SOEs into joint stock companies)

45. More generally, it will be effective to develop a competitive private sector if the Government focuses its control only on a small number of carefully selected sectors and enterprises. Currently, the Government instead retains the majority or substantial shares of most SOE-converted joint stock companies that are listed or are qualified for listing. Government intervention in those companies can undermine the competition in the sectors in which the companies operate. In addition to owner-regulator conflicts, a protective environment for government-controlled companies undercuts the efficiency of their operations and, consequently, their sectors.

17 A listing requirement of the HOSTC

18 P. 19, the World Bank, *ibid.*

19 Natural monopolies as well as strategic industries are exceptions to this. Such SOEs may need to be controlled by the State or provincial government into a foreseeable future.

20 *cf* data in Projection on Monitoring of SOE New Establishments and Transformation , NSCERD

46. The scope of "state capital" that the State Capital Investment Corporation (SCIC)[21] will manage should be carefully limited so that the Government may not be seen as interfering with the market through the SCIC. The SCIC may or may not be a solution for capital market-related issues arising from SOEs, depending mainly on the scope of "state capital." The SCIC may help rationalize and accelerate the liquidating process of state ownership in equitized SOEs by functioning as a professional and centralized decision making mechanism. It may also alleviate an owner-regulator conflict by transferring the State ownership rights in equitized SOEs from line-ministries or other public offices to the SCIC. However, if it operates to retain state control over many sectors and/or the securities markets, the SCIC will hinder or at best substantially deter developing the private sector as well as forging the public's and confidence in the securities markets.

4.1.2 Lessons from European transition countries and China[22]

47. In European transition economies, the quality of listed companies and the market were key determinants of the development of their capital markets. The quality of listed companies is represented by the companies' profitability, growth, size, governance, disclosure, etc., while the quality of the market is reflected by market regulation and supervision, trading and settlement efficiency, professional, competitive and ethical intermediation, etc. None of the privatization approaches European transition economies took could develop its capital markets in the short term.[23] Direct sales of state assets did not have any influence on capital markets, at least initially. On the other hand, mass privatization tended to put aside the standard requirements for due diligence, disclosure and listing and destroyed the confidence in the capital markets. The assumption that more companies listed regardless of their quality would create more liquidity has empirically been shown to be incorrect

48. Another common factor among European transition countries now enjoying high or steady economic growth is that they employed the privatization of SOEs as one of multiple policy measures for private sector development. As such, private sector's share of GDP increased sharply in European countries during the first several years of transition. For instance, the share of the private sector in Hungary increased from 30 percent in 1991 to 80 percent in 2003. (Table 5) By contrast, the state sector's share in Vietnam has remained approximately 40 percent of GDP at least from 1995 to 2002. (Table 6) The private sector's share in Czech Republic's total employment went up from 20 percent in 1990 to 65 percent in 1994 (Table 7), while in Vietnam 56.2 percent are employed in non-state sector in 2003. (Table 9 in p.25) The four European countries, Czech Republic, Hungary, Poland, and Russia, instituted private pension funds for the social security of workers in the private sector, though Vietnam has yet to introduce a pension fund system for the private sector workers...

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21 The Prime Minister's Decision of June 20, 2005 (Decision No. 151/2005/QD-TTg) established the SCIC and the underlying rationale behind the creation of the SCIC was to reform the State Owned Enterprises (SOE) sector primarily through the consolidation of the shareholding in most SOEs into one institution. The SCIC will start with a charter capital base of about VND 5 trillion (US$316.5 million). The Government is said to have modeled the SCIC after Temasek Holdings of Singapore, which is the Singaporean Government's investment management company.

22 This section heavily relied on various literatures on the subject published by the World Bank and other institutions as well as input from World Bank's staff working for East European countries and China.

23 Fungacova (2005), Building a castle on sand: Effects of Mass Privatization on capital market creation in transition economies.

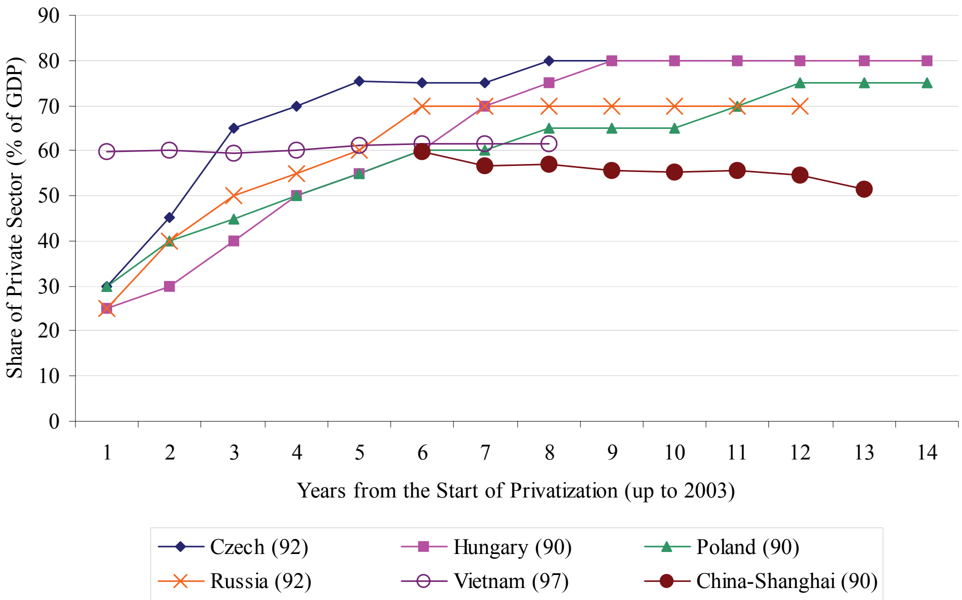
Table 4: Private Sector Share of GDP in Years from the Start of Privatization

(percent)

	Privatiza-tion started	Stock exchange est'd or re-est'd	Years from the Start of Privatization (up to 2003) Yr 1	Y 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Yr 12	Yr 13	Yr 14
Czech	1992	1993	30	45	65	70	75	75	75	80	80	80	80	80	-	-
Hungary	1990	1990	25	30	40	50	55	60	70	75	80	80	80	80	80	80
Poland	1990	1991	30	40	45	50	55	60	60	65	65	65	70	75	75	75
Russia	1992	1995	25	40	50	55	60	70	70	70	70	70	70	70	-	-
China-Shanghai	1990	1990	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	60	57	57	56	55	56	54	52
Vietnam	1997	2000	60	60	61	61	62	62	61	-	-	-	-	-	-	-

Source: EBRD, GSO, and World Bank staff's analysis

Figure 1: Private Sector Share of GDP in Years from the Start of Privatization

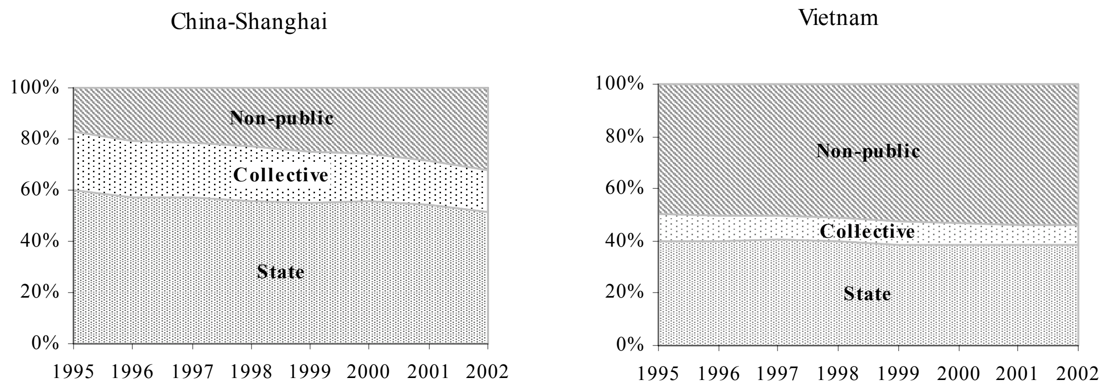


Source: EBRD, GSO, and World Bank staff's analysis

49. At the start of privatization, the Vietnamese and Chinese economies were much less state-owned and industrialized than the European transition economies used to be, privatizing SOEs to much less a degree than the European counterparts did.[24] In Vietnam and China, non-stated owned sectors remained around 60 percent and in the range of 50 to 60 percent of GDP, respectively, since privatization had started; and hence the state-owned sector hardly shrank in Vietnam, and slightly expanded in China (Table 4 and Figure 1). Instead, foreign-owned enterprises increased in the share of GDP at the expense of collectives during the privatization period (Figure 2). By contrast, privatization programs in the European transition countries drastically transferred ownership from the state to the private sector.

24 The sector share of GDP by ownership in China is not available. Instead, the sector share of GDP by ownership in Shanghai available at http://www.stats-sh.gov.cn/2003shtj/tjnj/2003e/tables/2_9.htm is used here as its proxy. However, the sector share of GDP by ownership at the national level might significantly differ from that in Shanghai.

Figure 2: Sector Share of GDP by Ownership in China-Shanghai & Vietnam



·ce: GSO, Shanghai Statistical Bureau, and World Bank staff's analysis

50. Vietnam's GDP may have been less dependent on SOEs and collectives, its privatization may have been slower, and its collectives may have shrunk more modestly, as compared to China. (Figure 1) The state-owned sector's share of GDP in Vietnam marginally declined from 40.2 percent in 1995 to 38.4 percent in 2002, while that in China decreased from 59.7 percent in 1995 to 51.6 percent in 2002. Collectives' share of GDP in Vietnam fell from 10.1 percent in 1995 to 8.0 percent in 2002, whereas collectives' share of GDP in China dropped 23.2 percent in 1995 to 16.5 percent in 2002. (Figure 1) In China, a noticeable growth of foreign ownership made up for a decline in collectives' share. European transition countries and China have more active capital markets than Vietnam in terms of stock turnover over GDP (Table 10), but the forces behind their active capital markets seem different.[25] In European transition countries, privatization helped rejuvenate the economy dominated by inefficient industrial SOEs, ultimately leading to brisk market activity. In China, the "quota system" – an administrative incentive system under which a better performing region was given a larger IPO quota – [26] played a key role in jump-starting the market. Chinese SOEs have not been privatized to the same extent as SOEs in the European transition countries.

51. It is not clear whether China's stock market policy based on SOE corporatization – i.e. listed companies are kept majority-owned by the state while only about 35 percent of the total shares of a company are tradable – has been successful in reforming SOEs.[27] China's stock trading started with listing of eight SOEs on the Shanghai Stock Exchange in 1990. SOE privatization was stepped up in mid-1990s. The quota system was applied to SOEs' IPOs and listing. In contrast to marginal capital raising in the Eastern European markets, consequently, the Chinese market supplied as much as RMB 508 billion (US$ 62 billion) through 414 IPOs from 1998 to 2001.[28] However, the selection of companies for listing was not necessarily based on economic merits (*e.g.* profitability and profit), but

25 The comparison of component changes in the whole Vietnam's GDP with the metropolitan Shanghai's GDP has to be cautiously made.

26 Each year from 1993 to 2000, the People's Bank of China established the amount of shares firms were allowed to issue to the public. Within the quantity constraint thus established, the China Securities Regulatory Commission (CSRC) allocated quotas to different provinces and ministries on the basis of the size of the quota that each provincial government and the respective provincial branch of the CSRC had agreed upon through negotiation for their province. (Pistor, Katharina, and Chenggang Xu, 2004, "Governing Stock Markets in Transition Economics: Lessons from China," Working Paper No. 262, Columbia Law School, Columbia University)

27 Wang, Xiaozu, et al., 2004, "State-owned enterprises going public: The case of China," *Economics of Transmission*, Vol. 12 (3), 467-487, EBRD

28 Pistor, Katharina, and Chenggang Xu, 2004

was found significantly influenced by political factors. Reckless lending also pyramided stock prices,[29] driving many IPOs. Sharp market corrections and substantial capital losses were inevitable.

52. The consolidation and industrialization of the private sector appears essential for Vietnam's private sector development, and the capital market is likely to need to adapt for facilitating such process. Listing of high-quality equitized SOEs will drive private sector development. From the analysis above, however, it is reasonable to assume that Vietnam has a smaller number of high-quality SOEs than the European transition countries did. Furthermore, about a half of the country's private sector output is attributable to household businesses (Table 6), presumably for lack of skills, materials, capital, technology, and/or regulatory framework necessary for large-scale operations. There could be

Table 5: Private Sector Share of GDP in Selected Transition Countries

(percent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Czech	10	15	30	45	65	70	75	75	75	80	80	80	80	80
Hungary	25	30	40	50	55	60	70	75	80	80	80	80	80	80
Poland	30	40	45	50	55	60	60	65	65	65	70	75	75	75
Russia	5	5	25	40	50	55	60	70	70	70	70	70	70	70

Source: EBRD

Table 6: Sector Share of GDP by Ownership in Vietnam

(percent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003*
State	40	40	40	40	39	39	38	38	39
Non-state	60	60	60	60	61	61	62	62	61
Collective	10	10	9	9	9	9	8	8	7
Private	7	7	7	7	7	7	8	8	8
Household	36	35	34	34	33	32	32	32	31
Foreign investment sector	6	7	9	10	12	13	14	14	14

Source: GSO * preliminary

Table 7: Private Sector Share of Employment in Selected Transition Countries

(percent)

	1990	1991	1992	1993	1994	1995	1996	1997
Czech	20	30	40	60	65	-	-	-
Hungary	-	-	-	-	-	-	-	-
Poland	49	50	54	57	59	62	65	-
Russia	13	13	18	28	33	34	35	-

Source: World Bank

a lot of promising candidates in the household sector that may develop into high-quality listed companies if the government sets policies to facilitate the consolidation of such household ventures. Therefore, SOE equitization alone cannot address low productivity arising from small-scale private sector businesses. Thus, the capital market may also meet the need of small-scale private enterprises by tuning its regulations and market infrastructure partly for financing institutions such as leasing companies, venture capital funds, micro-finance companies that directly serve small- and medium-size enterprises.

29 Cooper, Mary Comerford, 2003, "The Politics of China's Shareholding System," Stanford University

4.2 Foreign Direct Investment

53. **FDI commitment reached US$ 4.2 billion in 2004 and has significantly contributed to rising investment and economic growth**. Vietnam had enjoyed an FDI boom in the middle of 1990s, which was driven by large-scale investments in real estate, hotels and other capital intensive

Table 8: FDI Projects Licensed 1998-2005 [1, 2]

	Number of projects	Total registered capital (US$ mil.)	Total registered capital per project (US$ mi.)
1988	37	321.8	8.7
1989	69	525.2	7.6
1990	108	735.0	6.8
1991	151	1,275.0	8.4
1992	197	2,027.0	10.3
1993	274	2,589.0	9.4
1994	367	3,746.0	10.2
1995	408	6,848.0	16.8
1996	387	8,979.0	23.2
1997	358	4,894.2	13.7
1998	285	4,138.0	14.5
1999	311	1,568.0	5.0
2000	389	2,018.0	5.2
2001	550	2,592.0	4.7
2002	802	1,621.0	2.0
2003	748	1,899.6	2.5
2004	679	2,084.5	3.1
2005	259	1,685.9	6.5

Source: GSO
[1] Excluding supplementary capital to the licensed projects of the previous years, the projects of VIETSOPETRO
[2] As of 20 May 2005

industries.[30] (Table 8) By contrast, the majority of current FDIs are relatively small investments in labor-intensive industries of small manufacturing and export-oriented businesses,[31, 32] but FDIs have substantially increased in number and amount. In the first four months of 2005, commitments amounted to US$ 2.1 billion, or 45 percent of the yearly plan.

54. Vietnam still has barriers preventing multinational enterprises from investing in the country, though the country has been making every effort to be competitive to rival countries in attracting FDIs. For instance, some ministries, ministerial agencies, and provincial people's committees are said to have issued documents that restrict or cease investment licensing. In fact, Prime Minister's Directive No. 13 of 2005 warned not to issue such documents that "do not comply with the Law on Foreign Investment and related legislative documents and international commitments." It is encouraging that Vietnam will unify the enterprise law with the SOE law and the domestic investment law with the foreign investment law in order to ensure that all sorts of enterprises in Vietnam can operate in a level-playing field and equal footing.[33]

55. **FDIs' impact on capital market development would be indirect rather than direct.** It is hardly expected that locally established FDI companies will raise debt and/or equity capital in the local markets in a significant manner. Generally, their foreign parents have better credit standing and better access to finance in more advanced financial markets. Hence, the parents can provide their local subsidiaries with funds that they raise at a lower cost and in a timelier manner than the local subsidiaries do by themselves. When they need local currency funding, the local companies tend to look to the local branches of foreign banks with which their parents have business relationship. The local branches of

30 Economist Intelligent Unit (April 2005), *Country Report: Vietnam.*

31 Economist Intelligent Unit (April 2005), *ibid.*

32 http://www.vneconomy.com.vn/vet/?param=print&id=7253

33 The 11th National Assembly passed the Unified Enterprise Law and the Common Investment Law in December 2005, and the two laws will take effect in July 1, 2006.

Table 9: Business Factor Distribution by Type of Business in 2003 (%)

	Number of enterprises	Employees	Capital sources	Turnover	Contribu-tion to state budget
State enterprises	6.7	43.8	59.1	46.6	48.5
Private sector	89.6	39.6	19.6	33.3	14.9
Cooperatives	5.8	3.1	0.7	0.9	0.3
Private businesses	35.6	7.3	2.2	7.1	1.9
Limited companies	41.9	22.1	9.6	19.3	9.2
Joint stock companies	6.3	7.1	7.0	6.0	3.5
Foreign investment companies	3.7	16.6	21.4	20.1	36.6
Total	100.0	100.0	100.0	100.0	100.0

Source: GSO

foreign banks often fund the local companies at a competitive rate in the local currency with a letter of guarantee, a letter of awareness, or similar arrangements from their parents. Furthermore, their parents normally prefer not diluting their ownership through equity issuance in order to retain their control over the local companies. IPOs and listings by locally established FDI companies are exceptional. Nonetheless, FDIs will help develop the local capital markets by providing purely local companies with growth opportunities.[34]

56. **FDIs by overseas Vietnamese may be more involved in the local capital markets**. Entrepreneurial overseas Vietnamese tend to be capital-constrained, relative to multinational companies. Therefore, they are likely to attempt to leverage their direct investment in Vietnam with capital that is locally available. The local capital markets will allow them to raise additional capital through initial public offerings or debt issues. In addition, the possibility to divest in the local markets enables them to have an exit strategy for their FDIs, and may help maximize their return on investment.

4.3 Private sector development

57. The private sector remains substantially outnumbered by the SOEs in terms of number of workers as well as amount of capital recourses. The number of private enterprises sharply increased by 22.6 percent per year between 2000 and 2003, while that of SOEs decreased by 5.6 percent per year. [35] As a result, the SOEs and the private sector accounted for 6.7 percent and 89.6 percent of Vietnamese enterprises in 2003, respectively. (Table 9) In a sharp contrast to the numbers of enterprises, the private sector hired 39.6 percent of the workforce and utilized 19.6 percent of the capital sources in 2003. At the same time, SOEs had 43.8 percent of the workforce and used 59.1 percent of the capital resources.

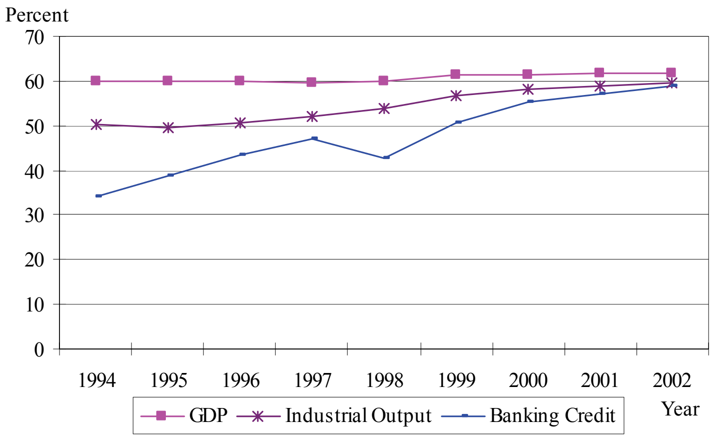
58. Meanwhile, the private sector appears to have steadily increased its share in industrial output and banking credit relative to the public sector since 1994.[36] The share of "non-state" sector, which is assumed to be a proxy for the private sector, in industrial output increased from 50.4 percent in 1994 to 60.9 percent in 2003, while its share in banking credit rose from 34.1 percent to 60.4 percent during the same period. (Figure 3)

34 Developed capital markets will at least in theory give the foreign parents an additional exit strategy for their FDIs – divesture in the local capital market –, making Vietnam attractive as an FDI destination.

35 The General Statistics Office of Vietnam at http://www.gso.gov.vn/default_en.aspx?tabid=508&ItemID=2603

36 In the "non-state sector, banking credit noticeably increased from 1994 to 2002, relative to industrial output and GDP. (Figure 3) The interpretation of the conspicuous differences in increase rates among the three indicators needs more analysis. At this moment, statistical ambiguity prevents us from doing a meaningful analysis.

Figure 3: " Non-State" in GDP, Industrial Output & Banking Credit from 1994 to 2002



Source: Based on data from GSO and SBV.

59. Financial efficiency and productivity gains will become increasingly important for enterprises to compete as Vietnam joins the WTO. WTO accession will require Vietnam to open domestic markets further to foreign countries and multinational corporations that are in general more financially sophisticated. Vietnamese enterprises will inevitably be put in a position to compete with financially sophisticated foreign corporations.

60. Liquidating line-ministries' holdings in equitized SOEs is likely to eliminate line-ministries' owner-regulator conflict, by encouraging private sector companies to enter the market in which the equitized SOEs operate. The shifting of line-ministries role from owners to regulators would increase chances that private sector companies succeed and go public. As has been discussed in Section 4.1.1, substantial state ownership through line-ministries is rife in Vietnam's industries. That business environment does not warrant fair competition, a level playing field, or an equal footing.

4.4 Conclusion and Recommendations

61. **Vietnam's capital market development should not be compromised to accommodate the current form of SOE equitization.** Minority shareholders' rights and a liquidation of line-ministries' owner-regulator conflict are vital to enable proper functioning of capital market mechanisms. The experiences of European transition countries proved the importance of capital market fundamentals such as institutional and legal framework and high-quality companies rather than a flood of poorly screened companies for a smooth running of capital markets. By contrast, China administratively allocated IPO quotas to provincial governments and ministries from 1993 to 2000 to jump start its capital market (the quota system), while retaining control over many privatized SOEs. China's administrative drive for IPOs and listing apparently backfired when listed companies performed poorly. In Vietnam, the non-state sectors with a large GDP share but small-scale operations also are worth attention. Financial efficiency to be achieved by the private sector is likely to play a key role in Vietnam's surviving WTO competition. Meanwhile, FDIs' positive impact on capital market seems indirect.

62. The Government is advised to:

- Rely more on private sector initiatives for capital market development;
- Refrain from compromising listing eligibility for the sake of SOE equitization;
- Respect minority shareholders' rights to enhance values of equitized SOEs;
- Deepen SOE equitization to eliminate line-ministries' owner-regulator conflict;
- Carefully limit the scope of "state capital" that the SCIC will manage; and,
- Consolidate and industrialize small-scale operations in the private sector and partly adapt the capital market for facilitating the consolidation and industrialization process.

Table 10: Comparative Chart of SOE Equitization and Capital Markets

			Czech	Hungary	Poland	Russia	China	Vietnam
GDP (2003, Current USD billion)			90	83	210	433	1,417	39
Population (2003, million)			10	10	38	143	1,218	81
GDP per capita (2003, USD)			8,794	8,169	5,487	3,018	1,100	482
GDP growth rate (average from 1999 to 2003)			2.5	4.0	2.8	6.7	8.0	6.5
Membership of major economic organizations			WTO (1995), EU (2004), OECD (1995)	WTO (1995), EU (2004), OECD (1996)	WTO (1995), EU (2004), OECD (1996)	-	WTO (2001)	ASEAN (1995)
Privatization / Reform of SOEs	Year of privatization		1992	1990	1990	1992	1990	1997
	Main exceptional industries / companies		Railways, postal service, power generation	Railways, postal service	Major banks, insurance companies, steel companies, mining company	Oil, natural gas	Defense, natural monopoly industries and industries which provide essential public goods	National and international communication cable network, publishing, railways, oil, defense, tobacco, some large wholesale
	Primary Method		Vouchers	Direct sales	Direct sales	Vouchers	MBOs and MBEOs[1] for small and medium enterprises, Direct sales for large enterprises	Equitization
	Secondary Method		Direct sales	MEBOs	MEBOs	Direct sales		Negotiated sales
	Year of voucher / share distribution		1992, 1994	-	1995	1992	-	-
	Other countries with similar models		Bulgaria, Moldova, Romania, Slovakia	-	Kazakhstan, Romania	Belarus	-	-
	Sequence of restructuring and corporatization / privatization		Corporatized-first-restructure-later [2]	n.a.	n.a.	Corporatized-first-restructure-later [2]	Sale of small and medium SOEs had started in localities in the first half of 1990s	The number of SOEs had reduced from about 12,000 to about 5,500 between 1991 and 1997, and then full-scale Equitization started in the late 1990s
	Privatization of state-owned commercial banks (privatized / initial #)		n.a.	n.a.	n.a.	n.a.	n.a.	0/6
	Ownership distribution	Insiders	n.a.	n.a.	n.a.	62.3% (2000)[3]	n.a.	58%
		State	n.a.	n.a.	n.a.	5.7% (2000)[3]	n.a.	32%
		Outsiders	n.a.	n.a.	n.a.	32.0% (2000)[3]	n.a.	10%
		Others	n.a.	n.a.	n.a.	0% (2000)[3]	n.a.	0%
	EBRD transition indicators[4] (change from 1995 to 2004)	Large-scale privatization	4 → 4	4 → 4	3 → 3+	3 → 3+	-	-
		Small-scale privatization	4 → 4+	4- → 4+	4 → 4+	4 → 4	-	-
		Governance and enterprise restructuring	3 → 3+	3 → 3+	3 → 3+	2 → 2+	-	-

			Czech	Hungary	Poland	Russia	China	Vietnam
	Name		Prague Stock Exchange	Budapest Stock Exchange	Warsaw Stock Exchange	Moscow Central Stock Exchange, Russian Stock Exchange, Russian Trading System (RTS) etc	Shanghai Stock Exchange, Shenzhen Stock Exchange, Hong Kong Stock Exchange	Ho Chi Minh City Stock Trading Center (HOSTC), Hanoi Stock Trading Center (HASTC)
	Starting year of operations		1993	1990	1991	1995 (RTS)	1990 [5]	2000 (HOSTC), 2005 (HASTC)
	Sources of stock market origins [6]		Mandatory listing after mass privatization	Voluntary IPOs	Mandatory listing of minority packages during privatization	Mandatory listing of minority packages during privatization	Mandatory listing of large SOEs	Voluntary IPOs and then mandatory listing
Stock Exchanges	the total number of listed companies		52 [7]	45 [8]	230 [8]	215 [10]	1,287 [5, 9]	28 (HOSTC)
Stock Exchanges	the number of ex-SOEs listed		48 [7]	29 [7]	n.a.	n.a.	940 [5, 9]	25 (HOSTC)
Stock Exchanges	exchange turnover (stocks only) / GDP	2002	8.18%	9.04%	8.16%	10.47%	26.61% [5]	0.15%
		2003	10.07%	9.96%	9.89%	18.83%	34.33% [5]	0.07%
		2004	17.44%	12.83%	13.95%	22.47%	31.01% [5]	0.24%
Stock Exchanges	exchange turnover (stocks only) / market capitalization (stocks only)	2002	41.29%	51.36%	57.58%	29.09%	73.03% [5]	n.a.
		2003	39.95%	53.30%	47.56%	35.10%	n.a.	17.86%
		2004	49.16%	50.30%	40.63%	48.83%	114.24% [5]	44.45%
	EBRD transition indicators[4] (from 95 to 04)	Banking sector reform	3 → 4-	3 → 4	3 → 3+	2 → 2	-	-
		Reform of non-bank financial institutions	3 → 3+	3 → 4-	3 → 4-	2 → 3-	-	-

Source: The European Bank for Reconstruction and Development (EBRD), Transition Report. Fungacova (2005), Building a castle on sand: Effects of mass privatization on capital market creation in transition economies. Desai (1995), Russian Privatization: A comparative Perspective. US Department of State, People's Bank of China, Prague Stock Exchange, Budapest Stock Exchange, Warsaw Stock Exchange, Shanghai Stock Exchange, Shenzhen Stock Exchange, Ho Chi Minh Stock Trading Center and World Bank staff analysis

1 MBO means Management Buy Out, and MEBO Management Employee Buy Out

2 Desai (1995): "Russian Privatization: A comparative Perspective,"

3 Kuznetsov et al. (2001): "The determinants of privatized enterprises performance in Russia," and Sprenger: "Ownership and Corporate Governance in Russia Industry: A Survey"

4 A score of 1 indicates little progress, and a score of 4+ standards and performance typical of advanced industrial economies.

5 Only Shanghai and Shenzhen

6 For European transition countries, Claessens S., Djankov S., Klingebiel D. (2000): "Stock Market in Transition Economies," Financial Sector Discussion Paper No.5, The World Bank

7 As of June 27, 2005.

8 As of June 24, 2005.

9 At the end of 2003.

10 At the end of 2004.

5 Operations of Capital Markets

63. This section will review the operation of Vietnam's capital markets in terms of their regulatory framework and market activities, and will explore key issues to enhance the robustness and efficiency of the markets.

5.1 Regulatory framework

64. **The securities market reforms underway represent significant progress towards best practice regulation.** At present, the SSC is responsible for regulating the country's security market under the MOF. The regulatory framework for capital markets in Vietnam mainly comprises Decree No. 90 of 2003[37], Decree 144 of 2003,[38] and Decree No. 66 of 2004[39]. Decree 144 of 2003 limits the country's securities market regulation to the two securities trading centers (STCs), namely, the state-run securities exchanges.[40] The draft securities market law under review will expand its purview to unlisted securities, clarify public offering procedures, and incorporate basic provisions for a central securities depository, investment funds, investment advisory, self-regulatory organizations and so on. (Table 11)

Table 11: Evolution of Capital Market Regulatory Framework in Vietnam

Month/Yr	Event	Remarks
Nov-93	The Capital Market Development Board under the SBV	Governor's Decision No. 207/QD-TCCB
Sep-94	The Board for Drafting the Decree-Law of Securities Market	
Jun-95	The Board for the Preparation of the Securities Market	PM's Decision No. 361/QD-TTg
Nov-96	The State Securities Commission as a government agency	Decree No. 75/CP
Jul-98	Decision to set up Securities Trading Centers (STCs), one in Hanoi and the other in Ho Chi Minh City	PM's Decision No. 127/1998/QD-TTg
Jul-00	The Ho Chi Minh City Securities Trading Center (HOSTC)	
Aug-03	The Strategy for Development of the Securities Market up to 2010	By PM
Aug-03	The reinforcement of the SSC's duties and powers	Decree No. 90/2003/ND-CP
Nov-03	Decree No. 144 on securities and securities markets	Decree No. 144/2003/ND-CP
Feb-04	The transfer of the SSC into the Ministry of Finance	Decree No. 66/2004/ND-CP
Sep-04	The reorganization of the SSC as an organization under the MOF	PM's Decision No. 161/2004/QD-TTg
2006	The draft Law on Securities and Securities Markets to be submitted to the National Assembly	
2007	The Law on Securities and Securities Markets to be enacted	

Source: SSC

37 Decree No. 90/2003/ND-CP of August 12, 2003 on Functions, Tasks, Rights and Organization Structure of State Securities Commission

38 Decree No 144/2003/ND-CP of November 28, 2003 on Securities and Securities Market

39 Decree No. 66/2004/ND-CP of February 19th 2004 on Joining the State Securities Commission into the Ministry of Finance

40 Article 110-3 of Decree 144

65. **Vietnam's regulatory framework is at an early stage.** For example, only six months after it issued a decree to reinforce the SSC's duties and powers, the Government transformed the SSC from an independent government agency to an agency under the MOF It is not clear that this shift has enhanced the Government's policy making capacity for capital markets. Similarly, the Law on the State Bank of Vietnam of 1997 as amended has not yet set up an internationally compatible regulatory framework for central banking activities for effective and independent monetary policy operations, which will affect the development of government securities market, and other parts of the capital market.

66. **The scope of securities markets has been defined narrowly.** A securities market under Decree 144 is limited to the STCs. As such, the market of shares not listed on the securities trading centers remains unregulated, though the unregulated market has a far larger market capitalization than the HOSTC, the only fully operating STC. Even subsequent versions of the draft securities market law whose purview is expanded to unlisted securities and their issuers remain opaque in their regulation over private placements. In addition, the definition of securities encompasses a less comprehensive list than capital market instruments and activities. It should be equipped with an appropriate catch-all clause to provide adequate flexibility to expand the list as necessary.

67. An attempt to regulate capital market activities rather than narrowly defined securities markets has become increasingly relevant in Vietnam as the WTO accession will substantially change the landscape of financial markets. The draft Securities Law has addressed the issue and substantially expanded the scope of "Securities" by including derivative instruments, and that of "securities market" by differentiating it from "Securities trading market."[41] Globally, financial services have been being integrated and/or interlinked geographically, institutionally and activity-wise. As a result, the demarcation between commercial and investment banking has become less distinct in many jurisdictions. Even if Vietnam may not have the whole range of capital market activities available domestically, Vietnamese institutions and individuals are likely to be exposed to most capital market activities as the Government open the domestic financial market to foreign financial institutions and liberate the access of Vietnamese institutions and individuals to foreign markets. In such a situation, the market regulator will have to protect Vietnamese investors' interest and reduce contagious systemic risk even with regard to capital market activities available in foreign markets.

68. The enactment of a new securities market law will be a good chance to ensure the independence and public accountability of the SSC as market regulator. In financing its budget deficit as well as in equitizing SOEs, the Government or MOF are competing with the private sector in capital markets. Besides, SOEs and companies majority-owned by the Government will increasingly raise long-term capital in the capital markets. Meanwhile, the market regulator is obliged to be fair to all market participants. As a result, the Government finds itself in a conflict of interests. Accordingly, the SSC's actual and perceived ability to fully control the Government's conduct in the capital markets in terms of fairness and transparency will considerably help win the public's and the private sector's confidence in the capital markets. By contrast, the skepticism about the regulator's neutrality will hamper the country's market-based economic development process. As such, ensuring at least the operational independence of the SSC as the market regulator is necessary to make it easier for the capital markets to be supported by the investment public in the long run. The independence of the SSC will be substantially warranted by explicitly prohibiting the MOF's interference with the SSC's regulatory operations as well as limiting the grounds on which an SSC member can be removed from office. On the other hand, greater independence of the SSC must be paired with its stronger public accountability.

69. The Vietnamese policymakers are faced with the choice between a unified model (unified regulatory agencies) and a specialist model (specialist agencies). The industry is already operating on a bank-parent model of universal banking. The proposed amendments of 2004 to the Law on Credit Institution clarify the features of bank-owned subsidiaries and expand business lines permissible for

41 Article 5 of the fifth draft of the Securities Law

Table 12: Trading Values and Their Profile on HOSTC in 2004

		Order-matching	Put-through	Total
Trading Value in VND bill.	Stocks	1,701	270	1,971
	Bonds	5	17,878	17,883
	Investment Fund	30	3	33
	Total	1,736	18,151	19,887
Trading Value in US$ mil.	Stocks	108	17	125
	Bonds	0	1,132	1,132
	Investment Fund	2	0	2
	Total	110	1,149	1,259
Distribution by Security Types	Stocks	98.0%	1.5%	9.9%
	Bonds	0.3%	98.5%	89.9%
	Investment Fund	1.7%	0.0%	0.2%
	Total	100.0%	100.0%	100.0%
Distribution by Trading Methods	Stocks	86.3%	13.7%	100.0%
	Bonds	0.0%	100.0%	100.0%
	Investment Fund	90.1%	9.9%	100.0%
	Total	8.7%	91.3%	100.0%

Source: HOSTC and World Bank Staff's analysis

them.[42] Major commercial banks have set up brokerage subsidiaries. Bao Viet, the largest state-owned insurance company owns a brokerage firm[43] as well.

70. The choice between a unified model and a specialist model will be followed by a choice between entity regulation and functional regulation. Vietnamese regulation is traditionally based on entity regulation whereby the whole operations of an entity are subjected to a specific regulator. For example, the SSC regulates the STCs and stock exchanges rather than securities trading systems, and the Central Securities Depository rather than clearing, clearing and depository systems. However, capital market activities are being diffused beyond institutions defined by the securities market regulation. For instance, the SBV recently issued a regulation on banks' marketable securities issuance, and the Ministry of Planning and Investment (MPI) approved the initial public offering of Taya Vietnam, because the issuer was a foreign-invested company licensed by the MPI. While the central bank as the bank supervisor has a legitimate concern about banks' funding activities that affect their prudential standing, SSC should be a principal regulator with regard to the requirement of due diligence, disclosure, offering process as well as compliance with minimum standards for public issuance. A similar logic of functional regulation should apply to the case of Taya Vietnam.

42 The following compares the proposed text of the amendment with the current text of Article 32-2 of the law: "A credit institution shall be entitled to …~~Set up attached companies which have~~ Establish a subsidiary company of separate legal ~~person status, apply an~~ entity and independent ~~cost~~ accounting status ~~with~~ by using its own capital to ~~operate~~ engage in ~~some~~ financial, banking and insurance ~~fields~~ businesses, and in ~~accordance with~~ management, exploitation and forced sales of assets in the course of settling assets secured for loans and other assets assigned by the ~~stipulations of the Government.~~ State to credit organizations for debt settlement and recovery."

43 Bao Viet Securities Joint Stock Company

71. The regulatory inconsistency stemming from opportunistic application of entity regulation could adversely affect capital market development in Vietnam. It may risk creating regulatory loopholes, allowing regulatory arbitrage and undermining investor protection. Other ministries or government agencies are unlikely to have the same level of expertise on capital markets regulation and supervision as the SSC does. Furthermore, it is desirable for the Government to concentrate its valuable resources for institutional capacity building with respect to capital market regulation and supervision on a single specialist regulator – the SSC. Moreover, regulatory ambiguity may slow capital market development in Vietnam and the ability to diversify into new instruments (*e.g.* insurance services). Regulatory ambiguity or inconsistency is likely to prevent the local financial market from meeting evolving financial needs in a timely manner.

72. **The conglomeration of Vietnam's financial industry may be inevitable to meet mounting global competition.** Both bank-subsidiary and holding company models will work well with the existing a specialist and separatist regulator model. Nonetheless, the intensifying universal banking trend will require the country's regulatory method to be gradually transformed from entity regulation to functional regulation. Regulation should also ensure sound corporate governance, transparency, fair trade and competition as well as application of sound prudential standards to the financial conglomerates.[44] The transformation will call for formalized information sharing and coordination mechanism among financial regulators and law enforcement agencies.

5.2 Market activities

5.2.1 Regulated stock market

73. **Vietnam's capital markets[45] appear to be at a critical juncture that will determine the long-term prospects**. Vietnam has two organized securities market places – the HOSTC and the Hanoi Securities Trading Center (HASTC) [46] – as well as an unregulated market of unlisted stocks. The STCs are non-business units attached to the SSC.[47] The HOSTC started its operations with two former SOEs listed on it in July 2000, and had 30 companies,[48] 281 bond issues, and one closed-end fund[49] listed on it as of the end of June 2005. Of the 30 companies listed on the HOSTC, 27 companies were former SOEs. The market capitalization of the 30 listed stocks, the 281 bond issues and the one investment fund stood at VND 5,853 billion (US$ 370 million), VND 33,730 billion (US$ 2,135 million), VND 300 billion (US$ 19 million), respectively. Established in March 2005 for the listings of small- and medium-sized companies, HASTC conducted 14 auctions for initial public offerings[50] and six auctions for government bonds as of October 2005. It also started secondary market trading in July 2005. Trading volume in unregulated markets substantially exceeds that of regulated STCs (Section 5.2.4).

74. Market activities will be magnified if capital market activities are regulated, supervised, and promoted through an expanded scope of regulated intermediaries' activities. In capital markets,

44 The conglomeration should not be allowed to encompass large financial institutions and large industrial enterprises.

45 Capital markets normally include offerings, buying, selling, and trading in securities, currencies, and their derivatives.

46 The Prime Minister's Decision No. 127/1998/QD-TTg provides for the establishment of the two securities trading centers. The Hanoi Securities Trading Center was set up in March 2005 for listing small- and medium-sized companies.

47 Article 61 of Decree 144

48 The Prime Minister's Decision No. 528/2005/QD-TTg dated June 14, 2005 provides that the Prime Minister approved the list of 165 equitized companies to be auctioned, listed, or registered at Vietnam's Securities Trading Centers.

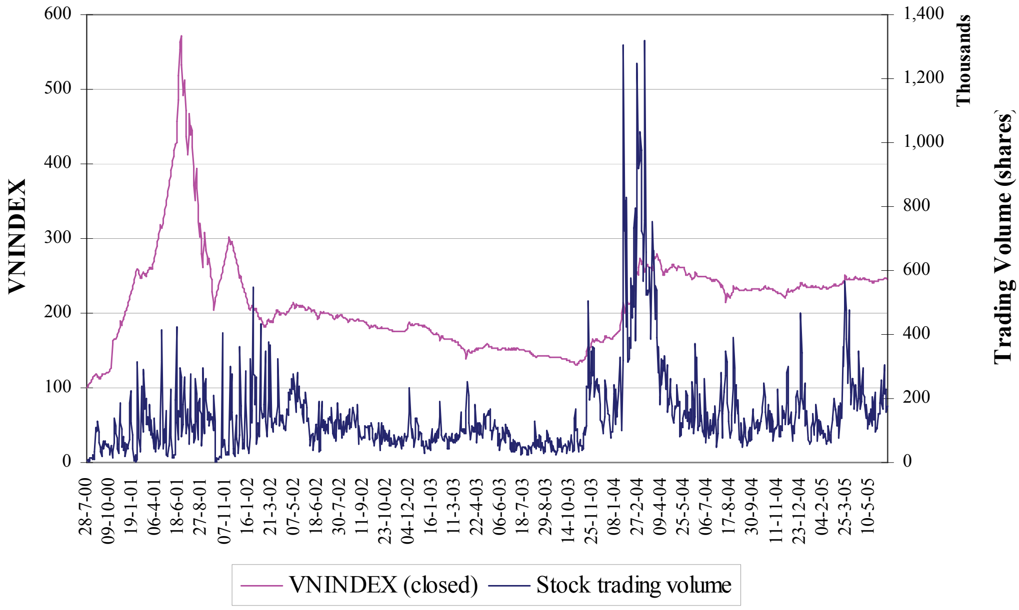
49 The Vietfund Management Company (VFM), which is a joint venture 70 percent owned by Saigon Joint Stock Commercial Bank (Sacombank) and 30 percent owned by the Dragon Capital Company.

50 The Posts Equipment Factory (March 8, 2005) and the Vinh Son-Song Hinh Hydropower Plant (March 10, 2005)

arbitrage, hedging, and speculation will help increase liquidity, enhancing price discovery for genuine investments and divestments. Accordingly, market fragmentation is one of the first things to eliminate or alleviate for market efficiency. A question to be asked is whether market players can freely or with a minimum cost arbitrage or switch among different sub-markets that actually exist. In this sense, the HOSTC is a sub-market but not "the" market. Permitting market intermediaries to operate in different sub-markets by licensing them by type of securities market activities, instead of attempting to integrate as many instruments onto the HOSTC as possible, is likely to generate more transactions. Particularly, the currently unregulated market of unlisted stocks is a market to which regulated intermediation should be formally extended.

75. **The unlisted stock market trading exceeds trading at the HOSTC by more than three times.** The trading value of the HOSTC in 2004 totaled to VND 19,887 billion (US$ 1,259 million). Of the total amount, stock transactions whose orders were matched on the HOSTC amounted to VND 1,701 million (US$ 108 million) or 9.7 percent.[51] Surging in late 2003, bond trading dominated the HOSTC with 89.9 percent of the 2004 trading value, of which nearly 100 percent were traded over the counter[52] and reported to the HOSTC merely for clearing and settlement purposes (Table 12). The order matching of bond transactions on the HOSTC was terminated in August 2004. Secondary market activity on the regulated market has been generally modest, except during the first-year boom and when buoyed by foreign investment in the six months ending in March 2004. The average daily

Figure 4: HOSTC Performance and Trading Volume



trading value for one year ending in May 2005 was VND 3,913 million (US$ 0.248 million) in stocks, as compared to VND 78,436 million (US$ 4.977 million) in bonds. During the first one-year period after its opening in July 2000, the HOSTC experienced some exuberant performance, shooting up the VNINDEX or the HOSTC market index to 571.04 on June 25, 2001, which was followed by a sharp market correction. Subsequently, the market remained depressed for more than two years before they were buoyed by foreign investment in the fourth quarter of 2003. The market index quickly rose to 279.71 on April 1, 2004, with the daily average trading value of VND 8,687 million (US$ 0.550 million) during the six months from October 2003 through March 2004. Earlier in July 2003, the

51 98.0 percent of 9.9 percent (Table 12)

52 The term of "over the counter" is used here in an internationally standardized meaning, that is, a dealers market.

Government raised the foreign ownership ceiling of a local company from 20 percent to 30 percent.[53] Then, the foreign ownership of the seven stocks recommended by brokers reached the ceiling by March 2004. (Figure 4)

5.2.2 Intermediaries

76. Most market intermediaries are closely connected to traditionally influential state-owned financial institutions and/or political institutions. (Table 13) The market is currently served by 13 securities firms, one fund management company, five custodial banks,[54] and one settlement bank that have been licensed by the SSC. Of the 13 securities firms, with a total chartered capita of VND

Table 13: Securities Firms - Their Capital, Licenses and Affiliations

Securities Firms – Their Capital, Licenses and Affiliations

As of October 2005

	Chartered Capital in VND bil.	License Categories					Affiliation
		Broker-age	Deal-ing	Portfolio Mgmt	Under-writing	Consul-tancy	
		Required Capital in VND bil.					
		3	12	3	22	3	
MeKong Securities Corporation	6	x				x	60 % owned by an individual investor
Saigon Securities Incorporation	51	x	x		x	x	Pan Pacific and Saigon Business Consultancy – a private enterprise
Eastern Asia Bank Securities Company, Ltd	21	x	x	x		x	Eastern Asia Bank majority-owned by HCMC Communist Party Economic Committee
Hai Phong Securities Joint Stock Company	22	x	x	x		x	46 % owned by the city budget via the Hai Phon Lottery Company, and the rest by municipality or state-controlled companies or entities*
ACB Securities Company Ltd.	43	x	x	x	x	x	Asia Commercial Bank
Bao Viet Securities Joint Stock Company	43	x	x	x	x	x	Bao Viet Insurance Company
The First Securities Company	43	x	x	x	x	x	Becamex - co-owned by the People's Committee of Binh Duong Province and several business partners
Thang Long Securities Company, Ltd	43	x	x	x	x	x	Military Bank owned by the Army
HoChiMinh City Securities Corporation	50	x	x	x	x	x	Ho Chi Minh Investment Fund for Urban Development
Incombank Securities Company, Ltd	55	x	x	x	x	x	Commerce Bank of Vietnam
Vietcombank Securities Company, Ltd.	60	x	x	x	x	x	The Bank for Foreign Trade of Vietnam
BIDV Security Company, Ltd	100	x	x	x	x	x	The Bank for Investment and Development of Viet Nam
Agribank Securities Company, Ltd	100	x	x	x	x	x	The Bank for Agriculture and Rural Development

Source: SSC, Dragon Capital

* Haiphong Paper Joint Stock Company, the Region 3 Petroleum Company, the Waterway Petroleum Transport No.1 Company, the Vietnam Ocean Shipping Company, Haiphong Port, and Haiphong Post Office

605.75 billion (US$ 38.3 million), seven are wholly owned by commercial banks and one by the state-owned insurance company. Securities business is divided into five license categories: brokerage, dealing, portfolio management (discretionary account management), underwriting and investment consultancy. Underwriting licenses, which require the largest capital, are concentrated on securities firms owned by commercial banks and an insurance company with two exceptions[55]. Approximately 24,000 accounts were opened with the 13 securities firms as of the end of June 2005.[56]

77. All the HOSTC members, which are SSC-licensed securities firms, are required to trade or clear their transactions of listed securities on the HOSTC. Trades on the HOSTC are executed through periodic call auctions that are conducted every weekday in two sessions between 9:00 am and 9:20 am, and between 10:00 am and 10:30 am on a price/time priority basis, and through over-the-counter transactions[57] that are cleared in a "put-through" session between 10:30 am and 11:00 am. Securities firms put in trade orders through terminals designated for each securities firm on the floor of the HOSTC, and the orders are processed automatically. The price band is set at 5 percent of the previous trading day's close price.

78. All orders are subject to a pre-sale stock and pre-purchase fund availability requirement as well as a book-entry requirement, resulting in the absence of buy-in and sell-out rules. The seller is

53 Prime Ministerial Decision 46/QD-TTg dated July 17, 2003

54 Two domestic commercial banks and three foreign commercial banks

55 Saigon Securities Incorporation, and the First Securities Company

56 Of 24,000 accounts, 251 were held by foreign investors (Source: SSC) According to one of the 13 securities firms, approximately 10 percent of all the accounts are active with three to five trade a week.

57 Locally known as "put-through" transactions

required to deposit selling securities with the Securities Custody Center (SCC) through his or her broker before placing a sell order, and, if the selling securities are in bearer form,[58] the seller is concurrently required to convert them into book-entry form. Conversely, the purchaser is required to deposit at least 70 percent of his or her buy order amount with his or her broker before placing a buy order. Some securities firms require their buying customers to deposit 100 percent of his or her buy order amount. As such, the market, unlike more developed markets, is free from trade fails at the expense of the turnover efficiency of funds and securities, depressing trading volumes.

79. **More entrants in the securities industry may help make market regulation enforceable.** At present, market surveillance and enforcement have not been very effective. For example, it is not clear how thoroughly the SSC officials scrutinize order tickets, journals, and other documents in the offices of securities firms at the time of on-site inspections,[59] and identified irregularities are said to be dealt with by moral suasion. Visible sanctions against market misconduct by intermediaries and/or influential investors will help enhance the public's confidence. Enforceability of market regulation is dependent on many factors. Nonetheless, competition created by a new breed of players is likely to help make the SSC's enforcement easier. The great majority of the current intermediaries are wholly or substantially owned by stakeholders in the old economic regime that follow the old rules of the game. (Table 13) New entrants are likely to be more respectful to new rules and regulations.

80. Broadened intermediation, improved market infrastructure and enhanced regulatory capacity would make capital market business commercially viable enough to attract more entrants in the industry. The current regulation defines regulated market places as the HOSTC and the HASTC and, then, regulated intermediaries as those who intermediate the transactions of securities listed on the two securities trading centers. Rudimentary market infrastructure does not accommodate more flexible trade fail rules. The regulator's limited capacity presumably allows the regulator to supervise only transactions of the simplest forms. As a result, the currently regulated intermediation is restrictive. Capital market intermediation can take various forms beyond those on stock exchanges.

5.2.3 Clearing, settlement, custody and registry systems

81. **Executed trades are settled semi-automatically on T+3 for stocks and T+1 for bonds on a delivery versus payment (DVP) basis.** The placement and execution of orders and the confirmation of executed orders are done electronically, though the delivery instructions as well as the payment instructions of traded securities are manually in a diskette. In addition, title transfer documents are physically executed and delivered in hard copy due to a legal limitation on the validity of electronic documents under current Vietnamese laws. The cash and securities legs of an executed transaction settle at the settlement bank, which is Nam ky Khoi nghia Branch of the Bank for Investment and Development of Viet Nam, and at the SCC[60] attached to the HOSTC, respectively.

82. The centralized clearing, settlement and depository system (CSD) has been planned to improve Vietnam's capital market infrastructure. The CSD plan is already in the draft securities market law,[61] and the country is preparing for its implementation in the next few years. A key policy issue will be whether the CSD is allowed to serve as single depository for all tradable securities, including government securities,[62] which would be desirable for market efficiency. The SBV may have a prudential issue over the CSD. The separation of the CSD from the HOSTC, which the draft law anticipates, would require policymakers to deliberate over the governance structure of the CSD and the addition of a central counterparty (CCP) function to the clearing system at the CSD.

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58 Securities can be issued in book-entry form as well as in bearer form.

59 The SSC has been examining order tickets since 2002.

60 The Securities Custody Center also act as the registrar for issuers of listed securities (Article 38 of Decree 144)

61 Articles 43-50 of the third version of the draft Securities Market Law

62 The SSC has recently decided that the new CSD will serve as the depository for both listed and unlisted securities of public companies.

83. The CSD contemplated under the fifth version of the draft Securities Law[63] is likely to enable the regulator to control issues with listed and unlisted securities effectively. The current Securities Custody Center (SCC) attached to the HOSTC serves as a register. Under the current arrangement at the SCC, a share ownership registration function is auxiliary to clearing, settlement, and custody functions for listed stocks. Therefore, share ownership registration function is and will be limited to listed stocks. By contrast, the CSD contemplated under the fifth version of the draft Securities Law is designed to expand its registry service to all public companies,[64] listed and unlisted alike.

84. **A centralized registry function will be an effective base for securities market reforms in the country.** Unlisted stocks are expected to continue to float around to varying degrees of liquidity, due to the current methodology of SOE equitization and emerging private sector companies, supplying shares to marketplaces outside the HOSTC and the HASTC. In such an environment, a centralized registry function will provide a basis for comprehensively regulating the whole securities markets in distinct manners appropriate for the categories of securities – *i.e.,* listed or unlisted, etc. Today's information technology appears to allow a country to set up and maintain a centralized register for securities of all listed and unlisted companies. In doing so, it is probably necessary to coordinate the new Securities Law and the Common Enterprise Law legislation with regard to the ownership transfer of securities.

85. **The contemplated CSD system seems to remain unclear about share ownership registration of securities in bearer form.** The CSD system is intended to promote a book-entry system in the country. However, a significant number of securities of listed and unlisted companies are circulated in bearer form in the market. In addition, it is the World Bank's understanding that both listed and unlisted companies continued to be allowed to issue their securities in bearer form as well as in book-entry form. If that is the case, title to securities in bearer form will need to pass by delivery instead of by entry in the register at the CSD. Otherwise, the legal finality of bearer securities transaction may be destabilized, potentially resulting in severe market dislocation of bearer securities or unlisted securities. Beside their trade finality concern and operational inefficiency, bearer form securities are conducive to money laundering, counterfeiting, tax evasion and other criminal conducts.

86. It is desirable to gradually dematerialize all securities into electronic book-entry form and ultimately make the CSD independent of the HOSTC and the HASTC to optimize the benefits of the CSD. The market of unlisted stocks in bearer form is likely to continue to exist in a sizable manner. At the same time, it is also likely to pose systemic risk and other serious problems with regard to market efficiency, investor protection, market confidence. Some regulation for unlisted stock trading is needed for various reasons. (Section 5.2.4) Nonetheless, indiscriminately forcing public companies to be listed on one of the STCs is a good policy for neither keeping the freedom of capital transactions in the private sector as much as possible nor protecting investors. Complete dematerialization will facilitate the regulator in regulating, supervising, and monitoring most kinds of securities transactions. The independence of the CSD will help expand the scope of freedom of capital transactions.

87. The modernization and reinforcement of a legal and regulatory framework that supports securities settlement would make the market microstructure more adaptive to evolving market needs as well as more resilient to systemic risk. An archaic nature of legal system can create a bottleneck to efficiency or a weakest link to trade finality as earlier exemplified by the hard copy requirement of title transfer documents. Financial investment, arbitrage, and hedging transactions in today's globally linked environment could be adequately effective only if the transactions settle speedily and incontestably. Legal concepts such as beneficial ownership, title transfer by registration, collateralization, close-out netting, novation, and electronic proof of ownership are central to the custody and settlement systems of contemporary securities markets. For instance, the current

63 The SSC provided the World Bank with the third version of the draft Securities Law, under which the registry function of the new CSD was limited to listed companies. This paragraph is based on the information that the SSC provided to the World Bank in September 2005.

64 Article 16 of the third version of the draft Securities Market Law. See also Section 5.2.4.

settlement arrangement for DVP may break down even if a single element of legal consistency is questioned. Foreign institutional investors tend to be sensitive to this sort of legal issues when they consider investing in Vietnamese securities.

5.2.4 Active and sizable unregulated market

88. **The unregulated stock market is far more active than the regulated one in Vietnam.** The shares of many unlisted joint stock companies are traded in the unregulated market. The stock trading volume of the unregulated market is estimated to range from three to six times as much as that of the HOSTC. The average daily stock trading value of the HOSTC in May 2005 was approximately US$ 0.3 million equivalent as compared to approximately US$ 1 million on the unregulated stock market. It is estimated that roughly 60 to 100 trades of VND 15 to 25 million (US$ 10 to 16 thousand) in trade value are taking place daily in the unregulated stock market. Of more than 6,700 unlisted joint stock companies that have been incorporated in the country, 15 to 20 stocks are almost daily traded and another 40 to 60 stocks are traded from time to time in the unregulated market. The unregulated stock market is an informal network of unlicensed and licensed brokers who intermediate the transactions of Vietnamese stocks that are not listed on the HOSTC. Two kinds of stockbrokers are operating in the unregulated market. The first one is independent unlicensed brokers, presumably totaling to 60 to 80 persons in Ho Chi Minh City. Many of them are doing securities business as a side-job. The majority of them work for financial institutions, including licensed brokerage firms. A typical unlicensed broker has about ten regularly trading customers out of a clientele of about 100 investors whom he covers. The second is licensed brokers who are illegally engaged in brokering or trading unlisted stocks. They are licensed to intermediate only stocks listed on the regulated markets. The Mission has identified at least four licensed brokerage firms engaging themselves in the unregulated market, while the majority of licensed brokers are said to be involved in the unregulated market. Some of the licensed brokerage firms go as far as arranging margin loans to their customers.[65]

89. An independent unlicensed broker typically maintains a personal network of about 20 other unlicensed brokers, and covers at least both Ho Chi Minh City and Hanoi. He matches his customers' orders through the network when he cannot match an order with another investor in his clientele or for his own account. Some independent unlicensed brokers used to stay in particular cafes on Pham Ngoc Thach Street in Ho Chi Minh City in the morning to exchange information among stockbrokers and wait for customers. At present, they do not use cafes as much as before, though some of them still gather in a certain cafe to exchange information. An unlicensed broker normally brokers selling and buying customers, charging a 0.5 percent commission each. Occasionally, the unlicensed broker trades with his customers for his own account, taking a buy/sell spread. A trade usually settles in physical certificates and in cash within a few days of its trade date. A messenger of the unlicensed broker carries stock certificates or cash between the investor and the broker. The unlicensed broker additionally charges VND 50,000 per trade for the settlement processing of a trade. The settlement of unregulated trades enjoys no regulatory or institutional protection, being solely dependent on unlicensed brokers' personal reputation.

90. The unregulated market emerged out of economic necessity, due to the Government's delay in keeping up the formal financial system with rapidly evolving economic realities, limitedly contributing to capital reallocation in the Vietnamese economy. The market spontaneously started in a regulatory vacuum a few years before the HOSTC began to operate in 2000. The main sources of shares traded in the unregulated market are joint-stock companies equitized from SOEs and joint-stock companies established by private entrepreneurs and investors including foreign ones. The

65 This practice is known as "repos" in the brokerage community in HCMC. Subject to the market conditions, the customer sells shares to the broker normally at 60 to 80 percent of the market price of an unlisted stock with a commitment to repurchase the same shares at the original sale price plus a predetermined interest at a predetermined date. The financing period can be one to three months.

Government of Vietnam has restructured about 2,250 SOEs,[66] of which about 1,500 were converted to joint stock companies as of December 2004 (known as "equitization") in order to promote a market-based economic reform. Line ministries, on behalf of the Government, have retained substantial shares issued by many equitized SOEs,[67] while selling part of the newly issued shares to strategic investors, allocating or auctioning the shares to the employees of equitized SOEs at discount, and/or auctioning them to the public. Concurrently, the Government has allowed and encouraged entrepreneurs to form joint stock companies since 1995. Since then, about 5,200 joint stock companies have been set up by private sector entrepreneurs. Some of them have issued additional shares to the public. Of about 6,700 joint-stock companies, only 30 companies were listed on the HOSTC as of June 2005. The rest remain unlisted. Minority shareholders have needed a securities market to cash their holdings. Some individuals have found investment opportunities in shares thus left in the hands of minority shareholders. Thus, the unregulated stock market has been facilitating the reallocation of capital in the emerging economy.

91. **Market players and the regulators have not adequately recognized the fragility and vulnerability of the market.** Unlicensed brokers in the unregulated market claim that they have not been faced with any serious troubles in their broker careers of the past several years, though investors may have different experiences. The fact that there has been no serious call for regulating the unregulated stock market may support the brokers' claim. However, the Vietnamese economy has not experienced any material economic shocks or dislocations in the past several years as the unregulated stock market emerged.

92. **The current state of Vietnam's stock market is unsound to financial stability.** The unregulated market overwhelms the regulated market by a three to six times margin. In the unregulated stock market, none of investor protection, orderly, fair and efficient market, and transparency is warranted despite a certain broker's voluntary effort to make the market transparent.[68] Decree 144 of 2003, the securities market regulation in effect, does not apply outside the organized securities market, and, therefore, the SSC has no power to regulate the unregulated stock market.[69] Without a trade information reporting and dissemination system that covers the entire unlisted stock market, pricing remains opaque. Intermediaries' financial, professional, and operational capacity is neither attested nor monitored. Issuers' disclosure is assured at all. Thus, the unsafe, uncertain, and non-transparent nature of the market keeps transactions inefficient and minimal. For example, the intermediary charges the investor a larger commission or takes a wider spread in uncertain circumstances than otherwise. The investor is likely to limit his or her order size in order to control his or her exposure to risk inherent in the market. The inefficiency of the indispensably emerged market constrains the pace of the country's economic development. Furthermore, the insolvency of an intermediary or investor, if it happens, may instantly spill over to the regulated market, disrupting the whole securities market in the country. In case insolvency occurs in a highly leveraged market condition, the whole financial market or economy may be adversely affected through balance sheet effects.

93. The regulator is currently trying to resolve issues arising from the unregulated trading of unlisted securities by setting a level playing field for all companies with a certain size or larger under a "public company" concept.[70] All listed and unlisted public companies will be required to file

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66 As of June 2005. Source: The National Enterprise Reform Committee. According to the World Bank's definition of "equitization" as registration under the Enterprise Law, 2,093 former SOEs were equitized as of mid-April 2005. Many of equitized SOEs were small.

67 In 686 equitization cases from 2001-2005, the State retained more than 35 percent of outstanding shares, while in 838 cases, it did not. (Source: a World Bank survey)

68 Vietstock Pte at http://www.vietstock.com.vn/

69 Article 110-3 of Decree 144. The decree has not necessarily been enforced even with regard to securities activities in the organized securities trading market.

70 Article 16 of the third version of the draft Securities Market Law

disclosure documents with the SSC.[71] Disclosure requirements of unlisted public companies will enable the market regulator to monitor the status and changes of their ownership. However, disclosure requirements of unlisted public companies are unlikely to be sufficient for monitoring market activities in unlisted securities.

94. The introduction of a centralized registry system, an integrated securities depository system, and an individual securities broker/dealer registration system would be effective in regulating securities intermediation outside stock exchanges. It is also essential to keep a market of unlisted securities alive for the country's private sector development. A securities registration system, which requires issuers to register all their publicly offered securities with the regulator and subjects the issuers to disclosure requirements,[72] will reduce information asymmetry between the issuers and investors. The current listing system mixes up listing with securities registration. An integrated securities depository system, coupled with dematerialization, will make securities settlement reliable and efficient, regardless of intermediation methods and markets. It also makes the capturing and dissemination of trade information easy. An individual securities broker/dealer registration system, which is a license category for securities agents who are not members of a stock exchange, will enable the regulator to hold them accountable for their misconducts, while keeping their entrepreneurship alive. The enactment of a comprehensive capital market law and the enhancement of the regulator's institutional capacity will be prerequisites for the three policy measures.

95. Institutional capacity building of the SSC will be necessary to put the current unregulated market activities under regulatory control. The expansion of the SSC's jurisdiction under the new Law will close a loophole of Degree 144 that has been allowing unlicensed brokers to operate in the unregulated market. This new move will be a good practice for market stability. However, the effectiveness of the new Law will be contingent mainly upon the SSC's ability to enforce the provision of the new Law, requiring more human resources, information system capacity[73] and higher functionality of the SSC. In reality, the SSC has so far had no visible enforcement record. A seriously unfair situation will most likely arise if the new Law is enforced selectively or arbitrarily for lack of the SSC's enforcement capacity.

96. Furthermore, it is advisable to amend the draft Law so as to entice the players of the unregulated securities market, which is far larger than the regulated markets, into a regulated framework. Simply banning the currently unregulated market with the new Law is likely to defeat the objective of the new Law. The ban will push unregulated market activities deeper underground, being conducive to market distortion and corruption, unless the structural causes of unregulated market activities are removed. Equity and long-term debt capital will not be efficiently supplied to a broad range of the private sector, slowing down the development of the indigenous private sector. How to optimize the private-sector initiatives for capital market development and simultaneously control any systemic risk would be a critical policy challenge. For example, the introduction of a sub-broker system may be considered.

5.3 Conclusion and Recommendations

97. **The ongoing reform with new securities market legislation will considerably improve the regulatory framework.** Nevertheless, the current reform falls short of embracing the concept of capital markets, which will soon become more relevant as the Government opens up the markets to international market players. The legislative assurance of the SSC's operational independence should help forge the public's and the private sector's confidence in the capital markets. The policymaker and regulator would be required to weigh functional regulation against its traditional entity regulation

71 Share ownership registration is not necessarily in the purview of a securities law.

72 The new Securities Law will, if enacted, materialize the securities registration system, which is referred to as a "public company statements and reporting requirements" in Chapter IV of the third version of the draft Securities Law."

73 especially, an electronic filing system to register all publicly traded securities including those unlisted.

as universal banking evolves in the country. The regulatory framework should address issues in prudential regulation, governance, transparency and competition arising from the conglomeration of the financial industry.

98. **The regulated stock market is marginal in the economy.** Domestic demand for trading is minimal. Despite a relatively extensive set of market regulations in place, the regulator has had no significant enforcement record. The clearing, settlement, custody and register systems have some flaws. The great majority of market intermediaries are affiliated to old-time financial or political institutions.

99. **Evolving out of economic necessity, the unregulated market of unlisted stocks is more active than the regulated one.** However, market players and the regulators have not yet adequately recognized the fragility of the market. It is important to entice currently active unlicensed stockbrokers into the formal system, rather than excluding them from the market by simply banning their activities.

100. In order for the securities market mechanisms to meet the current and future needs of the economy, the Government is recommended to consider:

Legislatively assuring the SSC's operational independence;

Regulating and supervising the markets through activities of market players rather than particular institutions such as stock exchanges, and adequately widening the scope of market players' licensed activities;

Setting up the centralized registry system together with the single CSD for all tradable securities;

Reviewing and reinforcing the legal basis for securities settlements;

Encouraging the entry of new-breed of institutions into the markets; and,

Create a license category for non-STC member broker/dealers to entice currently active unlicensed stockbrokers into the formal system.

6 Two Principal Problems for Capital Market Development

101. This section will explore the two principal problems for further development of Vietnam's capital markets: management of government securities market, and the lack of depth in the primary market.

6.1 Management of the secondary market for government securities

102. **The inactive government securities market is one core impediment to Vietnam's capital market development.** An active government securities market finances a country's budget deficit at low costs and provides the investment community with safe and liquid investment instruments of medium- to long-term maturities. However, more importantly, it usually serves as a basis on which the term structure of interest rates in the domestic currency is built. Most financial assets and liabilities are valued against the term structure of interest rates for efficient capital reallocation in the economy. This economic mechanism is weak in Vietnam. As such, the country's economic activities are not as efficient as they should be.

103. **Trading in the government securities market has been very modest, though it is becoming remarkably active.** In fact, bond trading represented 89.9 percent of the total trading on the HOSTC in 2004 as compared to stock trading at 9.9 percent. (Table 11) Some licensed securities firms made the majority of profits on bond intermediation for their own account as well as for clients' account. However, Vietnam's bond market is small and inactive relative to other ASEAN countries. (Table 14) Its outstanding balances accounted for 7.4 percent and 9.7 percent of GDP in 2003 and 2004,[74] respectively, and its turnover in 2004 was 1.0.

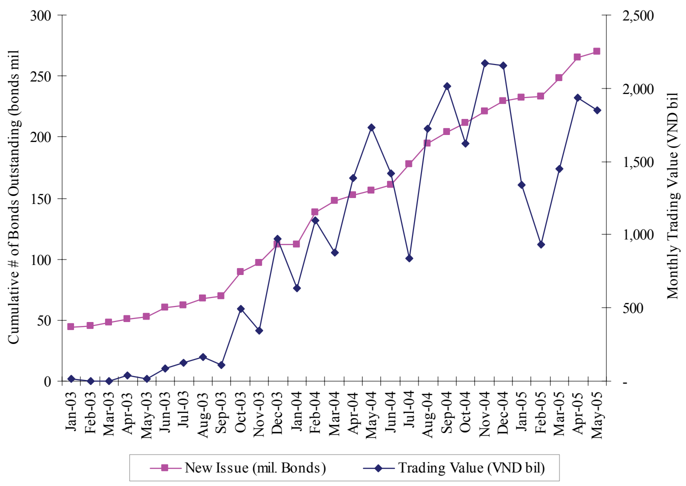
Table 14: Sizes and Liquidity Levels of Bond Markets in ASEAN+3

	Outstanding Balances (% of GDP)								Turnover Ratio
	Dec 2003				Dec 2004				2004
	Govt	Corp	Fin Inst	Total	Govt	Corp	Fin Inst	Total	
China	20.3%	0.9%	10.0%	31.2%	20.1%	0.7%	11.1%	32.0%	2.24
Hong Kong	9.7%	35.5%	0.0%	45.2%	9.5%	37.6%	0.0%	47.1%	34.72
Indonesia	24.7%	1.3%	1.0%	27.0%	19.8%	1.5%	1.2%	22.5%	0.65
Japan	124.6%	17.0%	26.8%	168.5%	139.4%	16.9%	26.1%	182.4%	5.38
Korea	18.8%	27.7%	27.4%	73.8%	25.0%	23.4%	35.1%	83.5%	3.32
Malaysia	38.9%	43.3%	13.0%	95.3%	40.2%	38.6%	15.3%	94.0%	1.82
Philippines	30.3%	0.0%	0.2%	30.4%	28.8%	0.1%	0.3%	29.2%	N.A
Singapore	40.1%	32.6%	0.0%	72.7%	41.2%	32.3%	0.0%	73.5%	3.15
Thailand	21.5%	15.0%	4.8%	41.2%	22.2%	13.7%	5.4%	41.3%	2.03
Vietnam	7.8%	0.0%	0.0%	7.8%	8.8%	0.0%	0.0%	8.8%	1.00

Source: AsiaBondOnline, WB staff's estimation

74 The turnover ratio could be much lower. Assuming that the outstanding balances of TBs at end-2003 and end-2004 were 2/3 of the amounts issued in the same years, the end-2002 and end-2004 balances of all outstanding debt securities were estimated at VND 14,443 and 24,984 billion, respectively. These estimated balances accounted for 2.4 percent and 3.5 percent of GDP in 2003 and 2004, respectively.

Figure 5: Cumulative Bond Issue Amounts and Monthly Trade Values



Source: Vietcombank Securities, HOSTC and WB Staff's estimation

104. **Outright purchases and sales in the turnover of Vietnamese government securities were ever lower than shown in the table**, because the statistics of bond trading volumes and values on the HOSTC include repo transactions in the interbank as well as the open markets. Additionally, trading values of Vietnamese bonds closely followed the increase of their cumulative outstanding balances. (Figure 5) This trend suggests that there has been no significant improvement in liquidity over the time.

105. The government securities market is highly segmented due to multiple issue channels, methods and registers and to the lack of market making function. The State Treasury of the MOF, on behalf of the Government, currently issues more than 100 issues per year of dong-denominated treasury bills of 6, 9 and 12 months, and bonds of 2, 3, 5, 10 and 15 years through four different channels, and methods. The methods and channels are (i) treasury bill auctions to designated banks through the SBV as the fiscal agent for the State Treasury and as the registrar, (ii) bond auctions to designated banks, insurance companies, finance company and securities firms through the STCs with the SCC as the registrar, (iii) underwriting by a syndication of designated banks and securities firms with each underwriter as a registrar, and (vi) direct placement of bonds with the public through the national network of about 600 Treasury offices of the State Treasury with each Treasury office as a registrar.[75] TBs accounted for more than 80 percent of the Government's debt securities issuance in 2003 and 2004. (Table 15) The designated financial institutions are locally called "primary dealers," but they do not have market making obligations. The State Treasury issues an issuance calendar of auctions and underwritings every quarter. TB auctions are held every week, bond auctions on the STCs every two weeks, and bond underwritings every two weeks. In addition, the SBV also issues its own short-term securities for liquidity management purposes from time to time.

75 In addition to VND-denominated securities, the State Treasury issued small amounts (equivalent to VND 9 million and 5.5 million in 2003 and 2004, respectively) of foreign currency denominated bonds through the SBV.

Table 15: Government Securities Issue Amounts byChannels & Methods

Channels & Methods	2003		2004	
TB auction thru SBV	15,130	86.7%	18,411	82.9%
Bond auction on STCs	672	3.9%	1,419	6.4%
Underwriting	1,650	9.5%	2,390	10.8%
Direct Placement	-	0.0%	-	0.0%
Foreign currency bond auction thru SBV	0	0.0%	0	0.0%
Total	17,452	100.0%	22,220	100.0%

State Treasury and HOSTC

106. **Non-government bonds are still fledging in Vietnam.** The Development Assistance Fund (DAF), a government agency for development and trade finance, is a major issuer of non-government bonds. The DAF raised VND 7.2 trillion and VND 6.0 trillion in 2004 through bond issuance. Other issuers include Ho Chi Minh City Investment Fund for Urban Development (HIFU) and Vietnam Oil and Gas Corporation's (PetroVietnam).

107. It is said that the holdings of not only treasury bills but also government bonds are concentrated in commercial banks, especially SOCBs. SOCBs owned 94.09 percent of treasury bills in 2003, as compared to joint stock banks at 0.67 percent and foreign bank braches at 0.20 percent.[76] The State Treasury placed 77.7 percent of the VDN 2-trillion education bonds issued on May 19, 2005 in credit institutions (commercial banks and finance companies) and insurance companies, 1.9 percent in centrally-managed SOEs, and 20.4 percent with "residents."[77]

108. The illiquidity of the government securities market appears attributable to a combination of several policy and institutional level problems. The problems include (i) a non-comprehensive regulatory and supervisory framework for the SSC, (ii) a deficient debt management[78] and suboptimal debt issuance policies at the State Treasury, (iii) a suboptimal reserve management structure, rudimentary monetary policy framework, and weak banking supervision at the SBV, (iv) low confidence in the judicial system for financial transactions, and (v) a lack of contractual savings development policies. In addition, delay and incompleteness of SOE equitization is partly responsible for the inactive market by allowing SOCBs to continue to dominate the financial sector. Of the several problems at the policy and institutional level, the most critical are two: a deficient debt management and suboptimal debt issuance policies at the State Treasury, and the suboptimal reserve management, fledging monetary policy framework, and weak banking supervision at the SBV.

109. The problem of debt management and debt issuance policies is typically reflected in more than 100 issues of relatively small amounts and fragmented primary markets. A necessary, though not sufficient, condition for a bond mark being liquid is a sizable, regular, consistent, transparent, and market-based supply of bonds of high credit quality and uniform characteristics. It is hard to meet these requirements for a liquid government securities market without clear-cut debt management objectives, a well-defined institutional framework, a practical strategy, and competent operational skills at the State Treasury. The unusually complex combinations of issuance methods, distribution

76 IMF Monetary and Financial Systems Department Report on Vietnam dated February 2004.

77 The State Treasury

78 The World Bank has, in conjunction with the British Department for International Development, extended a special investment loan to the Government of Vietnam through the MOF to implement the Project Financial Management Reform Project under the task management by Edward Mountfield, Senior Economist. The project, which is underway, addresses partly debt management. The scope of debt management that this report proposes covers organizational structure and regulatory framework, debt management strategy and risk management, system support and staff capacity, and cash management.

channels, and registers strongly suggest that the debt management and issuance policies of government securities, if any, have hardly been aimed at secondary market liquidity.

110. The deficiencies of the current reserve management, the monetary policy framework, and the bank supervision at the SBV are evident in limited interbank repo activity for lack of incentives for banks to trade liquidity for their reserve management.[79] A liquid repo market is essential to support active trading of government bonds. The problem of limited interbank repo activity is worsened by SOCBs' dominance in the financial sector. On the technical side, the requirement of trading repos through licensed securities firms[80] makes repos cumbersome and costly as compared to interbank call loans, reducing the liquidity of the interbank repo market.

111. The inadequate confidence in the country's judicial system for financial transactions is also a likely backdrop for the illiquidity of the interbank repo market. Banks in Vietnam do not have a standard master repo agreement among themselves. Non-standard agreements do not accommodate efficient close-out netting of transactions when the counterparty defaults. Nonetheless, a credit analysis is at present more highly valued than a legal certainty in Vietnam's banking sector. Banks seem more focused on the credit standing of their counterparties than a security arrangement, hence using more call loans with highly selected counterparts than doing repos with a diverse group of banks for liquidity management. Consequently, the interbank market is segmented. Liquidity in the banking system cannot be evenly distributed. If they had more trust in the judicial system for financial disputes, banks would put a standard master repo agreement in place and conduct more repo transactions, relying on the credit of government securities instead of their counterparties.

112. Furthermore, a lack of contractual savings development policies may be responsible for the absence of pension fund schemes for private-sector workers, indirectly allowing the holdings of government securities to be concentrated in SOCBs. A heterogeneous investor base helps keep a

Table 16: Capital Allocated to the Private Sector by Capital Markets and Bank Loans

(VND bil., %)

	2000	2001	2002	2003	2004
GDP	441,600	481,300	535,800	605,600	716,800
Capital Markets					
Equities	-	-	86	70	45
Debts	83	75	-	-	(83)
Net new issues on the HOSTC	83	75	86	70	(38)
% of GDP	**0.02%**	**0.02%**	**0.02%**	**0.01%**	**-0.01%**
Bank Loans					
Claims on non-SOE sectors	85,800	109,400	141,600	191,300	N.A
Net increase in claims on non-SOE sectors		23,600	32,200	49,700	N.A
% of GDP	N.A	**4.90%**	**6.01%**	**8.21%**	N.A

Source: IMF and HOSTC

securities market liquid. That is not the case with the government securities market in Vietnam. The legal requirement of title transfer in hard copy constitutes a weakest link in the clearing and settlement system, being a hidden impediment to a further increase in trading volume of government bonds. The legal requirement in a paper-age will become a bottleneck when the trading volume begins to increase.

79 See also IMF Monetary and Financial Systems Department Report on Vietnam dated February 2004.

80 All listed securities are required to be traded through HOSTC members. All government bonds are listed on the HOSTC.

6.2 Weak incentive for financing in Vietnam's securities markets

113. **The lack of depth in the primary market is another core impediment to Vietnam's capital market development.** In addition to its price discovery role, one core function of a capital market is capital raising achieved through securities issuance in the primary market. Equity issuance not only provides the issuer with additional capital, but also allows it to expand its equity base, on the basis of which the issuer can raise more debt capital (financial leverage). Debt issuance enables the issuer to raise debt straight from the investor without bank intermediation (disintermediation), allowing the bank to concentrate more on short-term lending with a minimal maturity mismatch on its balance sheet (liquidity supply). As will be discussed below, Vietnam's capital markets have yet to perform this function fully. The fledging function of the primary market suggests that businesses are short of total capital to support their growth, or they are over-leveraged with debt capital to continue to grow, adversely affecting banks' balance sheets. The annual credit growths of 28.4 percent and 41.6 percent in 2003 and 2004 respectively, as discussed in Section 2.1, indicates that the latter is the case with Vietnam.

114. Vietnam's capital market has supplied only a negligible amount of capital to the private sector, failing to live up to the country's economic growth in the recent years. The total net amounts of equities and debts issued on the HOSTC ranged between 0.01 percent and 0.02 percent of GDP from 2000 to 2003, and stood at even -0.01 percent in 2004, whereas bank loans steadily increased from 4.90 percent in 2001 to 8.21 percent in 2003. (**Error! Reference source not found.**)

115. **Three major groups of problems amount to the failure of the primary market.** The three major groups of problems are: (i) an ample supply of medium- and long-term debt capital from commercial banks, notably from SOCBs, (ii) the underdevelopment of independent or bank-affiliated non-bank financial institutions (NBFIs), and (iii) low confidence in issuers and cumbersome or restrictive issuance procedures.[81] The three major groups represent substitute, intermediation (distribution), and supply issues of Vietnam's securities markets, respectively. Secondarily, a lack of contractual savings development policies – underdeveloped institutional investors – and a low income level underlie the impediment.

116. **Addressing the supply, intermediation, and substitution problems has policy priority over demand-side development.** It might be suggested that the Government facilitate the establishment of more mutual funds and the inducement of more foreign portfolio investment in order to generate more demand for Vietnamese securities. At present, however, the supply, intermediation, and substitution of securities appear to be a more critical constraint than the demand side is to Vietnam's capital market development. A significant market capitalization and a trading volume of the unregulated market (Section 5.2.4) and the shoot-ups of the activities in the regulated market every time the foreign ownership ceiling was raised (Section 5.2.1) indicate a brisk demand for securities relative to the supply. Accordingly, it will be effective in developing capital markets to concentrate resources on solving the supply, intermediation, and substitution problems for the time being. In the long term, the development of contractual saving systems such as pension funds and insurance companies, and collective investment schemes such as mutual funds needs to be explored for the expansion and sophistication of the market.

6.2.1 Substitute problem

117. An ample supply of medium- and long-term debt capital from commercial banks, notably from SOCBs, as was evidenced by the sharp credit growths in 2003 and 2004, almost completely substitutes the capital raising function of the capital markets. Bank loans are more convenient for average borrowers because of their confidentiality and flexibility. However, the Vietnamese economy

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81 For instance, the Enterprise Law and Draft Enterprise Law have mandatory preemptive rights provisions with no procedure for waiving them. These provisions will prevent an issuer from using shares, among other things, for acquisitions or employee stock compensation.

is apparently paying price for this easy substitute. NPLs and maturity mismatch problems still cast a cloud over the banking system (Section 3.1). Weak banking supervision, delayed SOCB equitization, and incomplete SOE equitization are collectively the causes for the continued supply of medium- and long-term debt capital from commercial banks. Conversely, tightening banking supervision without a well functioning capital market will likely reduce the supply of mid- to long-term capital in the economy.

6.2.2 Intermediation problem

118. The underdevelopment of independent or bank-affiliated non-bank financial institutions means a weak distribution or intermediation of capital market products and services. The dominance of securities firm subsidiaries of the big four SOCBs in the securities industry is an undesirable situation. As the Government started issuing bonds more sizable than before, the four resourceful securities firms appear heavily dependent on bond intermediation for their parent banks. Universal banking is a major global trend that Vietnam is also following. However, universal banking under a management with insufficient understanding of merits of capital markets risks myopically constraining intermediation of capital market products and services.

6.2.3 Supply problem

119. Low confidence in issuers is partly rooted in a weak incentive system for or some disincentive system against good corporate governance and transparency. The weak incentive system is underpinned by the following policy or institutional problems: non-comprehensive regulatory and supervisory framework for the SSC, low confidence in the judicial system for financial matters, and weak accounting, auditing and tax collection systems. The first problem has been analyzed in Section 5.1. The second one has been partly discussed in Section 6.1. It will be further explored in this section, together with the third problem.

120. Perhaps, the first step toward good corporate governance and transparency may be the establishment of robust, efficient, clear and equitable accounting, auditing and tax collection systems. The improvement of the rules and practices of accounting and auditing is underway. A public company statement requirement has also been proposed to alleviate the disincentive against the corporate governance and transparency of issuers by setting a level playing field for all joint stock companies. The implementation of new rules and practices takes years. Meanwhile, it may be useful for the regulator to publicly discuss the deficiency as well as the achievement of disclosure practices on a regular basis so that the market may discount the deficiency. This honest practice is likely to help build public confidence.

121. The Government has yet to fully adopt internationally-accepted accounting and auditing system that satisfies international standard. [82] The generally accepted accounting principles in the country are also at an early stage of development, gradually adopting principles from the International Financial Reporting Standards (IFRS). Listed companies do not necessarily comply with IFRS requirements. In addition, a prevailing accounting principle, which requires enterprises to measure asset values at historical costs, makes it cumbersome for the Government to find out the market values of SOE assets. Meanwhile, the MOF issued 33 statements on auditing as of the end of May 2005, most of which were adapted from the International Statements on Auditing (ISA) with some modifications. Notwithstanding, Vietnam does not have a plan to issue the audit practice statements in the near future. Local auditing firms are said to lack internal guidelines such as audit manuals and training materials. The MOF "supervises" the appointment of auditors for some SOEs, listed companies, and financial institutions to prevent undesirable influences of an audited company's

82 The World Bank has been providing the SSC with technical assistance on listing rules, financial statements of listed companies and auditing standards and practices in Vietnam under the task management by Behdad M. H. Nowroozi, Senior Financial Management Specialist.

management on auditing.[83] The tax collection system also seems weak. The Government has been unable to collect as much tax from the private sector as it should in accordance with its tax laws. The private sector's contribution to state budget was 14.9 percent of the state budget, whereas its turnover accounted for 33.3 percent of the aggregate turnover. (Table 9) Robust accounting and auditing systems are a prerequisite for efficient and equitable tax collection.

122. The substandard accounting and auditing systems and the weak corporate income tax collection system may have also been slowing down SOE equitization. The insufficient evaluation capacity of assets often delays equitization of SOEs with large assets. The inefficient corporate income tax collection system may cause the Government to think twice about converting SOEs into joint-stock companies for fear of the erosion of the existing tax revenue base. Consequently, the current state of accounting, auditing, and corporate income tax collection system is working as a strong disincentive against making business operations transparent. Transparency is a principle for capital market mechanisms.

123. Simplifying disclosure procedures and shortening the examination period of an issuance registration without compromising the quality of disclosure will help make the primary market attractive. Obtaining a certificate of registration of stock issuance to the public is a lengthy process in Vietnam. There were cases where it took more than three months, though a regulation requires the SSC to grant the certificate within 30 working days from the date of receipt of the full and complete documents.[84] The SSC believes that the incompleteness of the issuer's documentation was accountable for an unintendedly long documentation period. Regardless of which side, the issuer or the regulator, is short of experience in new issue documentation, the time-consuming nature of raising capital in the capital market could be one of major reasons for Vietnamese companies' continued reliance on the banking system for long-term capital. Issuer education on documentation will be useful. In addition, the rationalization of issuance procedures is likely to bring down issuing costs including opportunity costs and market risk to issuers, investors, as well as to intermediaries.[85] The rationalization may be achieved typically in two ways: capacity building of the regulator's staff, and an incentive scheme for listed companies or frequent issuers. First, staff's improved expertise, confidence in their expertise, and minimized bureaucracy will simplify and shorten the process. Second, allowing listed companies filing disclosure documents and/or frequent issuers to use some disclosure techniques such as incorporation by reference,[86] wrap-around prospectus,[87] or shelf-registration[88] will reduce costs and risk involved in financing in the capital markets. A clear regulation for private placements will also help small and/or novice issuers familiarize themselves with financing in the capital markets. If an underdeveloped and cumbersome state of the primary market lasts, Vietnamese issuers may start looking to foreign capital markets to raise funds, which will hollow out the Vietnamese markets.

124. The inadequate confidence in the country's judicial system for financial transactions also underlies weak intermediation for issuing and trading of securities on the formal market. A significant

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83 Findings in the above World Bank project and the WB/SSC Team's interview with accounting firms operating in Vietnam

84 Article 4.5 of Circular Guiding the Issuance of Stocks to the Public (No. 60/2004/TT-BTC dated June 18, 2004)

85 Subject to adequate education of all market participants including the investing public, the regulator may wish to consider shifting the new issue documentation process more towards a disclosure-based system from a merits-based system for the rationalization of new issue procedures.

86 A disclosure technique that uses documents already published and filed with the competent authority etc. by referring them in a disclosure document.

87 A prospectus produced by wrapping around documents already published and filed with the competent authority, such as an audited annual report, with a short supplementary document for a specific issue.

88 A disclosure technique that allows eligible issuers to file a registration statement with the regulator, and issue securities at any time during the effective period – e.g. two years – of the statement. This technique was first introduced in the US market. Three-part Prospectus System under the Proposed EU Prospectus Directive appears similar to shelf registration but more rationalized.

number of investors are trading far more actively on the unregulated market than on the formal market. This reflects the fact that Vietnamese investors hardly rely on either public or private enforcement of their contractual rights arising from securities transactions. Besides a public enforcement mechanism that is being strengthened, private enforcement before court is expected to enhance disclosure and deter negligence or fraud. Investors invest and trade only to the extent "informal" enforcement, if any, applies. "Informal" enforcement is unreliable and/or costly. If investors were confident in the judicial system for recovering their losses and/or settling their disputes, they would likely trade more on the formal market where their contractual rights could be better protected.

6.3 Conclusion and Recommendations

125. The inactive government securities market and the lack of depth in the primary market are two core impediments to Vietnam's capital market development. Trading in the government securities market has been very modest. Their holdings are heavily concentrated in commercial banks. A combination of several problems at the policy and institutional level is responsible for the illiquidity. Concurrently, Vietnam's capital market supplied only a negligible amount of capital to the private sector, failing to live up to the country's economic growth in recent years. There is almost no incentive for attractive issuers to finance in the regulated capital market, in comparison to the bank loan market. Meanwhile, weak accounting, auditing, and tax collection systems, combined with low confidence in the judicial system for financial transactions, create an incentive for issuers to keep their financial state nontransparent to investors.

126. In order to generate the secondary market trading of government securities, the Government is recommended to:

- Review the current debt management policies and debt issuance practices against the World Bank/IMF guidelines, establish a clear-cut debt management and debt issuance policy framework, and develop necessary skills;
- Review the current monetary policy framework, and consider introducing appropriate standing facilities;
- Review and reinforce the judicial system for financial contracts, and consider adopting a standard master repo agreement;
- Accelerate the deep equitization of SOCBs; and,
- Formulate contractual savings development policies, and expedite setting up of pension schemes for private-sector workers.

127. In order to facilitate capital raising in the capital markets, the Government is advised to:

- Establish robust, efficient and equitable accounting, auditing and corporate income tax collection systems for equitized enterprises as soon as possible;
- Streamline banking supervision to keep banks' maturity mismatch at a modest level;
- Review intermediaries' license categories and criteria to alleviate the concentration of market power on the SOCBs' subsidiary securities firms;
- Simplify securities issuance procedures, for example, using incentive schemes such as incorporation by reference, wrap-around prospectus, or shelf-registration;
- Review and reinforce the judicial system for not only public but also private enforcement of financial contracts to protect the interests of investors; and,
- Consider setting up an investor protection fund as an incentive for investors to trade through regulated brokers.

7 Policy & Institutional issues

128. This section will discuss policy and institutional problems that prevent Vietnam's technical and financial resources from being effectively transformed into desired outputs. Earlier sections in this report have discussed the key policy and institutional problems that have been interfering with individual outputs required for Vietnam's capital market development. Such policy and institutional problems include:

- Incomprehensive regulatory and supervisory framework for the SSC;
- Deficient management and suboptimal debt issuance policies at the MOF and the SBV;
- Fledging monetary policy framework and weak bank supervision at SBV;
- The lack of contractual savings development policies;
- Decentralized and incomplete equitization process;
- Low confidence in the judicial system for financial transactions; and,
- Weak accounting, auditing and corporate income tax collection systems.

Besides them, two policy and institutional problems underlie all other problems in Vietnam's capital markets. The two problems are:

- The lack of a coherent structure design of the financial industry; and,
- Insufficient financial statistics and information sharing among policy markers

7.1 A lack of coherent structural design of the financial sector

129. **The policymakers do not seem to have forged a consensus on the prospective structure of the financial sector.** The consensus will serve as the backbone of the country's financial sector development and regulation. Market realities driven by private sector entrepreneurs are already ahead of the regulatory framework in place as evidenced by the active unregulated stock market. The draft Securities Law has legitimately expanded the scope of "securities markets" beyond stock exchanges, but has yet to embrace the concept of "capital markets." The Prime Minister's Decision No. 163 falls short of referring to possible roles of the SBV and the MOF in the country's capital market development and the SSC's relationship with the central bank and the ministry. The IMF has been recommending the Government to substantially review the SBV and Credit Institutions Laws. Since the SSC was merged into the MOF in February 2004, the MOF has revealed no significant plan at a policy level.

130. The absence of a policy manifestation on the prospective structure of the financial sector may interfere with private sector development. It is not clear what the policymakers envisage the prospective structure of the country's financial sector. A future vision about the financial sector among policymakers will be a major determinant of an optimal regulatory model of the financial markets including the capital markets. Thus, the obscure state of the future financial sector structure generally prevents the private sector including foreign institutions from seriously planning their investment in the financial sector.

131. **The Government is recommended to forge a vision on the evolution of the financial sector as well as its environment.** In doing so, the Government need to envisage the sector's prospective structure, and design a regulatory framework of the sector optimal to Vietnam's economic development. The regulatory framework of the capital or securities markets will be best formulated and implemented in a thought-out structural framework of the financial sector. A typical set of steps that the Government may take can be as follows:

To review and analyze the situation of the financial sector and its regulation in terms of the level of financial activity and the mix of financial instruments and services available in the economy;

To identify the explicit as well as implicit objectives of the current financial regulation by reviewing recent policy actions and inventorying the regulatory resources in place;

To forecast a future environment surrounding the country and its financial sector;

To identify the financial sector's strengths and weaknesses as well as opportunities and risks to it in the future environment;

To evaluate the future robustness and resiliency of the financial sector and the future effectiveness of the current institutional structure of financial regulation in light of the financial industry's development strategy;

To establish the objectives of financial regulation relevant to the country's future;

To formulate and evaluate new or improved alternative institutional structures of financial regulation that may be in line with the objectives and more effective than the current one; and,

To choose and implement the institutional structure of financial regulation that is optimal to achieve the objectives.

132. **The needs for a policy manifestation on the prospective structure of the financial sector are extensive.** For example, the Government may wish to authorize the SSC to regulate and supervise capital market activities rather than securities markets activities in order to cope with challenges posed by Vietnamese financial sector's global integration. It may also wish the SBV to develop a more sophisticated monetary policy framework and master skills necessary for effective monetary operations in order to keep inflationary pressures under control. An effective transmission mechanism of monetary policy requires efficient money markets. The Government may find it necessary to establish an overall regulatory and supervisory framework for the financial sector to keep the financial system resilient enough to unexpected shocks as the economy is opened up and liberalized. The Government is probably anxious to foster contractual savings systems to finance the country's economic development as well as to put a security safety net in place for addressing potentially growing social issues as the private sector expands. How to address all these policy issues or concerns are closely related to what shape the financial sector will take and how the Government will organize its regulatory structure.

7.2 <u>Insufficient financial statistics and lack of information sharing</u>

133. **The improvement of financial statistics will facilitate policymaking, regulation, supervision, and financial transactions.** The country has developed the General Statistics Office (GSO) website, which is a high-quality and user-friendly statistical database of government statistics.[89] However, neither does the database carry financial statistics nor any other government agencies including the SSC and the SBV systematically release adequate financials statistics of the Vietnamese economy. The inadequate availability of financial statistics prevents accurate, comprehensive, and timely analyses of the country's financial activities. Consequently, it compromises the quality of economic and financial policies, market regulation and supervision, as well as financing and investment activities, frustrating the whole financial market development one way or another.

134. The ministries and government agencies can share more financial information within the Government, and, when necessary, with international organizations and/or foreign governments. Inadequate information sharing seems to stem from the inadequate availability of financial statistics as

89 http://www.gso.gov.vn/default_en.aspx?tabid=491

has been discussed above, and the lack of formal and simple rules for information sharing. This situation may have been making hard fort government officials to make optimal policies in a timely manner. The rules for information sharing typically include identification of the circumstances under which information sharing may be sought, identification of the procedures through which information sharing may be made; identification of the types of information and assistance that can be provided; safeguards of the confidentiality of information transmitted; and a description of the permitted uses of the information.

7.3 Conclusion and Recommendations

135. Beside the seven policy and institutional problems that have been discussed earlier, the function and development of Vietnam's capital markets also are hampered by (i) the lack of a policy vision on the institutional and structural development of the financial sector, and (ii) insufficient financial statistics and information sharing among policy makers. These two underlie all other problems with Vietnam's capital markets. The policymakers do not seem to have forged a consensus on the prospective structure of the financial sector, which also affects capital market development. The management of financial statistics is underdeveloped as compared to other kinds of national statistical data. The absence of formal and simple rules for information sharing has been aggravating information problems in the financial policy making, regulation, and supervision and business activities.

136. The Government is recommended to:

Make a master plan on a coherent financial sector structure as soon as it can;

Launch a project for building a financial statistical database similar to the GSO; and,

8 Formulate formal and simple rules for information sharing. Recommendations for the Five-year Plan

137. This section will present recommended policy actions to be implemented under the five-year plan of Vietnamese capital market development in consideration of sequence and priorities. The recommendations will be presented in lieu of our direct comments on the Prime Minister's Decision No. 163 on the Strategy for the Development of Vietnam's Securities Market up to year 2010. The sequence and priorities of policy actions are graphically shown, based on cause-effect linkages among the identified issues and policy measures in the Annex. All the policy measures that have been suggested in the preceding sections for the Government to consider are summarized in Table 17 at the end of this section.

8.1 Private-sector initiatives for market development

138. Vietnam's capital market development strategy may need to re-adjust its focus by relying more on private-sector initiatives for market development. Capital market development in Vietnam has so far been managed and sponsored by the Government. The Vietnamese officials with whom the Mission had meetings tend to focus on the equitization or privatization of SOEs for capital market development, while the Vietnamese economy is apparently accelerated by FDI and private-sector entrepreneurship. This is because SOEs still account for 40 to 50 percent of the country's GDP, and the stock market was conceived as an infrastructure to facilitate the enhancement of their operational efficiency. According to the Vietnamese officials, however, the equitization has been slower than they initially expected, setting back Vietnam's securities market development. By contrast, entrepreneurial activities in the private sector appear to need more accessible capital markets to accelerate their growth. In addition, capital market activities seem more active in the unregulated stock market than the state-managed market. How to optimize the private-sector initiatives and simultaneously control any systemic risk would be a critical policy challenge.

139. Private sector initiatives in capital market development may be encouraged by phasing out the state-control or ownership over the HOSTC and the HASTC, and/or by allowing privately-owned exchanges or trading systems to operate. The independence of the CSD from the HOSTC is also likely to help give room for market development under private sector initiatives. Privately-owned exchanges or trading systems should be allowed to set their own listing criteria and trading rules and to offer other services auxiliary to listing and trading under the regulatory oversight. Entrepreneurial initiatives are already observed in the unregulated market. The backbone of capital market development on private sector initiatives will be a robust and efficient clearing, settlement and depository system and a rational, comprehensive, and effective regulatory and supervisory framework. The former will alleviate market fragmentation by facilitating market arbitrage. The latter will help ensure an equal footing for all market operators as well as investor protection across the market.

8.2 Policy impacts of capital market development

140. Underdeveloped capital markets have limited the efficiency of financial intermediation and constrained Vietnam's economic growth potential. Developed capital markets are likely to have positive impacts on various segments and levels of the economy, consequently contributing to the sustainable growth of the national economy.

141. **The degree of underdevelopment of Vietnam's capital markets can be measured by certain performance indicators.** The current performance of Vietnam's capital markets is well reflected in three key indicators: the lack of a reliable yield curve of government bonds, the low level of medium- and long-term risk capital raising activities in the capital markets, and the lack of market liquidity and price discovery as shown in the previous sections. These problems, among other things, have been responsible for the ineffectiveness of monetary policy and its transmission mechanisms, and

the inefficient reallocation of financial resources in the Vietnamese economy. If they persist or worsen, the consequent deficiencies in the financial system, combined with the country's fiscal constraints, could pose the risk of growing external debt, weakening the international competitiveness of domestic production, or inducing asset price inflation (bubble) to the country. The improvement of Vietnam's capital markets can also be measured by the same performance indicators. The evolution of a reliable yield curve or reliable reference rates, the active raising of medium- and long-term risk capital and enhanced market liquidity will indicate the improvement of the markets' performance. The improving performance of capital markets will ultimately help keep the country's debt position and price level under control and enhance the competitiveness of domestic enterprises through various channels.

8.3 Policy inputs and outputs

142. **Political support as well as orchestrated efforts across the Government is essential for capital market development.** The SSC alone cannot develop the capital markets. The policy and institutional problems that we think are significantly responsible for the underdeveloped state of Vietnam's capital markets are spread beyond the SSC's jurisdiction. The interests, issues, and concerns with regard to capital markets are considerably interwoven since the benefits of well-functioning capital markets or the costs of the underdeveloped capital markets are far-reaching across the economy.

143. **Policy and institutional problems have been significantly weakening the effects of resource input by the Government.** Thus, they have brought about operational problems –deficient outputs– in the financial markets that have been interfering with the development of the capital markets. The operational problems are tangible components of the capital markets. The policy and institutional problems prevent the inputs from being effectively transformed into the desired outputs (operational solutions) in the current Vietnamese capital markets. The policy and institutional problems and some operational problems is likely to be effective policy intervention points on which the Government is recommended to focus in order to accelerate capital market development.

144. The policy and institutional problems have been adversely affecting the whole financial sector and deficient policies or institutions. The problems adversely affecting the whole financial sector are a lack of a coherent policy vision regarding the institutional structure of the financial industry at the MOF, the SBV and the SSC, and insufficient statistics and information sharing among policymakers. The deficient policies or institutions consist of a non-comprehensive regulatory and supervisory framework for the SSC, a lack of debt management and suboptimal debt issuance policies at MOF (State Treasury), a fledging monetary policy framework and weak bank supervision at the SBV, a lack of contractual savings development policies, decentralized /incomplete equitization process, weak tax collection systems, and weak accounting and auditing systems.

8.4 Priority and sequence

145. It is recommended that the 2006-2010 five-year plan of Vietnamese capital market development be composed of the following four courses of policy actions:

- **(i) private-sector securities markets development,**
- **(ii) public debt management and government securities market development,**
- **(iii) master planning on a coherent financial sector structure, and,**
- **(iv) statistical capacity building and setting an information sharing regime.**

146. Table 17 summarizes the policy actions at the policy and institutional level as well as at the operational level along with ministries and/or agencies that are presumably responsible for individual policy actions. In each course of policy action, it is desirable to give priority to policy and institutional

problems/solutions over operational ones in undertaking reform. Operational problems can be addressed without policy and institutional problems being cleared up. This approach, known as a piece-meal approach, may be easier to implement projects, but its effects are unlikely to be sustainable and substantial, because policy and institutional problems underlying operational problems are left unresolved. In contrast, a logical solution will be to address policy and institutional problems/solutions before operational ones in undertaking reform or reinforcement. Nonetheless, solving the policy and institutional problems will not be fully effective until operational problems have been worked out, in other words, until tangible improvements have been put in place.

147. Good coordination among ministries and government agencies will be vital to planning and implementing each course of policy actions. Table 17 shows ministries and government agencies that are presumably responsible for each policy action, taking into account the prevailing laws and regulations, the Vietnamese environment, and our general views on capital market development.[90] Planning and implementation responsibilities may be assigned to a single government office, ministry or agency or shared among the PMO, the MOF, the SBV, the SCC, and other government offices under an equal or primary/secondary relationship. A master plan on a coherent financial sector structure is likely to simplify the assignment of responsibility and coordination within the Government.

8.5 Monitoring of Market Development

148. For effective monitoring of policy implementation, it is essential for the Government to set the target milestone of capital market development with verifiable indicators, and to measure the progress of capital market development against the milestones. The following three indicators are practical to cover the Government's objectives of market development: (i) the evolution of a reliable yield curve or reliable reference rates, (ii) the amount of medium- and long-term risk capital raised, and (iii) the level of market liquidity. The Government can set target quantities, qualities, and timings for each course of policy actions, policy and institutional issue, or output that is chosen to implement.

Table 17: Recommended Policy Actions under a 2006-2010 Five-Year Plan of Vietnamese Capital Market Development

Recommended Policy Goals (by Priority)	Implementation Actions	Responsible Ministries / Agencies[1]	Timeframe (Maximum Years)
A. Private-sector securities markets development			
1. A comprehensive legal, regulatory, and supervisory framework for the SSC	Develop and pass new Securities Law that ensures SSC operational independence	MOF / SSC[2]	2
	Regulate and supervise the markets through activities of market players rather than particular institutions Create a license category for non-STC member broker/dealers and enforce licensing standards	SSC	2

90 An actual assignment will be subject to further deliberation within the Government.

	Confidence building in the judicial system for financial transactions and contracts, including the possible development of specialized courts for financial issues and arbitration systems for private settlements	MOF - MOJ? [3]	5
2. Sound privatization (equitization) process that is linked to market development	Partially privatize the state banks and larger SOEs	MOF - SBV[4]	5
	Reduce preferences for SOEs and limit the scope of state capital investments and holdings Pursue deep equitization of SOEs to eliminate a owner-regulator conflict of line-ministries	NSCERD / MOF	5
	Implement strong corporate governance rules and regulations and protections for minority shareholders	SSC	2
	Establish an investor protection fund	SSC	2
3. Strong network of market intermediaries	Develop policies to encourage the formation and growth market intermediaries and new financing vehicles and instruments	SSC	2
	Formulate contractual savings development policies, and expedite setting up pension schemes for private-sector workers	MOF / SSC / MOLISA / ?	2
4. A reliable accounting, auditing and tax collection system	Maintain clear and consistent standards for accounting and auditing of public firms Establish and enforce new standards	MOF / SSC	3
5. Robust and efficient stock market infrastructure	Create efficient trading, clearing, settlement, custody and register systems Set up a centralized registry system together with the central securities depository for all tradable securities	SSC	3
B. Public debt management and government securities market development			
1. Well-functioning debt management & optimal debt issuance policies	Review the current debt management and debt issuance policies against the World Bank/IMF guidelines Create a debt management policy framework for sizable and predictable government debt issues and integrated primary market	ST / MOF / SBV / SSC	2
	Diverse distribution of Government Securities in the primary market	ST - SBV	3
2. Robust and efficient bond market infrastructure	Efficient/robust trading, clearing, settlement, custody and register systems	SSC / SBV / ST	5
	OTC bond trading with trade price info dissemination	SSC / SBV	4

3.	Optimal reserve management structure, viable monetary policy framework & close bank supervision at the SBV	Review the current reserve requirement structure, and consider introducing appropriate standing facilities Clearly establish a monetary management framework	SBV	2
C. Master planning on a coherent financial sector structure				
1.	A coherent master plan for financial sector development and regulatory structure	Analyze the current and forecast the future structure of the financial sector Formulate objectives for regulating the financial sector in the future Design and implement a new financial regulatory structure	MOF / SBV / SSC	3
D. Capacity building for financial statistics and setting an information sharing regime				
1.	Market statistics standards and enhanced market surveillance	Establish a standard set of market indicators Develop data sharing and safeguard protocols across the Government Build capacity for data analysis for market surveillance and policy making	SBV / SSC?[3]	4

Notes:

1. Subject to further deliberation within the Government.
2. "/" indicates a primary/secondary relationship.
3. "?" indicates "unknown" or "not sure".
4. "-" indicates an equal relationship.

ANNEX: Cause-Effect Linkages and Solution Sequences for Vietnam

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How to Use the Diagrams of the Cause-Effect Linkages and Solution Sequences

One of the key purposes of this project is to recommend policy implementation sequence and priorities for the improvement of Vietnam's capital markets. The series of diagrams in the following pages are intended to show visually the policy implementation sequences and priorities that have been discussed earlier in this report.

The diagrams are divided into two groups: Hypothetical Cause-Effect Linkages and Sequence and Solution Sequence. Of the twelve diagrams, Figure 11: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (6/6), and Figure 17: Solution Sequences in Vietnam's Capital Markets (6/6) are representative of each group of diagrams.

The diagrams of "Hypothetical Cause-Effect Linkages" show how the problems that we have identified are hierarchically linked as causes and effects. It illustrates which other problem(s) a particular problem is responsible for. Therefore, this visual recognition of the cause-effect linkages of the problems is helpful to determine the policy implementation sequence and priorities.

The diagrams of "Sequence and Solution Sequence" show how possible solutions (suggested policy actins) will support or contribute to other solutions that will be ultimately needed for the improvement of Vietnam's capital markets. Their relations determine the sequences and priorities of policy actions to be implemented.

In order to make it easier to understand the two representative diagrams (**Figures 11 and 17**), each of them was decomposed into five sub-diagrams.

The first ones (**Figures 6 and 12**) focus on what negative impacts of the underdeveloped capital markets are and what positive impacts of the developed capital markets will be on the overall growth and development of the Vietnamese economy.

The second ones (**Figures 7 and 13**) illustrate only the failures of operational functions that are directly responsible for the underdeveloped state of Vietnam's capital markets, and the improvements of operational functions that are expected to contribute directly to the development of Vietnam's capital markets. They can be reduced into three key operational problems and solutions. They are depicted separately in the figures that follow.

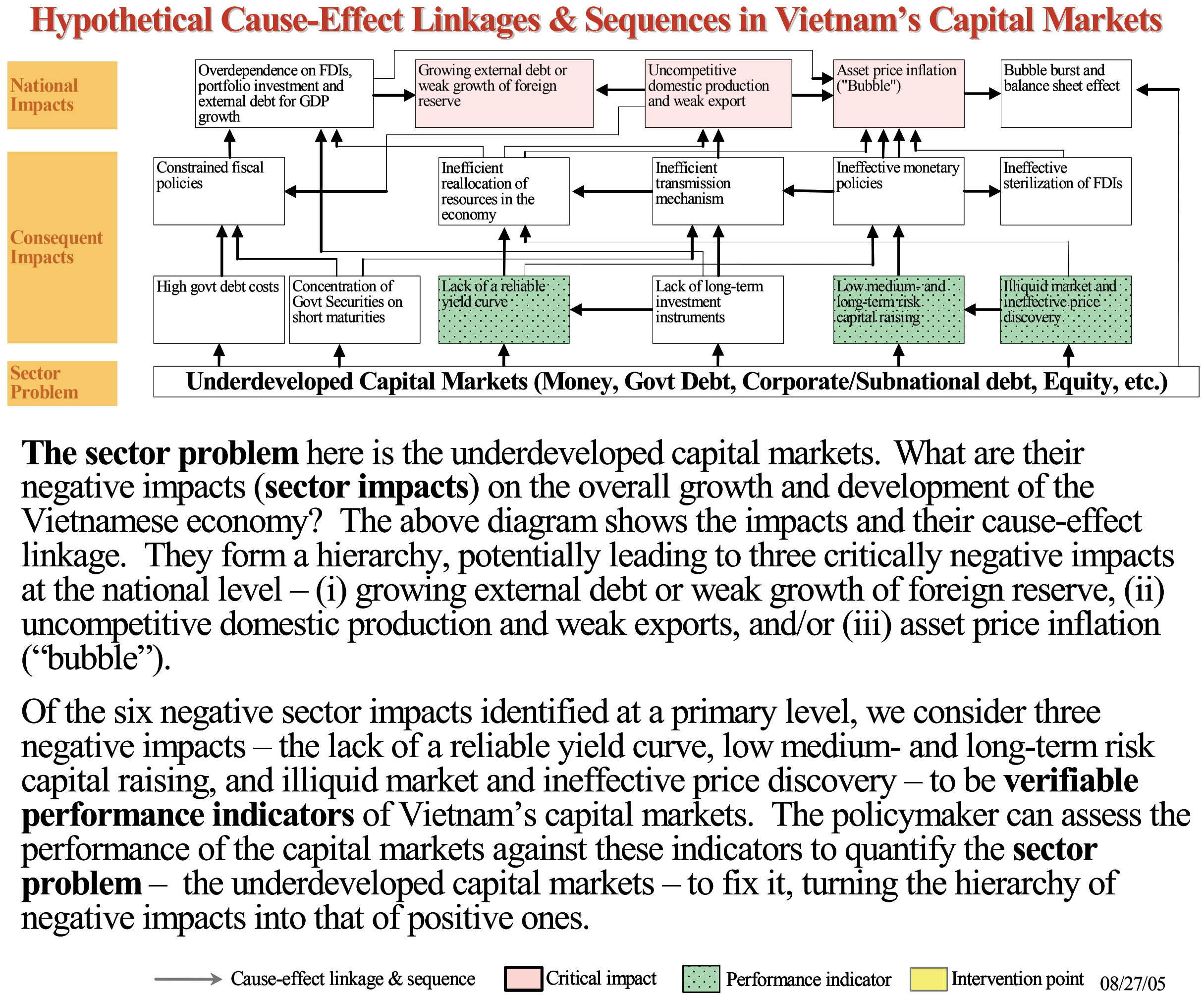
The third ones (**Figures 8 and 14**) hierarchically depict the elements of the inactive and active government securities market – one of the three key operational functions. We consider some influential problems to be intervention points where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical sequences of policy interventions (actions).

The fourth ones (**Figures 9 and 15**) hierarchically depict the elements of the incentive issues of financing in the regulated and unregulated issues. We consider some influential problems to be intervention points where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical sequences of policy interventions (actions).

The fifth ones (**Figure 10 and 16**) represent key policy and institutional problems underlying the failures of the operational functions, and key policy and institutional solutions that are likely to support the operational improvements that have been suggested in Figures 14 and 15). Unless the policy and institutional problems are adequately addressed, Vietnam's capital markets are likely to repeat problems that are the same as or similar to those shown in Figures 8 and 9 even if they are temporarily solved through government interventions.

Finally, Figures 6-10 and 12-15 constitute Figures 11 and 16, respectively. Figures 11 and 16 may look complex. Nonetheless, the diagrams are intended to help the policymaker to sequence and prioritize his or her policy actions, and to locate where he or she is in terms of policy sequences and priorities when addressing a particular policy issue.

Figure 6: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (1/6)



The sector problem here is the underdeveloped capital markets. What are their negative impacts (**sector impacts**) on the overall growth and development of the Vietnamese economy? The above diagram shows the impacts and their cause-effect linkage. They form a hierarchy, potentially leading to three critically negative impacts at the national level – (i) growing external debt or weak growth of foreign reserve, (ii) uncompetitive domestic production and weak exports, and/or (iii) asset price inflation ("bubble").

Of the six negative sector impacts identified at a primary level, we consider three negative impacts – the lack of a reliable yield curve, low medium- and long-term risk capital raising, and illiquid market and ineffective price discovery – to be **verifiable performance indicators** of Vietnam's capital markets. The policymaker can assess the performance of the capital markets against these indicators to quantify the **sector problem** – the underdeveloped capital markets – to fix it, turning the hierarchy of negative impacts into that of positive ones.

Figure 7: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (2/6)

Hypothetical Cause-Effect Linkages & Sequences in Vietnam's Capital Markets

Sector Problem

Operational Problems (Deficient Outputs)

In our view, the underdeveloped capital markets have resulted from the capital markets' failures in producing the quantity and quality of outputs required for the markets to perform required functions (**deficient outputs** or **operational problems**).

The critical failures are represented by (i) the inactive secondary market of government securities, (ii) the lack of incentives for financing in the regulated capital market, (iii) active and sizable unregulated markets.

→ Cause-effect linkage & sequence | Critical impact | Performance indicator | Intervention point 08/27/05

Figure 8: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (3/6)

Hypothetical Cause-Effect Linkages & Sequences in Vietnam's Capital Markets

A host of operational problems amount to the **inactive secondary market of government securities**. They are interlinked as depicted below, forming a hierarchy with seven policy and institutional problems at the foundation level.

We consider some influential problems to be **intervention points** where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical **sequences** of policy interventions (actions).

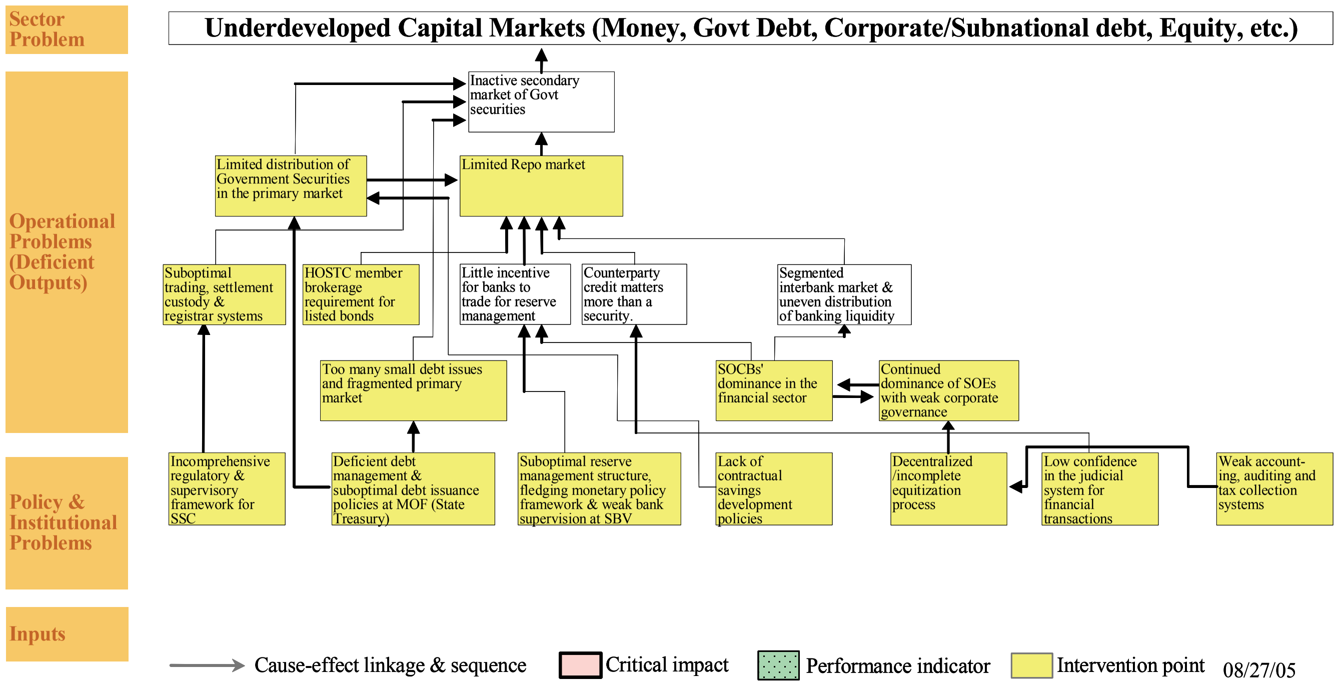


Figure 9: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (4/6)

Hypothetical Cause-Effect Linkages & Sequences in Vietnam's Capital Markets

A host of operational problems also amount to **the lack of incentives for financing in the regulated primary market,** and to **active and sizable unregulated market**. They are interlinked as depicted below, forming a hierarchy with six policy and institutional problems at the foundation level.

We consider some influential problems to be **intervention points** where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical **sequences** of policy interventions (actions).

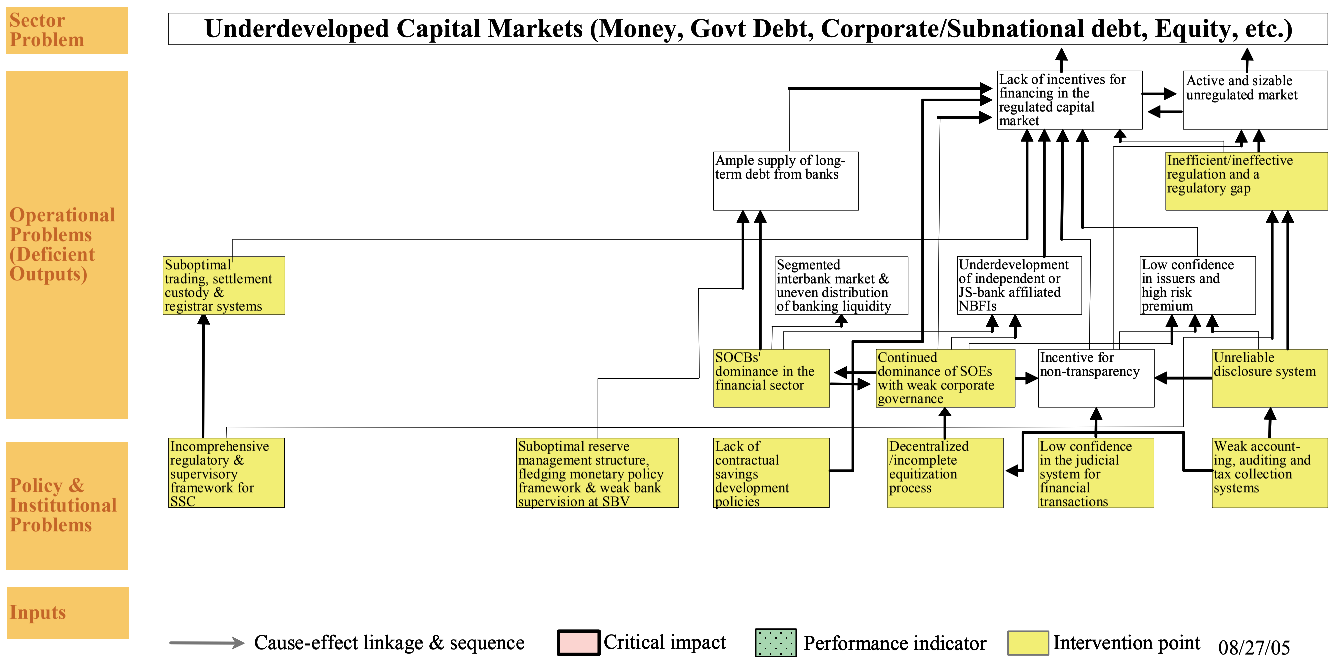
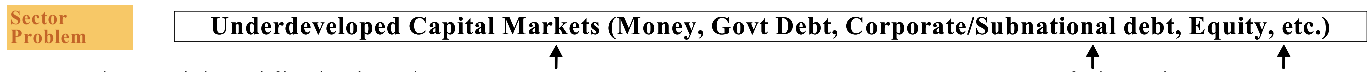


Figure 10: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (5/6)

Hypothetical Cause-Effect Linkages & Sequences in Vietnam's Capital Markets



We have identified nine key **policy and institutional problems**. Of the nine, two problems underlie all other problems. The two problems are (i) the lack of a coherent structure design of the financial industry, and (ii) insufficient financial statistics and information sharing among policymakers.

Inadequate technical (and financial) resources (**input**) have, as shown at the bottom of the diagram, caused the policy and institutional problems. Therefore, financial and/or technical assistance may be needed. In addition, policy and institutional problems may prevent the inputs from being effectively transformed into the desired outputs (operational solutions).

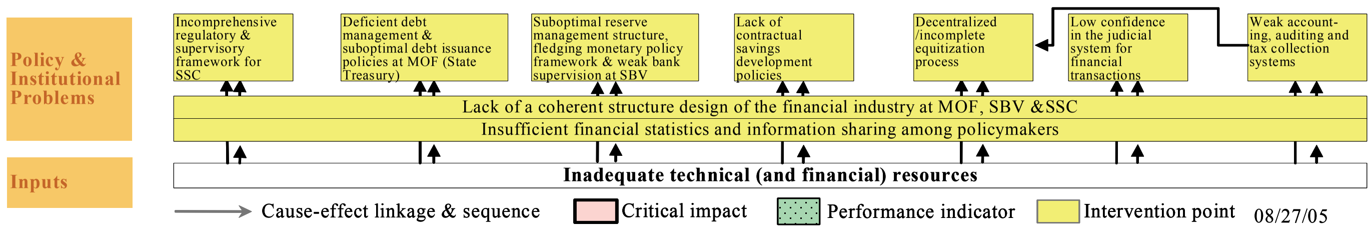


Figure 11: Cause-Effect Linkages and Sequences in Vietnam's Capital Markets (6/6)

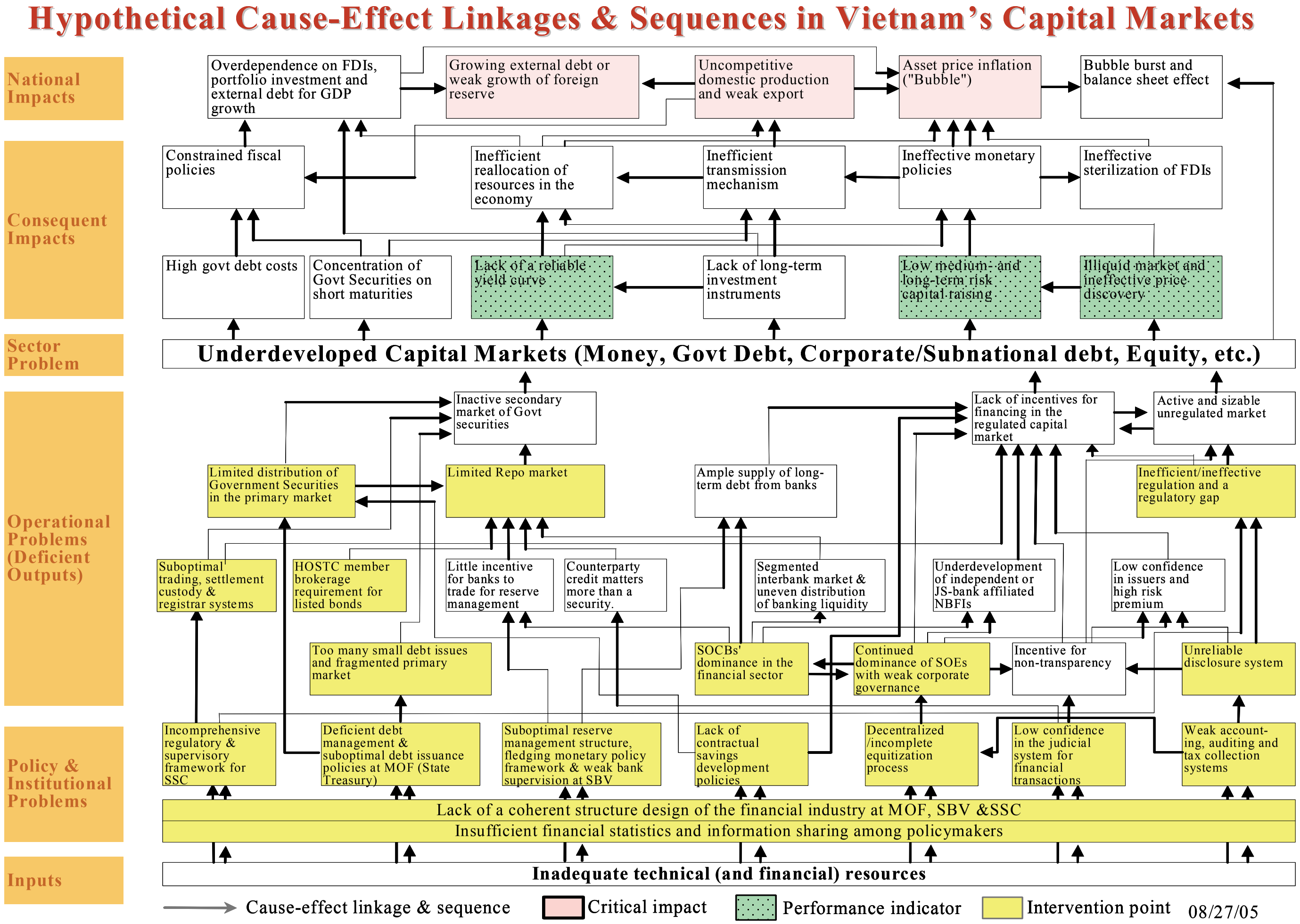
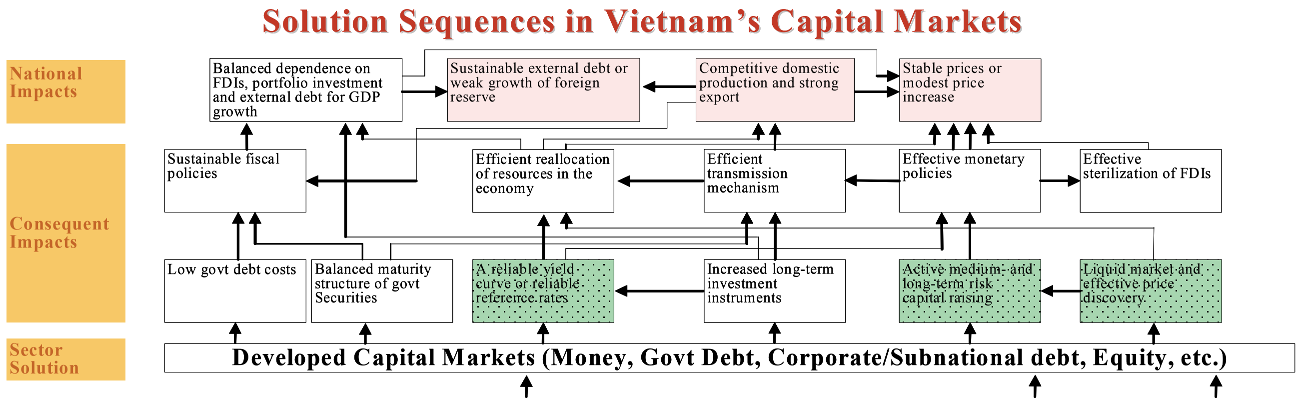


Figure 12: Solution Sequences in Vietnam's Capital Markets (1/6)



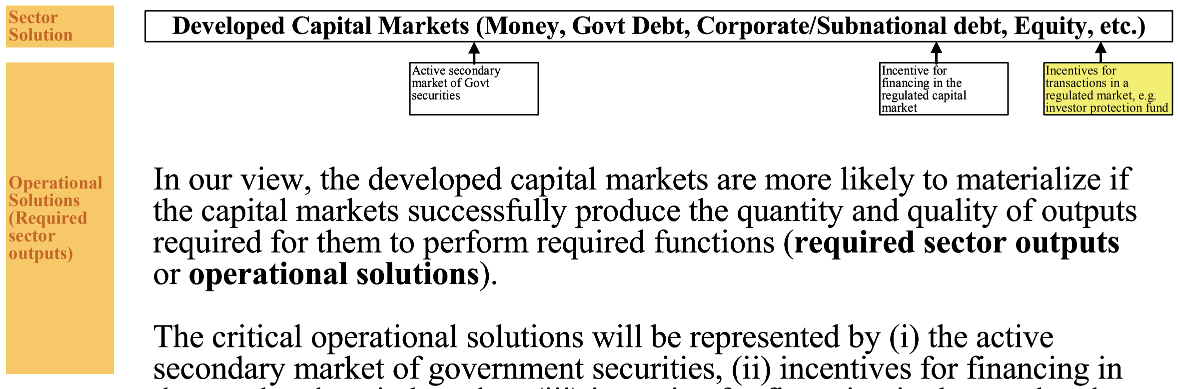
The sector solution will be the developed capital markets. What will their impacts (**sector impacts**) be on the overall growth and development of the Vietnamese economy? The above diagram shows the positive impacts and their cause-effect linkage. The positive impacts will form a hierarchy, potentially leading to three critically positive impacts at the national level – (i) sustainable external debt or weak growth of foreign reserve, (ii) competitive domestic production and weak exports, and (iii) Stable prices or modest price increase.

Of the six positive sector impacts identified at a primary level, we consider three positive impacts – a reliable yield curve or reliable reference rates, active medium- and long-term risk capital raising, and liquid market and effective price discovery – to be **verifiable performance indicators** of Vietnam's capital markets. The policymaker will be able to assess the performance of the capital markets against these indicators to measure the achievement toward the **sector solution** – the developed capital markets – to further it, reinforcing the hierarchy of positive impacts.

Cause-effect linkage & sequence Critical impact Performance indicator Intervention point 08/27/05

Figure 13: Solution Sequences in Vietnam's Capital Markets (2/6)

Solution Sequences in Vietnam's Capital Markets



In our view, the developed capital markets are more likely to materialize if the capital markets successfully produce the quantity and quality of outputs required for them to perform required functions (**required sector outputs** or **operational solutions**).

The critical operational solutions will be represented by (i) the active secondary market of government securities, (ii) incentives for financing in the regulated capital market, (iii) incentive for financing in the regulated capital market.

Cause-effect linkage & sequence | Critical impact | Performance indicator | Intervention point 08/27/05

Figure 14: Solution Sequences in Vietnam's Capital Markets (3/6)

Solution Sequences in Vietnam's Capital Markets

A host of operational solutions will amount to the **active secondary market of government securities**. They will be interlinked as depicted below, forming a hierarchy with seven policy and institutional solutions at the foundation level.

We consider some influential solutions to be **intervention points** where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical **sequences** of policy interventions (actions).

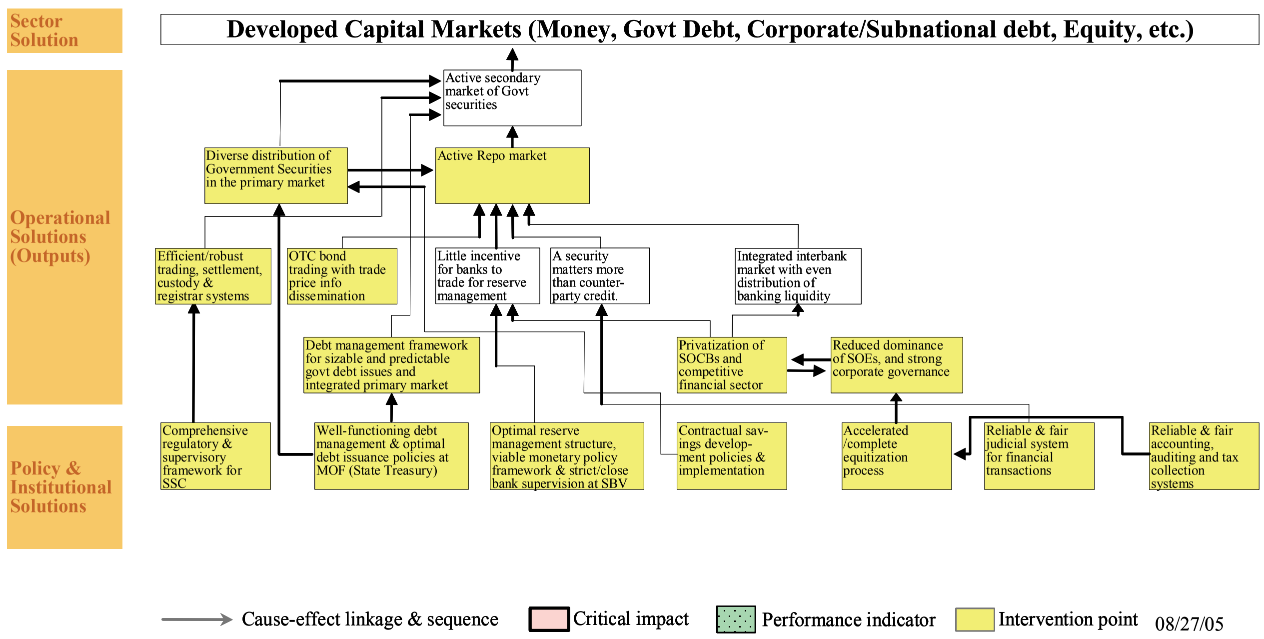


Figure 15: Solution Sequences in Vietnam's Capital Markets (4/6)

Solution Sequences in Vietnam's Capital Markets

A host of operational solutions will also amount to **incentives for financing in the regulated primary market,** and to **incentives for transactions in a regulated market**. They will be interlinked as depicted below, forming a hierarchy with six policy and institutional solutions at the foundation level.

We consider some influential solutions to be **intervention points** where policy actions, backed by technical assistance if necessary, are likely to be effective. The hierarchical linkages indicate logical **sequences** of policy interventions (actions).

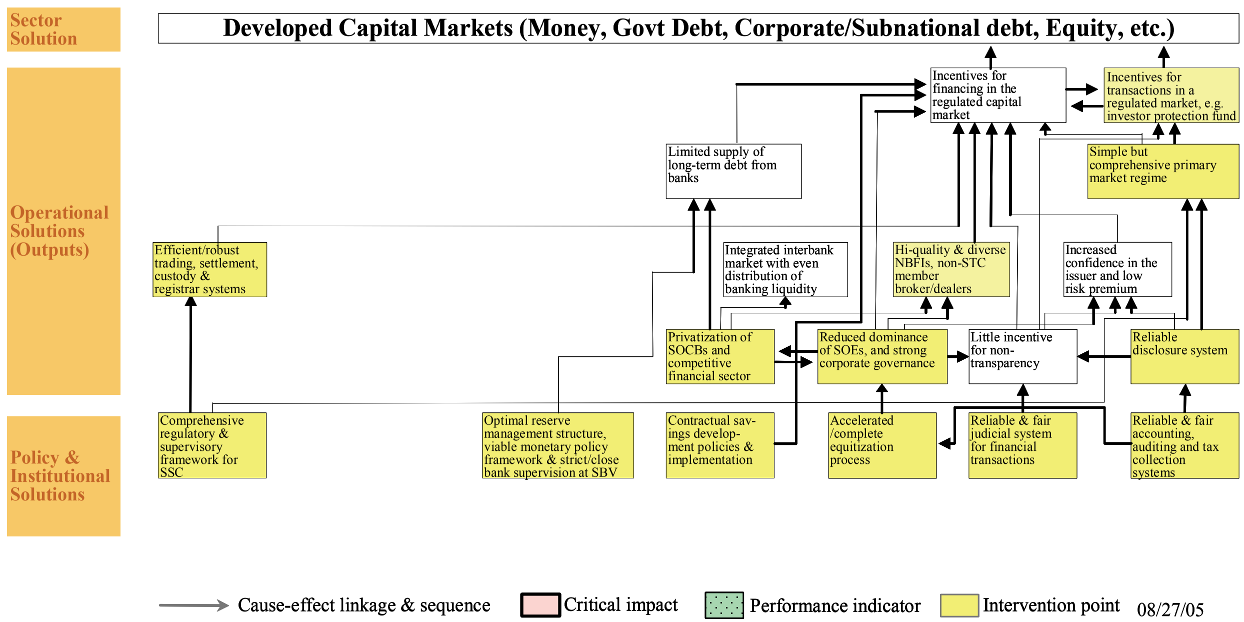


Figure 16: Solution Sequences in Vietnam's Capital Markets (5/6)

Solution Sequences in Vietnam's Capital Markets

We have identified nine key policy and institutional solutions. Of the nine, two solutions will support all other solutions. The two solutions are (i) master planning on a coherent structure design of the financial industry, and (ii) sufficient financial statistics and information sharing among policymakers.

Adequate technical (and financial) resources (**input**) will, as shown at the bottom of the diagram, help solve the policy and institutional problems. Thus, financial and/or technical assistance may be needed. In addition, policy and institutional solutions are likely to help effectively transform the inputs into the desired outputs (operational solutions).

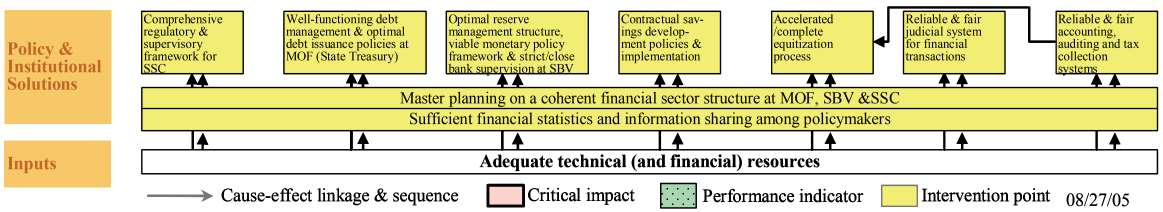


Figure 17: Solution Sequences in Vietnam's Capital Markets (6/6)

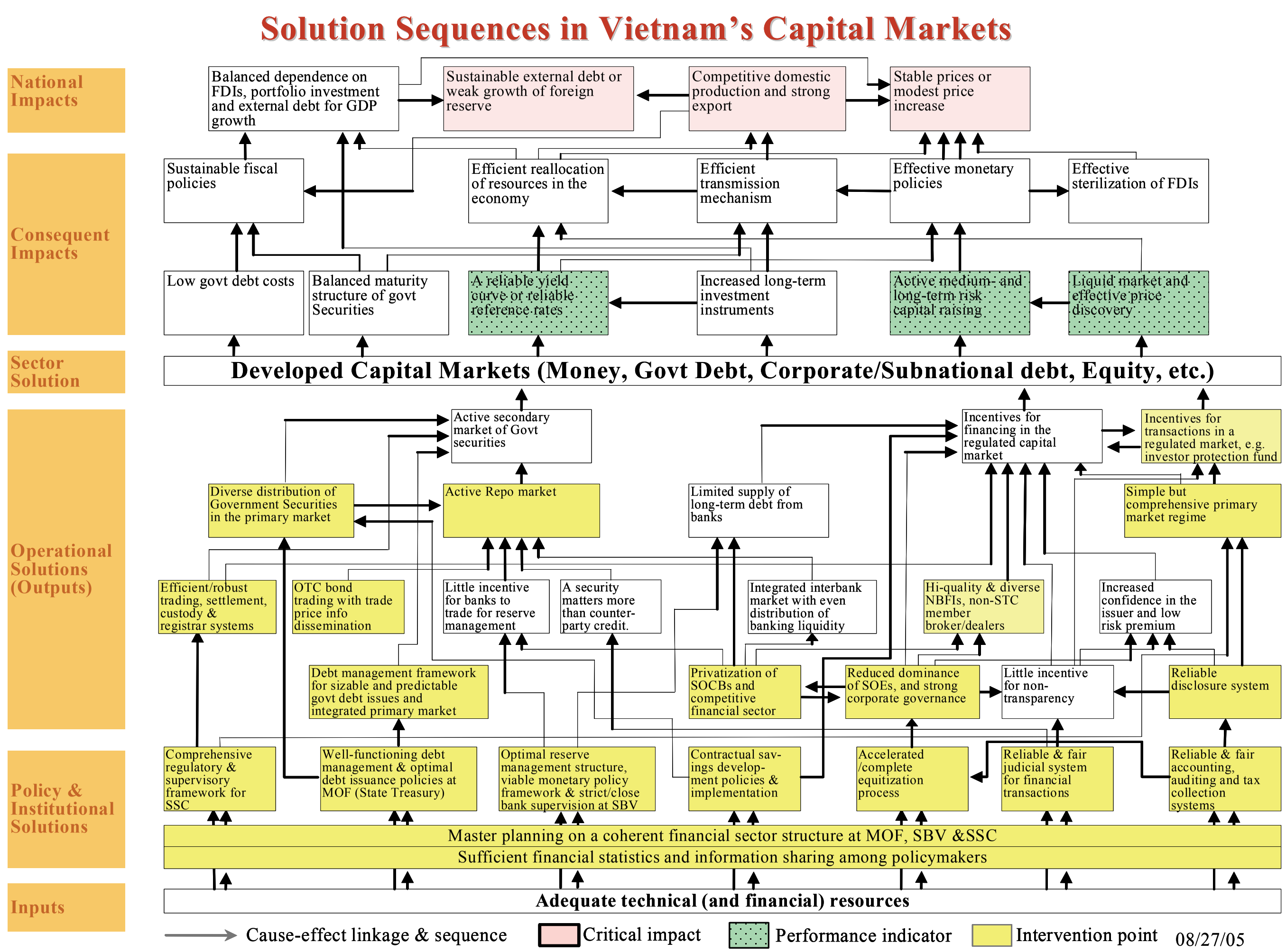


Figure 18: Four Courses of Policy Actions