PRUDENT RATIOS IN OPERATIONS OF CREDIT INSTITUTIONS

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The State Bank of Vietnam (SBV) recently issued a number of supervisory regulations monitoring internal activities of commercial banks in an effort to improve the credit quality and safety of the whole banking system and to comply with the core Basel recommendations as well as other international standards. One of the new regulations is Decision No. 457/2005/QD-NHNN dated April 19, 2005 of the SBV Governor promulgating the Regulations on Prudent Ratios in Operations of Credit Institutions (Decision 457). This article introduces the major tenor of Decision 457.

Capital

The first and foremost significant novelty of Decision 457 is to present a comprehensive definition of the "capital" of credit institutions. As defined in the Law on Credit Institutions, the capital includes "the actual value of the chartered capital, reserves, and a number of other liabilities of credit institutions as stipulated by the SBV." The capital serves as a basis for calculating the prudent ratios applicable to banking operations. Nevertheless, the Law on Credit Institutions does not set out any further specification about other liabilities.

For the first time in accordance with Decision 457, the capital of a credit institution is divided into two tiers which essentially consist of chartered capital and reserves for tier 1 and additional capital from internal and external sources for tier 2.

Intrinsically, tier 1 capital comprises (i) chartered capital, (ii) retained earnings and (iii) reserves (i.e., reserves for the purposes of chartered capital supplement, financial provisioning, and investment and development) constituted from the deducted profits of a credit institution. Tier 1 capital shall serve as a basis for setting out the limit for purchasing and investing in fixed assets of a credit institution (the current applicable limit is 50%).

Tier 2 capital covers (i) surplus value of the assets re-valued (including 50% of the surplus value with respect to fixed assets and 40% with respect to investment securities), (ii) increased capital from internal and external sources (including convertible bonds, preferential stocks and certain subordinated debt instruments) and (iii) general loan loss provisioning (not exceeding 1.25% of the total risk weighted assets). Decision 457 however sets forth certain restrictions against tier 2 capital, two of which require that the total value of tier 2 capital shall not exceed tier 1 capital and the aggregate value of convertible bonds, preferential stocks and other debt instruments shall not exceed 50% of tier 1 capital.

The two-tier capital mechanism allows local commercial banks to specifically calculate and augment their own capital the calculation of which was previously based upon tier 1 only. Thus, the credit institutions may find it now easier to comply with the prudent ratios computed on the basis of their own capital.

In parallel with the adding-up of the above tier 2 items, the capital of a credit institution must exclude (i) the total amount of the reduced value of fixed assets or investment securities following

their re-valuation, (ii) the total paid-up equity or shares in other credit institutions, (iii) the share of such credit institution in the equity, joint venture capital or shareholding capital of other investment funds and enterprises which exceeds 15% of its capital, and (iv) the business losses including accumulated losses.

Minimum Capital Adequacy Ratio

Credit institutions (except foreign bank branches) shall maintain the minimum capital adequacy ratio (i.e., the ratio of the capital and the total risk weighted assets) equal to 8%. The total risk weighted assets are the aggregate of on-balance-sheet assets (including, among others, cash, gold, deposits, loans and receivables) and off-balance-sheet assets (including, among others, guarantee undertakings, lending agreements, letters of credit and payment acceptance) assessed by the risk weighting factors.

Based on the risk level, the risk weighting factors applicable to the on-balance-sheet assets comprise 4 groups of 100%, 50%, 20% and 0%. Meanwhile, the off-balance-sheet assets must be converted into credit exposure equivalents through the use of the credit conversion factors of 100%, 50%, 20% and 0% before being multiplied with the risk weighting factors (100%, 50% and 0%) for risk weighting purpose. For instance, a VND1,000,000 bid bond has a credit conversion factor of 50% and a risk weighting factor of 100%, thus the respective risk weighted asset value will be (VND1,000,000 x 50% x 100% = VND500,000).

In fact, most if not all State-owned banks have not reached the 8% ratio. Therefore, the SBV sets out a phase-out period of 3 years from the effective date of Decision 457 (i.e., May 15, 2005) for the State-owned banks to increase their minimum capital adequacy ratio to 8% provided that the annual increase shall be at least equal to one third of the balance of their current ratios and the required minimum ratio. Nevertheless, the non-State-owned banks that have not so far satisfied this capital requirement will not benefit from the 3-year-phase-out period. It is likely that a number of banks may have to call for additional equity contribution to raise up their own capital.

Credit Limits

Decision 457 requires that credit institutions (except foreign bank branches) formulate their internal policies regarding the criteria for determining "single customers" and "groups of affiliated customers" and the credit limits applicable to each of these types.

"Groups of affiliated customers" is a new term that has a very broad-spectrum meaning. A number of general criteria are laid out in Decision 457 for determining such type of customers. A group of affiliated customers of a credit institution are two or more customers that have one of the following mutual relationships:

- ownership (e.g., an individual customer owns at least 25% of or a legal entity customer owns at least 50% of the chartered capital of another legal entity customer);

- managership (e.g., an individual customer holds the title of board chairman or general director of another legal entity customer); or

- partnership (e.g., a partnership company and one of its partners are customers of the same bank).

A lot of difficulties either foreseeable or unpredictable are awaiting credit institutions in their compliance with the requirement of credit limits applicable to groups of affiliated customers. The banks must now collect and store information about not only a customer but its "affiliates" also, and the customers' database of each bank must be regularly updated to keep current with any changes in the status and relationship of a customer. This task seems to be a mission impossible, in particular when the number of banking customers is continuously increasing day

after day whilst the current database management tools of the whole banking system are not readily adaptable. Furthermore, the control of communication exchange among branches within a bank is not an easy task especially given the fact that only a few banks have a fully connected computerized network active in the nationwide scale.

Despite the aforesaid difficulties, any credit institution must now apply the following credit limits to its customers:

- The single borrower's loan limit is 15% of the bank's capital.
- The single customer's loan and guarantee limit is 25% of the bank's capital. As such, if a bank extends loans to a single customer up to the single borrower's loan limit of 15% the bank can only issue guarantees to the same customer up to 10% of its capital despite the current regulations allowing the total outstanding guarantees for a single customer to reach 15%.
- The total outstanding loans extended to a group of affiliated customers shall not exceed 50% of the bank's capital.
- The total outstanding loans and guarantees extended and issued to a group of affiliated customers shall not exceed 60% of the bank's capital.
- The single customer's financial lease limit is 30% of the finance leasing company's capital.
- The total financial leases for a group of affiliated customers shall not exceed 80% of the finance leasing company's capital.

Similar limit percentages apply to the lending and guarantee issuing activities of foreign bank branches though the limits are based upon the capital of the foreign "parent" banks rather than the paid-up capital or chartered capital of the Vietnamese branches.

Liquidity Ratio

Credit institutions must regularly maintain the following liquidity ratios:

- A minimum liquidity ratio of 25% between the assets realizable at any time and the liabilities payable within the following month.
- A minimum ratio equal to 1 between total assets realizable within the next following 7 business days and the liabilities payable within the following 7 business days.

Maximum Percentage of Medium- and Long-term Loans Funded by Short-term Resources

Any commercial bank is entitled to use up to 40% of its short-term resources to fund medium- and long-term loans. With respect to other credit institutions, the applicable maximum percentage is 30%. The short-term resources permissible to be used to fund medium- and long-term loans comprise deposits (demand deposits or term deposits of less than 12 months), individual savings (demand savings or term savings of less than 12 months), and short-term valuable papers issued by a bank.

Restrictions on Capital Contribution and Share Purchase

Credit institutions are permitted to use up to 40% of their chartered capital and reserves in order to invest in enterprises, investment funds, investment projects and other credit institutions

(collectively called "*commercial investment*") in the form of investment capital contribution, joint-venture capital contribution, or share purchase. The maximum investment by a credit institution in a commercial investment shall not exceed 11% of the chartered capital of an enterprise or investment fund, or 11% of the [investment project capital]. SBV approval must be obtained in case of any higher investment.

It is unclear under Decision 457 whether the monies deposited by the local credit institutions in overseas trusts for investment in various types of stocks and securities in foreign countries are subject to the above-mentioned restrictions. For instance, local Bank A put US$10 million into a trust account held by an overseas investment company so that the investment company can spend the said US$10 million on certain stocks, bonds and investment securities under the instruction of Bank A. In such case, it is questionable whether the said US$10 million investments of Bank A are subject to the restrictions on capital contribution and share purchase pursuant to Decision 457. With regard to this issue a further guidance of the SBV may be required.

Conclusion

The launching of Decision 457 is a positive signal reflecting the attempt of the SBV to better off the safety and security of the whole banking system though it will take time to answer the question of whether Decision 457 will be successfully performed by all credit institutions. It is certain that Vietnamese credit institutions will face with numerous difficulties in their compliance with this decision. Therefore, the close supervision by the SBV of the implementation process of Decision 457 will be of high significance so that necessary action, guideline and amendment can be made in an appropriate and timely manner.