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**NEW LAWS TO TEST VIETNAM'S BANKS**  
(*Vietnam Investment Review, May 30-June 5, 2005*)

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***On February 3, 2005, the State Bank of Vietnam (SBV) enacted Decision 127 to amend certain articles of the Regulations on Loans Extended by Credit Institutions to Customers accompanied by Decision 1627 dated December 31, 2001 (Regulation 1627)***

Effective within 15 days after the date of its publication in the Government's Official Gazette, Decision 127 will replace Regulation 1627 and certain implementing regulations of Regulation 1627 in relation to the calculation and reclassification of overdue debt.

Decision 127 makes a number of changes in the law. It clarifies the scope of eligible borrowers provided under Regulation 1627 and clarifies that all Vietnamese and foreign individuals and organizations – whether they are legal entities or not – are entitled to borrow from credit institutions operating in Vietnam. In addition, it imposes a number of new obligations on banks related to the establishment of a credit appraisal and supervision regime within each bank and the reporting requirements for such regimes.

However, the most fundamental change made in Decision 127 lies in its provisions dealing with rescheduling of loans and reclassification of overdue debt (which in turn are closely linked with loan loss provisioning requirements).

It is expected that the SBV will issue a series of regulations to provide guidelines for calculation and reclassification of overdue debt and loan loss provisioning to correspond to the new provisions of Decision 127. We also understand that the SBV is considering a two-tier capital regime for the 8 per cent minimum capital adequacy requirement in upcoming legislation, as well as other requirements on risk management, to comply with core Basel recommendations. Depending on the scope of the new regulations, the impact of Decision 127 on bank operations going forward could be very profound.

#### **DEFINITION OF "RESCHEDULING OF LOAN"**

Decision 127 introduces the concept of "loan rescheduling", which may be done in one of two ways, namely, "adjustment of payment schedule" and "extension of loan term". To put it simply, "adjustment of payment schedule" is a mechanism under which a bank may approve a change to the schedule of principal repayments and/or interest payments without changing the final maturity date of the loan. "Extension of loan term" also changes the schedule of principal repayments and/or interest payments but the final maturity date of the loan is extended as well.

Decision 127 does not limit the maximum period of loan term extension. In contrast, according to Regulation 1627, the maximum period of loan term extension was 12 months for short-term loans, and one-half of the loan term for medium and long-term loans.

#### **RECLASSIFICATION OF DEBT**

While the SBV no longer imposes any limits on the maximum period of loan term extension, it puts more stringent requirements on the classification of overdue debt. According to Regulation 1627, a credit institution was only obligated to reclassify outstanding

principal of a customer as overdue debt in case a payment default occurred and the credit institution did not agree to grant a rescheduling. In such cases, the outstanding principal recorded as overdue debt was the actual remaining outstanding principal of such loan and only such recorded portion was subject to the SBV loan loss provisioning requirements. If the loan was rescheduled (i.e. technically no payment default occurred) then the SBV loan loss provisioning requirements did not apply. Vietnamese banks are often found using rescheduling as a technique to avoid reclassification of overdue debt so that they do not have to set aside funds for loan loss reserve purposes. Nevertheless, the percentage of overdue debt (or non-performing loans) of Vietnamese banks is already on the high side.

Decision 127 treats rescheduling of loans and reclassification of overdue debt as two separate issues. On the one hand, it permits banks to agree on the adjustment or extension of loan terms for as long as they want. On the other hand, it requires that banks record any such extended loan as “deemed” overdue debt as soon as the borrower does not pay on the agreed payment date, regardless of whether or not a rescheduling arrangement is in place.

Article 22 of Decision 127 permits a credit institution to decide on rescheduling arrangements based on the payment ability of its customer. It then provides that “the whole outstanding principal of a customer whose loans have been rescheduled shall be deemed overdue debt and shall be reclassified in debt groups two through five in accordance with State Bank regulations on classification of debt”. Under existing regulations, and depending on the number of past due dates, overdue debt is classified into four categories, with loan loss reserves of 0, 20, 50 and 100 per cent, respectively.

### **Two Things Should Be Noted**

First, even if a loan is rescheduled, loan loss reserves will still be required under Article 22. As such, credit institutions no longer have an incentive to use rescheduling as a technique to avoid reclassification of overdue debt, as the loan will be reclassified in all cases. While the hoped-for effect of this provision would be to force banks to consider the rescheduling issue purely on a risk basis, it will likely create a significant loss reserve burden for credit institutions.

Second, the concept of “deemed” overdue debt raises interpretational questions. It is unclear whether the “whole outstanding principal” referred to in Article 22 relates only to the defaulted loan agreement or to all loan agreements of the borrower. It is equally unclear whether it relates only to the defaulted credit institution or to all credit institutions with which the borrower may have credit relationships. Therefore, the outstanding principal to be reclassified as overdue debt may be (1) the actual remaining outstanding principal amount under the relevant loan agreement, (2) the outstanding principal of all loans of a customer in a particular credit institution, or (3) the outstanding principal of all loans of a customer in all credit institutions with which such customer has credit relationships.

These issues can be illustrated with an example. Customer A has a \$100 million loan from Bank X, which is to be repaid in 10 equal installments of \$10 million each. Customer A also borrows another \$200 million loan from Bank X, a \$150 million loan from Bank Y, and a \$250 million loan from Bank Z.

Customer A pays properly the first four installments of the \$100 million loan. It then fails to pay the fifth installment and an adjustment of the repayment of such installment is approved by Bank X. Assuming that all of the other loans have not become due, the outstanding principal to be reclassified as overdue debts may be: (1) the actual remaining outstanding principal amount under the relevant loan agreement (i.e. \$100 million - \$40 million (which has been repaid in the four preceding installments) = \$60 million), (2) the outstanding principal of all loans of Customer A

in Bank X (i.e. \$260 million), or (3) the outstanding principal of all loans of Customer A in Bank X, Bank Y and Bank Z (i.e. \$660 million).

The first interpretation is consistent with the regime provided in Regulation 1627 and its implementing regulations. However, Regulation 1627 and its implementing regulations apply to reclassification of overdue debt only when a rescheduling arrangement is not agreed to. While this interpretation is possible, we don't believe it was the drafter's intention. Decision 127 purports to replace all existing SBV regulations on calculation and reclassification of overdue debt, and it is reasonable to predict that either the second or third interpretation will be adopted by the SBV.

A number of technical questions may arise as a result of application of either interpretation two or three. Generally, Decision 127 does not answer the question of whether or not it applies retroactively for loan agreements signed prior to its enactment. If it does, lenders will have to consider whether it would increase their costs of funding, thereby triggering the increased cost clause often found in standard loan agreements. In addition, if interpretation three is adopted, it is not clear under Decision 127 how the reclassification of the credit institutions involved could be enforced in practice.

## **CONCLUSION**

It is expected that the SBV will issue a series of regulations to provide guidelines for calculation and classification of overdue debt and loan loss provisioning to correspond to the new provisions of Decision 127 and other prudential requirements to comply with core Basel recommendations. The effect of these requirements on credit institutions in Vietnam is difficult to foresee, although it is clear that they will have an impact on all market participants, particularly in the way banks deal with their loan provisioning.

The implementation of the new provisions will require changes at banks, at least in terms of capitalization, organizational structure, personnel and data and information systems. These changes will be difficult, time-consuming and expensive, and most Vietnamese banks may face extreme difficulties because they have not developed sufficient risk management tools and systems. Unhealthy banks may go bankrupt if not recapitalized.

The SBV will be required to develop its own organizational structure and personnel. In particular, supervision based on evaluations of asset quality should become a routine task of SBV inspectors. The SBV will have to build up a regime of supervision and control on the implementation of such evaluation.

Finally, since costs incurred as a result of the changes mentioned above will likely be transferred to clients, bank costs and charges will likely increase.