VIETNAM BANKING PROFITABILITY AND PROSPECT

Sacombank Securities Company, Ltd
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EXECUTIVE SUMMARY

Vietnam's banking industry has recently seen promising growth in terms of the number of banks, amount of loans and deposits and the diversity of products and services. Credit and deposits both grew rapidly, 35% per year on average, from 2002 to 2007. Commercial banking products and services also grew substantially in concert with the overall growth of the economy.

The Vietnamese banking industry has witnessed material improvement in performance during 2007. The ratio of non-performing loans (NPLs) as a percent of all loans was reduced to approximately 1.5% from 3% in 2006. The average return on assets (ROAA) and average return on equity (ROAE) for the sector was approximately 1.9%, and 17%, respectively. Average capital adequacy ratios (CARs) of all banks were over the required rate of 8%.

Vietnam's banking industry, though facing current challenges and weaknesses, will benefit from its own strengths and opportunities. Near and long-term growth in the sector will significantly be driven by the potential growth of the retail banking and the SME market, the consumer lending market and the mortgage market. The banking industry will also likely see the beginning of a consolidation trend as acquisitions and mergers become a preferred strategy for growth. Effective governance and risk management will draw sufficient attention onwards since they are critical in delivering stable returns and supporting robust governance and compliance processes.

DEVELOPMENT OF BANKING INDUSTRY

Vietnam banking industry has recently experienced rapid annual growth in terms of both the number and size of institutions.

The total number of banks increased from 9 in 1991 to 86 in 2008. In 2007, total assets of the entire banking system exceeded VND 1,500 trillion, or 130% of GDP. This growth has been largely driven by traditional banking activities, which include granting loans and receiving deposits. Credit and deposit growth averaged 35% per year from 2002 to2007. Credit growth was especially rapid in 2007 accelerating to 54% due to the increased pool of borrowers including loans for securities and real estate investment. Deposit growth also accelerated in 2007, reaching 50% by the end of that year.

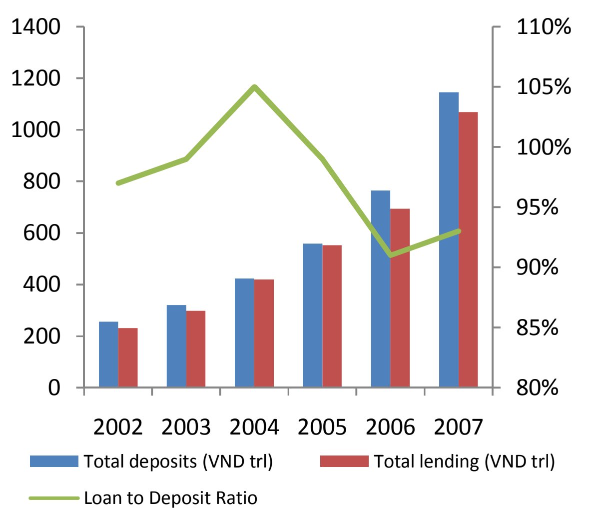
Commercial banks continued to expand their portfolio of products and services as the economy expanded in 2006-2007. Many banks diversified their offerings to include investment banking services via their own securities companies. In 2007 the average growth of income fees and commissions was 92% over those of 2006. In addition to diversification of products and services, most of the large banks invested heavily in technology and facilities. Because of this, and strong economic growth through 2007, Vietnamese commercial banks have achieved a high growth rate of assets over the past 2 years.

Table 1: Number of banks in 2004 – 2008

	2004	2005	2006	2007	2008
Joint-stock Commercial Banks	36	35	34	34	36
Foreign Banks	28	30	31	34	37
State-owned Commercial Banks	5	5	5	5	5
Joint Venture Banks	n/a	4	6	6	6
Development Bank and Policy Bank	n/a	1	2	2	2
Number of Banks	69	71	78	83	86

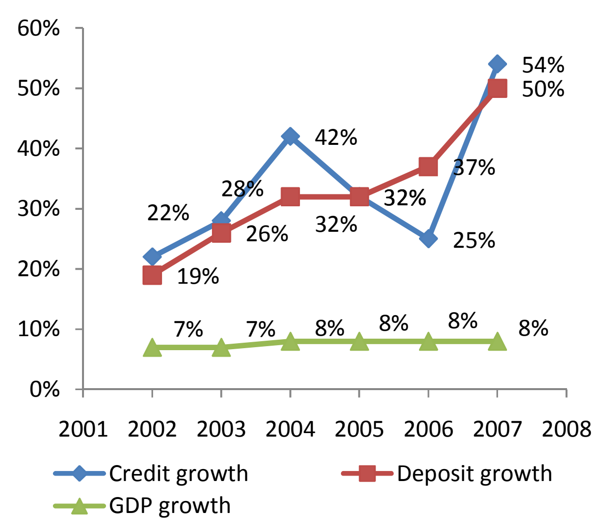
Source: SBV

Figure 1: Credit and deposit growth in 2002-2007



Source: ADB, BMI

Figure 2: Deposit, credit and GDP growth in 2002 – 2007



Source: IMF

MACROECONOMIC ENVIRONMENT

Macroeconomic Snapshot

Although economic growth (GDP) remained strong at 8.5% in 2007, the economy still faces a number of challenging policy issues for 2008 - 2009. Real GDP growth slowed in the first quarter of 2008, dipping to 7.4% year-on-year (yoy). Gross domestic products (GDP) in the first three quarters of 2008 increased by 6.52% over same period last year; of which agriculture rose by 3.57%, industry by 7.09% and services by 7.23%.

Inflation has been one of the most controversial issues affecting Vietnam's economic outlook in 2008. Inflation has continued to accelerate, soaring to 23.15% yoy in October 2008. While there are significant flaws in the methods used to calculate inflation in Vietnam, the country still faced significant price inflation from worldwide commodity prices as well as the price adjustment affects of Vietnam's accession to the WTO in 2008. After monthly CPI kept increasing through August, 2008 September's CPI, fell to 0.18% followed by a negative number of -0.19% in October. CPI in October 2008 was expected to rise by 23.15% annually against same period last year; by 21.64% against December 2007. The inflation for 2008 is estimated to stand at 22 to 23%. If the CPI basket for Vietnam were adjusted to reflect modern realities, inflation would be even lower.

The current account is likely to remain in deficit in 2008, estimated at 20% of GDP due to fast pace of import growth. After 10 months, Vietnam's total export value has reached USD 53.77 billion, an increase of 36% compared to the same period last year while import value was estimated at USD 70.1 billion, increasing by 42.6% against last year's same period. The trade deficit for the first 10 months of 2008 was USD 16.3 billion, rising by 66.2% yoy and equaling 30.3% of total export turnovers. The exchange rate is unstable, with the dong (VND) depreciating by over 15% in June (from VND 16,000 to 18,500 in free market), then recovering since July, 2008.

For the first three quarters of 2008, the government tightened monetary policy to reign in excessive credit growth the resultant inflation. The State Bank of Vietnam (SBV) increased reserve requirements, forcing banks to buy treasury bills, and setting a limit for loan growth in 2008. The monetary policy, however, has been loosened from October 2008. The SBV has three times dramatically lowered the benchmark, refinancing and discount rates within October and November 2008. These rates currently stand at 11%, 12% and 10% respectively for benchmark, refinancing and discount rates. In addition, the interest rate on compulsory reserves has been lifted four times in 2008 and stood at 10% by the end of October.

The stock market has fallen sharply since early 2008, largely because of the deleveraging driven by tighter credit policy. The VN-Index fell to a low of 366 point on June 22nd (compared with over 1,100 points in March 2007). After rebounding to slightly over 550 in August, the VN-Index resumed its downward slide in concert with the rest of the world's markets, although at a more moderate pace. The continued slide in stock prices over QI and QII was a direct result of not only deleveraging from 2007's overheated market, but also a result of domestic and international concern over rising prices in Vietnam. While some of this inflation was attributable to a rapidly growing credit and money supply, a good deal was directly related to the global commodity inflation in the summer of 2008 as well as one-time price increases related to Vietnam's accession to the WTO. As mentioned previously, Vietnam's inflation is also overstated due to an antiquated CPI basket that overweighs food and oil, 2 commodities that were at the center of the Summer boom in prices, but also two commodities for which Vietnam is a net exporter. While concern over the effect of double digit inflation to Vietnam's economy generated a lot of selling pressure in QI and QII, foreigners quickly became net buyers of the undervalued shares on the HOSE and HASTC, adding a net $500 mm USD to their positions by August. Inflation has been brought under control, and the SBV is now loosening its monetary policy, lowering benchmark rates and increasing interest rates on compulsory reserves, While Vietnam will not produce the 8+% GDP growth of prior years, it will grow 6.5% in 2008 and has plenty of domestic demand to produce 5.5-6% in 2009.

Table 2: Basic macroeconomic indicators

	2004	2005	2006	2007	2008 – 9 months
GDP (current million US$)	45,210	52,408	60,850	71,465	77,690
GDP growth (annual %)	7.7	8.4	8.2	8.5	6.5
Real GDP per capital (US$)	556	638	725	839	881
Inflation, GDP deflator (annual %)	7.9	8.4	6.6	12.6	22.3
Exchange rate (VND:USD)	15,676	15,817	15,964	16,114	16,536

Source: World Bank (WB), Economist Intelligence Unit (EIU), Government Statistic Office (GSO)

Monetary policy

The government tightened monetary policy to control inflation and achieve macroeconomic stability for the first three quarters of 2008. The SBV increased the reserve requirement to 11% from 10%; interest rates where the refinancing rate went up to 15% and the discount rate to 13% from 6.5% and 4.5%, respectively in 2007. The government also forced banks to buy VND20.3 trillion (US$ 1.26 billion) in treasury bills, and set a target for loan growth rate of 30% in 2008 (it had topped 50% in late 2007). Tighter credit policy together with higher reserve requirements and mandatory Treasury Bill allocations have shrunk banks' net margins and given them a high interest rate environment that has simultaneously curtailed their lending business.

Monetary policy, however, has been loosened since October. The SBV lowered the benchmark rates by 1%, to 13% from 14%, the refinancing rate to 14% from 15% and the discount rate to 12% from 13%, effective from 21 October 2008. The SBV has continuously loosen its monetary policy the third time which is effective on 21 November. The rates have currently stood at 11%, 12% and 10% respectively for benchmark, refinancing and discount rates. The interest rate on compulsory reserve has been lifted four times in 2008, from 1.2% to 3.6% then 5% and has now stood at 10% since the end of October. The compulsory reserve ratio has been cut twice in November and now stood at 8% on less-than-12-month term VND deposits, and at 2% on 12 – 24 month term deposits. The loosening monetary policy helps banks lower their cost of funding and encourages them to cut their lending rates.

MARKET STRUCTURE AND COMPETITION

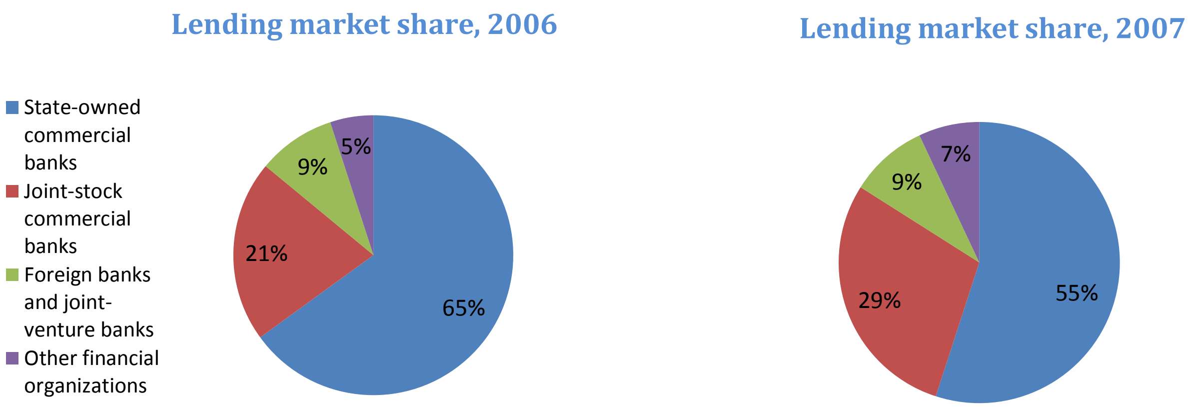
Assets

The total asset base for the banking sector stood at VND 1,872 trillion (US$ 117 billion) at the end of 2007, with the SOCBs controlling 48% of Vietnamese industry assets in the financial system compared with 67% in 2006. The JSCBs' market share has seen rapid growth and now stands at approximately 48% of total assets (up from 25% in 2006), although risk management is highly uneven and these figures may overestimate actual market share. Total assets of foreign banks now account for approximately 11% of the total banking sector.

At the end of 2007, outstanding loans were approximately VND 1,068 trillion (USD 67 billion). The greatest growth in loan market share belonged to the JSCBs, reaching 29% in 2007 from 21% the prior year, in large part by taking market share from the SOCBs, which saw their market share decline by 10% in 2007.

The loan market share of SOCBs accounted for 55% in 2007 compared to 65% in 2006. JSCBs and Foreign banks represented 29% and 9%, respectively in 2007, while these numbers were 21% and 9%, respectively in 2006.

Figure 3: Lending market share in 2006 and 2007



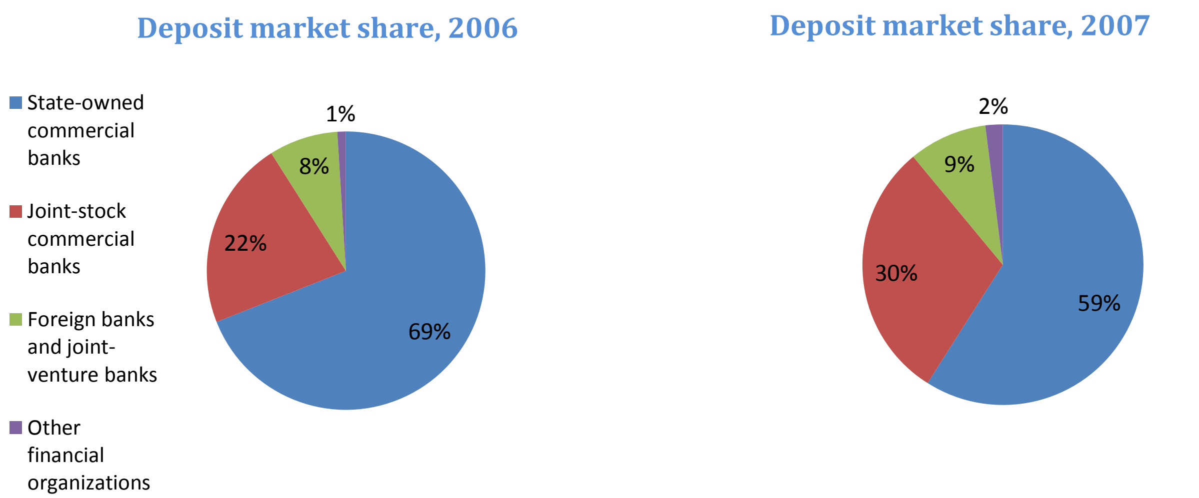
Source: ADB

Liabilities

In 2007, SOCBs held 59% of all liabilities in the market, a decline of 10% over 2006. Although SOCBs still have the ability to collect short-term and long-term deposits nationwide due to their extensive branch network and strong names, their proportion of deposits has decreased rapidly from 69% in 2006.

JSCBs are increasing their drive for more deposits, both from first time account holders and from depositors at the SOCBs (from 22% to 30% in 2007) and have developed a number of products to attract savings, targeting Vietnamese individuals to increase deposits. Meanwhile, foreign banks also reached 9% (from 8% in 2006) as they have allowed receiving deposit in local currency (VND) since 2007.

Figure 4: Deposit market share in 2006 and 2007



Source: ADB

Barriers to entry

New license requirements: Vietnam has officially allowed the establishment of 100% foreign-owned banks since 01/04/2007, as part of its WTO commitments. Newly established banks must have a minimum-chartered capital of VND 1,000 billion and reach VND 3,000 billion by 2010. The foreign ownership ratio is still limited to 30% and foreign strategic shareholders can only hold a maximum of 20% of chartered capital and must have a minimum total asset base of USD 20 billion. While stronger participation from the foreign banks is likely to increase competition in the market. The above requirements will likely hinder entrance to the sector.

Required international banking standards: As a result of commitment of integration, international banking standards required under WTO rules lead to more barriers to entry. The government, following World Bank recommendations, provides the necessary framework for an integrated financial system as required under WTO rules. Basel I will be in effect until 2010, when the stricter Basel II standards for corporate governance will be introduced. The government would introduce further legislation to force banks' compliance, particularly at the ownership level.

Potential competition from other financial organizations: The operation of banks bears a slight competition with non-bank financial organizations such as financial companies from which more esoteric products can be offered; and large-size securities companies (in the field of investment banking activities such as underwriting, M&A advisory, investment advisory). However, in the future, if those companies continue to operate successfully, they will become the direct rivals to the banks in their field of operation, especially the separate large-size securities firms with investment banking activities.

SWOT ANALYSIS

Strengths	Opportunities
▪ Expanding network ▪ Improved financial ability ▪ High assets growth with reasonable PE ratio ▪ Local knowledge, established presence ▪ Relationships with regulators	▪ Growth potential - The retail banking and the SMEs market, less than 10% of the population holds a checking account - The consumer lending market - The mortgage market
Weaknesses	**Threats**
▪ Very low market penetration ▪ A highly concentrated but highly fragmented banking market ▪ Heavy handed regulation with declining restrictions on foreign banks ▪ Relatively under capitalized ▪ Dip in net interest margin due to squeeze in 2008	▪ Lack of transparency concerning asset quality ▪ Bank risks such as liquidity risk, credit risk, and market risk ▪ High interest rates ▪ Basel II accord ▪ Rate of growth in both loans and deposits far exceeding GDP growth ▪ Non-performing loans ▪ Effects from current global financial crisis

Strengths

Vietnamese commercial banks have experienced dramatic growth over the last 5 years: expanding branch networks; improving financial ability including capital adequacy; improved risk controls; diversified services; enhanced human resources and implementation of advanced technology. Most Vietnamese commercial banks have actively developed their branches and ATM networks which provide opportunities for organic growth. Vietnamese commercial banks have demonstrated their capital strength and sophisticated risk controls through their improved CARs and asset quality. Because of its relative lack of integration into the world financial system, Vietnam's banking system is facing relatively little effect from current global financial crisis.

Weaknesses

Weaknesses underlying the Vietnam banking sector include: A highly concentrated but highly fragmented banking market, five state banks have held over 55% of the loans market while seventy-odd joint-stock and foreign banks compete for the remaining market share of less than 45%; Heavy handed regulation with diminishing restrictions on foreign banks; Relatively undercapitalized compared to international competitors and the growth facing Vietnam. The government still exerts strong control over the banking sector in two ways: Directly, through regulations and restrictions which govern how they conduct business and strictly licensing the type of businesses they can enter; and indirectly through the interference of a number of agencies and ministries, both local and national, who want to have a say on how scarce credit resources are allocated.

Average capital adequacy ratios (CARs), though have improved significantly and while they now meet international CAR, they are still low in comparison with an average CAR of 13.1% in Asia- Pacific and 12.3% in Southeast Asia. Vietnamese banks basically make money from traditional banking activities. Relatively little income is generated from fees: credit card, lending, and transaction fees. There is still a lack of diversified services like wealth management, private banking, corporate banking, investment banking research and trading.

Opportunities

With a population of 85 million, only 10% of whom use any sort of bank service regularly, the Vietnamese banking sector is likely to benefit from substantial retail and SME growth as well as consumer lending and an eventual mortgage market in Vietnam.

Retail banking is a bigger growth opportunity in Vietnam than in the developed world. With only 8.2 million bank accounts and 6 million ATM cards in a population of 85 million there is a lot of room for retail banking to develop.

The need for greater access to finance for the private sector, especially SMEs, will also generate growth opportunities for both corporate banking and retail banking. In 2007, the private sector contributed about 45% to the GDP. The contribution of private sector to GDP will only continue to increase as more state owned enterprises are equitized.

The research group Asian Demographics estimates that growth in the number of account holders in Vietnam will run at 33% annual for the next 3 years.

Debit/credit cards are expected to grow at 31% annually. Both of these are crucial components of the developing consumer lending market.

The mortgage market is relatively new to Vietnam and currently accounts for only 10 – 15% of the total housing finance market. Today it is far more common to purchase a home in Vietnam with cash than by any other alternative. The potential GDP growth rate of 6% or better from 2008 – 2012, and growing per capita income will drive the development of the mortgage market.

Threats

Credit and deposit growth swelled dramatically with the average rate of 35% per year during 2002-2007. Loans and deposits growth have reached 54% and 50% respectively in 2007, which substantially exceeded official targets and caused the credit bubble of 2007. The resulting deleveraging and revaluation of assets has mostly been accomplished, with one more round to take place in the fourth quarter of 2008. The concern for the banking sector is whether all of the non-performing loans have been shaken out of the system or whether there are still more to come. Vietnam's bad debt has, so far, been modest to date and certainly not on par with the challenge faced by the rest of the world. However there is concern that NPLs could increase from 1.5% to as much as 5% and there is speculation that as much as 10% of the $6 billion in real estate loans could need some form of restructuring.

Lack of transparency concerning quality of lending: Lending decisions in Vietnam are still based on relationships as much as cash flow. The assessment of loan customers is usually driven by the relationship with the bank and the size of the collateral being offered. Cash flow driven assessment and qualitative analysis is reserved for large private sector customers only.

Vietnamese commercial banks face several risks to their operations. High loans/ deposits ratios cause a liquidity risk. Part of loan growth is associated with lending for securities and real estate trading, most of which will be in due by the end of 2008. These loans are considerably risky and vulnerable due to stock market volatility. Credit risks therefore arise.

Vietnamese banks currently operate in a high interest rate regime. Although these rates are declining; this has a negative effect on banks' profits and raises their interest rate risk. In early 2008, the State Bank increased the prime rate twice from 8.75% to 12% and then to 14%. Increased interest rates in such an extreme environment squeezes banks' income from profitable assets and expense on capital mobilization. The competition for deposits also creates interest rate risk for the banking system.

OPERATION EFFICIENCY OF BANKING SYSTEM 2002 - 2007

The Vietnamese banking industry's financial performance and loan portfolio improved measurably in 2007. The sector experienced average growth in loans and deposits of over 35% during the period 2002 - 2007. The ratio of non-performing loans (NPLs) to total loans of the entire banking sector was reduced to approximately 1.5% from 3% in 2006. Sector average return on assets (ROAA) and average return on equity (ROAE) were approximately 1.9%, and 17%, respectively. Average capital adequacy ratios (CARs) of banks were over the required rate of 8%.

SOCBs Performance

Growth

Most SOCBs have achieved a rapid growth in loan portfolios in 2007 over 2006. However, SOCBs as a whole have lost market share in both loans and deposits. Deposit market share dropped to 59% in 2007 from 69% in 2006 and 75% in 2005. Loan market share shrunk to 55% in 2007 from 65% in 2006 and 73% in 2005.

Profitability

From 2006 – 2007 most SOCBs generated high ROAA and ROAE ratios compared to the industry's average. By the end of 2007, most SOCBs reached a ROAA of 0.6% - 1.2% while the average industry ratio was only about 0.59%[1]. Particularly, VCB, with a ROAA of 1.2%, was a standout at more than double the industry average. In terms of ROAE, all SOCBs surpassed the average industry ROAE of 10.54%[2]. VBARD posted 12.9% while MHB and VCB were even higher at 14% and 17.9%, respectively in 2007.

Net interest margin[3] of most SOCBs is relatively high. They achieved a band of 2.3% - 4.4% in 2007.

Cost efficiency ratios measure the consumption of resources in generating revenue. These ratios evaluate the success of technology utilization and, more generally, the productivity of banks' distribution platforms and sales forces. Cost efficiency ratios of most SOCBs have generally been in the range of 30% – 47% for the period of analysis 2002 - 2007. MHB, however, had a relatively high cost/income ratio of 64.6% in 2007.

[1] Data retrieved from Reuters Finance
[2] Data retrieved from Reuters Finance
[3] Net Interest Margin is net interest income (interest earned minus interest paid on borrowed funds) as a percentage of earning assets (any asset, such as a loan, that generates interest income).

Figure 5: State-owned Commercial Banks Profitability

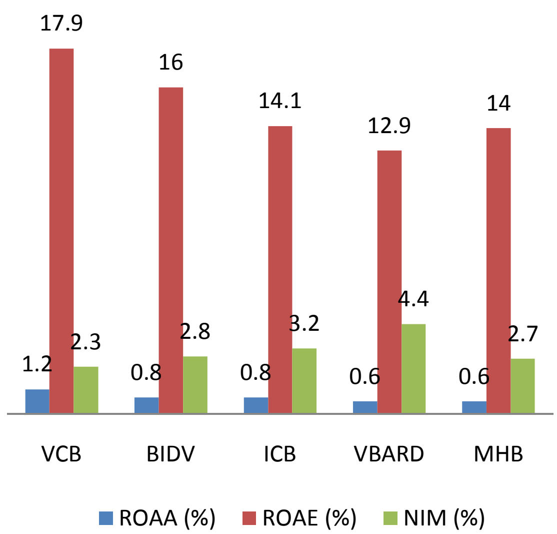
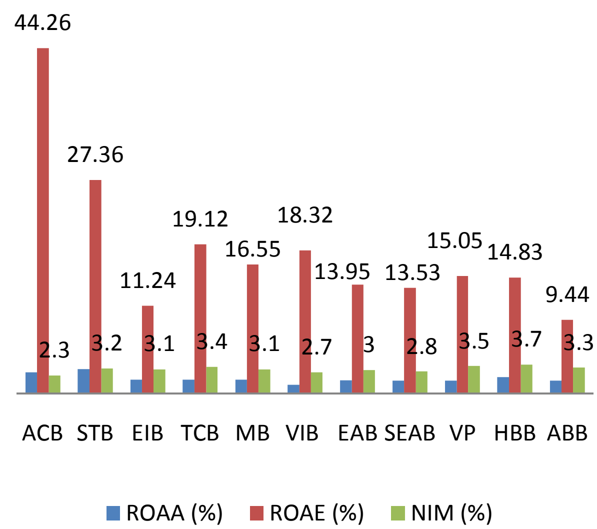


Figure 6: Joint-Stock Commercial Banks Profitability



Source: Annual report, SBV, IFC

Capital adequacy

By the end of 2007, almost all SOCBs met the international capital requirement of 8%. However, current capital adequacy ratios (CARs)[4] for the SOCBs are still lower than regional averages: 13.1% for Asia and the Pacific, and 12.3% for East Asia. Loans/total assets ratio is relatively high for most SOCBs. For instance, VBARD loans/assets ratio was up to 77% in 2007. This could result in higher liquidity risks for the banks in question. This ratio for VCB, BIDV, ICB and MHB is 48.9%, 64.5%, 60.5% and 50.6% respectively

Asset quality

The ration of Loans/deposits for the total industry is above 90%, exceeding the average of the region (83%).

The non-performing loans/gross loans ratio decreased over the period 2002 - 2007, yet stills remain high compared to other non-state banks. A high non-performing loans/gross loans ratio affects a bank's solvency risk.

[4] The Capital Adequacy assesses the financial strength of the bank. It implies that the required annual contribution of capital from earnings must be sufficient enough to maintain at least the regulatory minimums.

Table3: State Owned Banks Financial Ratios

	VCB		BIDV		ICB		VBARD		MHB	
Financial ratios	**2006**	**2007**	**2006**	**2007**	**2006**	**2007**	**2006**	**2007**	**2006**	**2007**
Growth of Loan Portfolio (%)	11	41.6	15	33.8	7.4	25.0	18.2	33.5	20	37.7
Profitability										
ROAA (%)	1.5	0.7	1.2	0.8	0.5	0.8	0.4	0.6	0.5	0.6
ROAE (%)	21.9	17.9	10.4	16.0	11.3	14.1	9	12.9	8.3	14
Net Interest Margin (%)	2.6	2.3	2.5	2.8	3.0	3.2	4.2	4.4	2.8	2.7
Cost/Income (%)	30.4	30.9	34.5	30.5	46.9	41.6	47.6	42.7	64.9	64.6
Capital Adequacy										
Net Loans / Total Assets %)	39.8	48.9	61.2	64.5	59.2	60.5	76.5	77	53.3	50.6
Capital Adequacy Ratio (%)	9.6	12	4.8	11.0	6.5	11.6	5	7.2	9.3	9.4
Asset Quality										
Total NPLs (millions USD)	114	n/a	675	358	71	161	224	n/a	n/a	3
NPL / Gross Loans (%)	2.7	n/a	11.9	4.80	1.4	2.5	1.9	n/a	n/a	4.7
Reserves / Gross Loan (%)	2.2	2.1	1.5	2.2	0.1	1.7	1.1	1.8	1.4	1.2

Source: Annual report, SBV, Fitch Ratings, IFC

JSCBs Performance

Growth

Joint-stock commercial banks (JSCBs) generated significant loan growth in period 2005 - 2007. Some banks more than doubled their portfolios in 2007. SEA bank loans grew 228% and HDBank loans grew 233% in 2007. While the loan growth reflects the capture by joint-stock commercial banks of the high growth SMEs market and the diversification of their lending products, it should be pointed out that part of this loan growth is associated with lending for securities and real estate trading which will be in due by the end of the year. These loans are considerably risky and vulnerable to stock market volatility.

Joint-stock commercial banks, especially top banks such as ACB, STB, TCB, have continuously expanded their retail networks. There is still a lot of room for the retail banking market to grow in Vietnam since out of a total population of 85 million, less than 10% are estimated to be using bank services regularly, and only around 8.2 million people have bank accounts, and only six million ATM cards from personal bank accounts had been issued by 2007. Sacombank for example currently has 239 transaction points nationwide. Techcombank had 132 transaction points in 2007 and it expects to have 170 transaction points by the end of 2008. After opening a lot of branches in July 2008, VP Bank now has 132 branches and transactions offices. Eximbank reports 70 transaction points.

Habubank has announced a plan to raise the number of its transaction points to 40. In terms of retail network, SOCBs currently have a competitive advantage over the JSCBs. The operation networks of SOCBs have developed for a long time and have spread nationwide. The Vietnam bank for Agriculture and Rural Development (VBARD), for instance, has covered almost all communes, even in rural areas, throughout Vietnam.

Most JSCBs divide their business into two main segments: personal banking and corporate banking. Personal banking services offer personal customers nationwide a wide range of personal banking services, including current and savings accounts, mortgages, credit cards, loans, insurance, payments and investments. With corporate banking segments, banks are involved in the provision of banking products including payments, collections, liquidity management, and account services. In addition, banks also provide insurance protection, trade services (credit, collections and financing products), leasing, finance and factoring, credit cards. Some banks have begun to specialize or expand their services such as foreign exchange transactions and export-import finance, including letters of credit (Eximbank and East-Asia Bank), mobile banking services (Sacombank, ACB and Techcombank), derivative trading, options to minimize commodity pricing risks (Eximbank and Techcombank), security and leasing subsidiaries. Many banks have diversified their investment banking services which include underwriting, advisory, and derivatives-related services via their own securities companies or funds such as STB, ACB, EAB, etc.

Figure7: SOCBs Number of branches in 2007

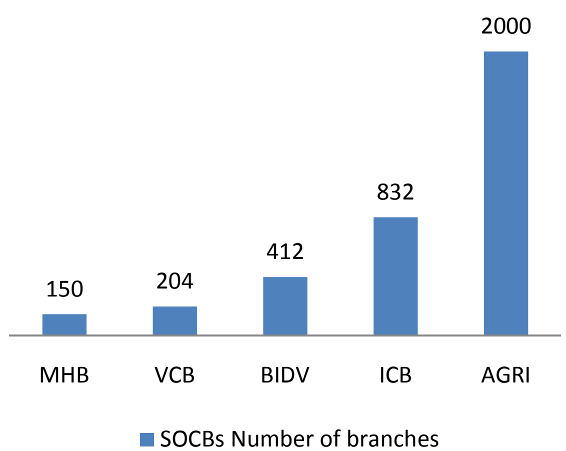
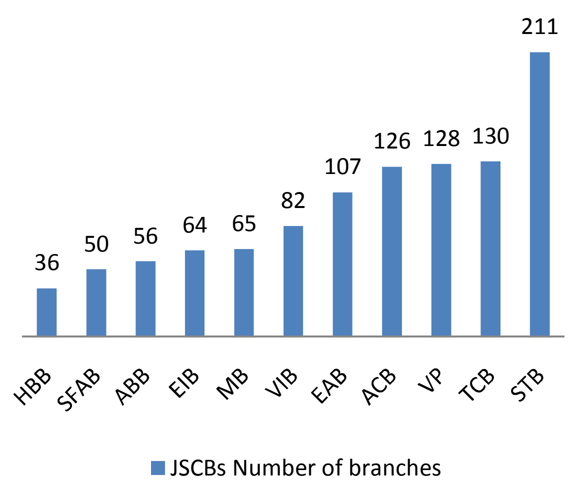


Figure8: JSCBs Number of branches in 2007



Source: SBS

Profitability

Compared to SOCBs, the joint-stock commercial banks were more profitable despite higher cost of funding (higher interest rates for deposits). JSCBs have achieved quite high ROAA and ROAE ratios in comparison with the industry's average ratios in the period 2006 – 2007. The average ROAE and ROAA were 16.65% and 1.9%, respectively in 2007. These ratios are higher than the average industry ratios at 10.54% and 0.59% for ROAE and ROAA respectively.

Banks' net profit has increased significantly; the average net profit of the JSCBs is about 2.5 times from 2006 to 2007.

Capital adequacy

Almost all joint-stock commercial banks maintain a relatively high capital adequacy ratio, higher than the international capital requirement of 8%. Compared to SOCBs, only 53% of total assets are loan assets. The risks, therefore, are limited. However, some JSCBs still maintain high loans/ assets ratios. SCB bank's loans/assets ratio is up to 75% in 2007.

In June 2007, the SBV issued decision No. 24/2007/QD-NHNN to increase minimum capital requirements for establishing banks to US$ 63 million (VND 1 trillion), and to US$ 190 million (VND 3 trillion) after 31 December 2008, which will definitely affect banks' capital adequacy ratio in future.

Asset quality

JSCBs' NPL/gross loans ratio is lower than SOCBs' ratio, ranging from 0.23 - 1.5%. JSCBs' loan loss reserve/gross loan ratios range from 0.21 – 1.18 while the same ratio for the SOCBs varies from 1.1 – 2.2%. JSCBs' average leverage, as measured by the ratio of equity to total assets, stood at 12.07.

Figure 9: JSCBs total asset growth

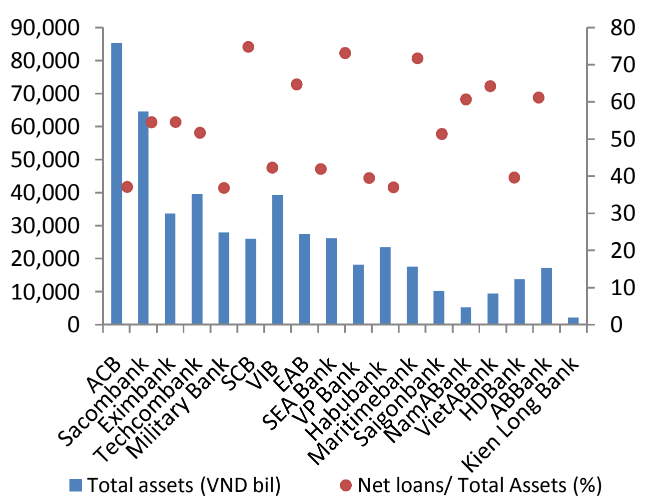
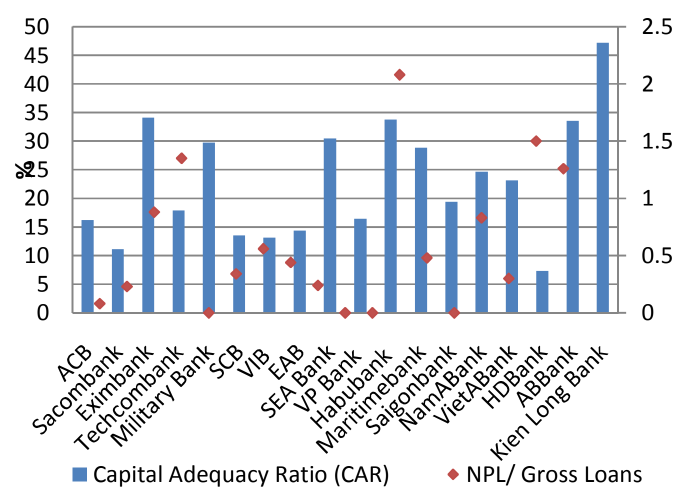


Figure 10: JSCBs Capital Adequacy



Source: Annual reports, SBV, Fitch Ratings

OPERATION EFFICIENCY OF BANKING SYSTEM IN 2008

Net interest margin decreases

Vietnamese commercial banks have faced a particularly challenging environment in 2008 which has significantly affected the banks' profitability.

Recorded high deposit rate: Vietnam's banks have been forced to deal with a high interest rate regime in 2008 which has significantly influenced banks' performance. For the first three quarters of the year, the State Bank of Vietnam increased the prime interest rate three times, from 8.25% in January to 8.75% in February to 12% in May and then to 14% effective in June. In addition, because of a shortage of liquidity, commercial banks are all in an interest rate race to attract new deposits. Therefore, the average deposit interest rate has been at very high level (15.3%) in 2008.

Capped lending rate: The State Bank has also set the ceiling loan interest rate at 21% as part of its tightened monetary policy. With such capped lending rate, the deposit interest rate should be lower than 17.5% per year to ensure effective operation, or at most 18.1% to break even. However, as the interest rate race gathered momentum some small & medium joint-stock commercial banks pushed the deposit interest rate to 19%. Many larger banks must also maintain the deposit interest rate at 18% in order to keep their customers. So, for all banks' the average net interest margin in 2008 is around 1.79%.

High required reserve with low interest: The discount rate and refinancing rate also remained at a very high level. The SBV twice raised the discount rate and refinancing rate by June 2008. The discount rate was raised from 6% in February to 11% in May and to 13% in June while the refinancing rate jumped to 15% in June from 7.5% in February. On the other side, the interest rate on compulsory reserves had been maintained at only 1.2% until 1 September while the compulsory reserve ratio remained at 11% on less-than-12-month term VND deposits, and at 5% on 12 – 24 month term deposits.

Further requirements put more pressure on banks' profitability in 2008: The government forced banks to buy VND20.3 trillion (US$ 1.26 billion) treasury bills with relatively low yield as a way of slowing credit growth and reducing the money supply. The SBV set a limit for loan growth rate of 30% in 2008 which has been achieved.

The high interest rate regime together with the tight monetary policy has lowered banks' pre-tax profit in 2008. Net interest margin is particularly problematic because of the high cost of capital mobilization and low income from profitable assets.

Figure 11: Annual prime interest rates on VND

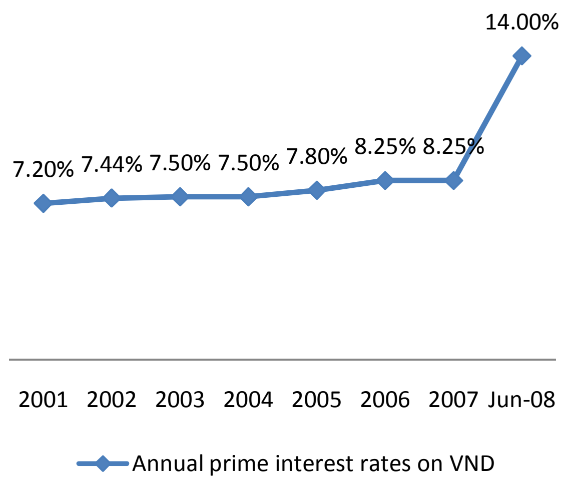
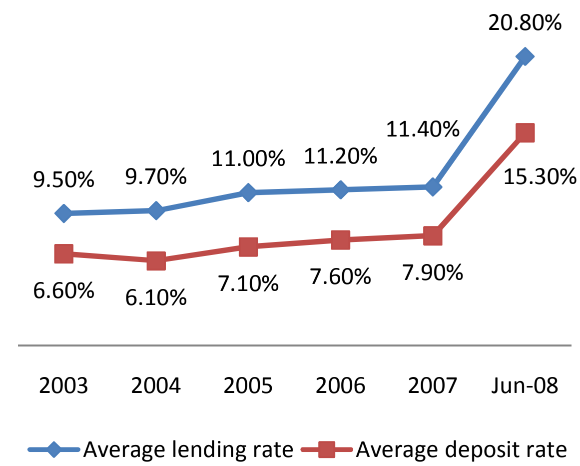


Figure 12: Average lending and deposit rate



Source: SBV, SBS, EIU

Dwindling credit growth

The SBV also introduced a lending limit to the property sector in late 2007 to prevent the property sector from overheating because of the rapid increase in property prices. The real estate projects, that have traditionally required big finance from banks, have either slowed down or found it difficult to access bank loans. Though the lending rate is now 14 – 16%, it is still very hard for most enterprises to absorb such a high interest rate under the existing condition of declining demand. These factors, therefore, lead to credit growth dwindling in 2008, even lower than 30% - a limit which the SBV set for growth rate at the beginning of the year.

Financial investment devaluation and provision

Direct investment and proprietary trading of banks accounted for a significant proportion of total income, approximately 13.59%, which resulted from the booming stock market in 2007. Banks' investment portfolios have concentrated on a large number of stocks and bonds, especially bonds with an average maturity of 3 years. Bond investments before 2007 only have an average coupon rate of around 8% while the current trading prices of government bonds are only around 70-80% of face value – equivalent to average yield of 18%. The quality of banking assets regarding the value of bond investments will be consequently reduced. Meanwhile, as the current deposit interest rate is above 17.5% per annum, the fixed interest income of 8% from bond investments leads to a reduction in NIM of banking system in 2008.

While securities trading and related activities used to be a large component of banks' incomes in 2007, these business lines contribute far less to earnings in

2008. Additionally, banks will also have to make provisions for devaluation of securities in 2009

Bad debt provisions amounted to 1.56% of the total outstanding loan

NPLs in 2008 increased to around 1.56% driven by two factors. First, the increase of bad debt provisions incurred in real estate and securities loans due to the decline in stock and real estate market recently.

Second, some banks can switch their overdue debts to long term financial investments via buying bonds issued by the debtors themselves. Then, the debtors can reduce their debt payment pressure and the banks also decrease NPLs provision cost which damages their operating results in 2008.

However, article 7 of Decision 493/2005/QĐ-NHNN dated 22 April 2005 of the State Bank of Vietnam requires banks to set up their credit classification system in order to calculate NPLs and loan-loss provisions accordingly. This Article brings VAS closer to IFRS for NPL figures. Banks have been given a grace period of three years to follow this Article, meaning all banks will need to follow this regulation beginning 2008. We estimate that under this decision, NPLs/Loans at SOCBs will be approximately 5 - 6% in 2009. NPLs for non-state banks were approximately 1.5%-2% of total outstanding loans.

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Profit of banks decreases significantly in 2008

In the context of the high interest rate regime, tight monetary policy together with credit and liquidity problems, banks' key income resources related to NIM and financial investments have been squeezed. Banks' pre-tax profit, therefore, have declined significantly in 2008.

		ACB	*Sacombank*	*Eximbank*	*Techcombank*	*VIB*	*Military Bank*	*EAB*	*Maritime bank*	*VietA Bank*
2008 Profit (billion VND)	***3Qs***	1,389	952	*1,100*	*800*			524	*175*	290
	2Qs					*323*	*450*			
	% Profit Target	55.6%	47.6%	*85.0%*	*53. 5 %*	*45.1%*	*61.0%*	75.0%	*n/a*	*60.0%*
2007 Profit (billion VND)		2,127	1,582	*629*	*710*	*426*	*609*	454	*240*	*200*

Source: SBS

The loosening monetary policy effective in QIV quickly decelerates deposit and lending rate. It is highly likely that borrowers are to prepay their loans with high interest rate and switch to lower rate contracts, while banks have been locked with large amounts of deposits which they have taken at high rates before. As a result, banks' profit also decreases.

Even though the larger JSCBs, are still making considerable profit compared to the banks, the larger JSCBs had to make the biggest adjustments to their profit plans 2008. Asia Commercial Bank (ACB) reduced its pre-tax profit target to VND1,600 billion from its initial plan of VND2500 billion. Sacombank (STB) targeted pre-tax profit of VND1,500 billion instead of the initial target of VND2000 billion. In comparison with the initial plan for 2008, pre-tax profit of some banks reduces by 40 – 50%. For instance, STB has achieved pre-tax profit of VND952 billion by the third quarter end, equivalent to only 47.6% the total initially planned profit. ACB's pre-tax profit of three quarters of the year has recorded at VND 1,389 billion, equivalent to 55.6% of total initially planned amount.

For smaller JSCBs, their profit strongly decreases while some banks would have loss in 2008. With poorer technology, services and risk management, these banks are not only under the serious concern of their short-term liquidity but also suffered significantly narrow NIM.

FORECAST

Vietnam's banking industry, though facing current challenges, is likely to benefit from a number of opportunities. GDP growth rate of 2008 will be 6.5% but is still expected to reach the average rate of 7%-8% in 2008-2012. This is an important factor for the development of the banking system. Vietnam's banking industry will be driven significantly by potential growth of the retail banking and SMEs market, the consumer lending market and the mortgage market. The banking industry will also likely to see a consolidation trend as a preferred means to growth in addition to the organic growth generated by the underserved market as a whole. An increase in capital via common stock issues to improve financial capability still remains vital trend in next several years. Increasing competition and integration require banks to pay much more attention to their corporate governance and risk management. This is critical in delivering stable returns and supporting robust governance and compliance processes. The Vietnam banking industry will see positive signs in the macroeconomic environment in 2009. Inflation is under control since last quarter of 2008. The government has loosened monetary policy since late October. The normal interest rate is expected to recover, thus stimulating economic activities in the near to long term. The increased interest rate on compulsory reserves and lowered base interest rate assist commercial banks in lowering their cost of funding and reducing their lending rates.

Based upon above analysis of performance, trend, and drivers for growth, we forecast the following for the banking sector in 2009:

- The credit and deposit growth will slow compared to the period of 2002 – 2007, but will still twice the growth of real GDP. The growth rate of deposits is projected at 18 -20%; while the growth rate of credit is 19 – 21%.
- The lending rate is estimated to decline to 14 - 16%.
- The NPL/gross loans ratio is projected at 1.5 - 2% for non-state banks. SOCBs' ratio will be three times as much as JOCBs'. We forecast NPL/ gross loans ratio of 4.5 – 6% for SOCBs. An initial evidence for this was the case of Vietcombank as the lender had to adjust its target NPL/gross loan ratio for 2008 to 5.58% instead of 2.60% as the 30 September number has already reached 5.55%.
- The majority of banks will come in line with the mandated minimum average capital adequacy ratios (CARs) of 8%.
- Most banks' profit in 2009 will be less than 2008. While some banks' profit (mainly larger JSCBs) may decrease moderately 10 – 20%, the others', especially smaller JSCBs group, will decelerate significantly by 30% - 40%. EPS of all banks, however, will decline even further because they raised more chartered capital in 2008 and 2009 to meet SBV's requirement. While business environment will still remain hard in 2009, with banking sector witnessing profit reduction in 2008, it will be interesting to see how banks are going to set their targets for 2009.

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