Chapter 13. Vietnam: The dilemma of bringing global financial standards to a socialist market economy

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Introduction

The implementation of international banking standards in Vietnam has been the subject of contestation between reformist and conservative factions within the banking regulatory system. In any given period, the speed of implementation has been affected by which of these factions dominates regulatory decision-making, as well as the health of the banking sector. The existence of two political factions with conflicting preferences regarding Basel standards generates dynamics that lead to mock compliance. With regards to the analytical framework, the dynamics are those of politically-driven mock compliance.

The adoption and implementation of Basel standards in Vietnam has gone through three distinctive periods. In the first period (1999–2006), Vietnam actively adopted economic integration as a development strategy. Vietnam signed a bilateral trade agreement with the US in 2001, and concluded its World Trade Organization (WTO) negotiations in 2006. The economy enjoyed a high growth rate of 7.4% in the first half of the 2000s, and everyone seemed to be very optimistic about future economic prospects. In this context, the internationally oriented reformist faction within government, which pursued international regulations to discipline state-owned banks and improve the functioning of the financial sector, won the tug of war with the conservative faction, at least temporarily. The central bank, the State Bank of Vietnam (SBV), which is always subservient to the prevailing political agenda, informally adopted Basel I and laid out the roadmap for its implementation. Banks – both private and state-owned – did not have a voice in setting Basel-related policies, and were indifferent to plans for its implementation since they thought it was premature and unfeasible.

At the beginning of the second period (2006–2013), Vietnam formally adopted Basel II standards. However, the country experienced a banking crisis between 2008 and 2012, when nearly a dozen banks were on the verge of collapse and some actually became technically bankrupt. Facing this crisis, even reformists factions hesitated to move forward with Basel, because implementing the standards properly would have exposed the significant weaknesses in both private and state-owned banks, exacerbating the crisis situation. The shift in the preferences of the reformists and the SBV during this period effectively halted the implementation of Basel standards. Meanwhile, the reluctance of banks, many of which were in a difficult situation, made Basel implementation even less feasible than in the previous period.

The third period (2014 onward) has been characterised by a return to pro-Basel preferences. Once the crisis had passed, and the economic integration process had regained its strong momentum, the

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reformist faction could again push forwards with the implementation of international standards. The SBV wants to use Basel standards to discipline and clean up weak banks. Moreover, many private banks and even state-owned banks now perceive Basel standards as being important for managing their liquidity, improving supervision and risk, signalling their health, and enduring competitive pressures. Thanks to more genuine interests from the politicians, regulators, and banks, the implementation of Basel II has been accelerated, and some elements of Basel III such as liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are reflected in the banking regulations issued by the SBV.

Vietnam	
GDP per capita (current US$, 2017)	2343
Bank assets (current US$)	267.7 bn
Bank assets (% of GDP)	130.4
Stock market capitalisation (% of GDP)	28.6
Credit allocation to private sector (% of GDP)	123.8
Credit allocation to government (% of GDP)	18.1
Polity IV score (2017)	-7

Table 13.1. Key indicators for Vietnam
Note: All data is from 2016 unless otherwise indicated
Source: FSI Database, IMF (2018); GDI Database, World Bank (2017); Polity IV (2014)

Through an analysis of aggregate data and 30 interviews with regulators, bankers, financial experts, and politicians in Vietnam, in this chapter we show that Vietnam's case is an example of conflicted preferences for Basel adoption and implementation, particularly in the second period. The reformists rely on Vietnam's international commitments and opt for international standards (Basel in particular) to reform the domestic banking sector. At the same time, interventionist financial policies, costly implementation, the low internationalization level of the banking sector, and the lack of competent technocrats inside both the SBV and domestic private banks have all contributed to a high level of forbearance in Basel implementation.

The rest of this chapter is organized as follows. Section 2 provides a brief description of Vietnam's political economic context for the adoption and implementation of Basel standards. Section 3 traces the three periods of Basel adoption and implementation in Vietnam since 1999. Section 4 provides a political economic explanation of Basel adoption and implementation in Vietnam. Section 5 concludes and provides some reflections on the analytical framework.

Political economic context of Basel adoption and implementation in Vietnam

Vietnam began Doi Moi—the transformation from a centrally planned economy to a socialist-oriented market economy—in 1986. Since then, international economic integration has been a major driver of economic growth, which has become an increasingly key factor in determining the performance legitimacy of the Vietnamese party-state. A growing list of economic integration commitments, including membership in the WTO, the Trans-Pacific Partnership (TPP), and the Regional Comprehensive Economic Partnership (RCEP) have created an interesting 'dualism' (Vu-Thanh, 2017). On the one hand, in order to continue economic integration, the Vietnamese party-state wishes to express itself as being internationally-oriented, by complying with international norms and practices. On the other hand, as a 'socialist-oriented economy', the party-state always wants to maintain firm control over the economy, both directly through state-owned enterprises (including state-owned banks) playing the leading role, and indirectly by means of interventionist regulations.

As of 2017, Vietnam's financial sector relies heavily on banks in which four big state-owned banks account for 45.7% of total assets and 48.3% of the credit market share. Private banks are much smaller and rather concentrated, with the ten biggest private banks making up 33% of total assets and 31% of the credit market share. Foreign-owned banks are of modest size, only accounting for 9.5% of total assets, even though they represent 21.4% of charter capital (State Bank of Vietnam, 2017). Nevertheless, this group of banks has enjoyed quite rapid growth in the last several years, as commitments to open up the financial market come into effect.

Vietnam still has a Leninist state in which the party rules over the government. The government, in turn, rules over the SBV, and the SBV exercises discretionary power over commercial banks. This hierarchical relationship is reflected in the policy cycle in Vietnam. Major strategic orientations (e.g. restructuring the banking system) originate from the Politburo (the highest organ of the Communist Party of Vietnam) through its resolutions and conclusions. When it comes to technical matters (e.g. banking supervision and safety regulations), the SBV will recommend policies to the government for approval. An approved policy will then come back to the SBV for implementation. If these policies are to be legalized, draft legal documents will be passed to the National Assembly for deliberation and approval. After these policies are enacted, commercial banks, which have virtually no voice during the policy process, are forced to comply.

The Party Central Committee exerts direct and indirect influence over the appointment of personnel to key positions, including Central Bank Governor and the chairmen of state-owned banks. This situation creates an ambiguity in the positions of politicians, regulators, and bankers. On the one hand, a number of politicians are in a position to supervise the banking and financial sector, but do not have a professional background in the industry. On the other hand, there are many key regulators who are just temporarily rotated through these positions before becoming political appointees somewhere else. Moreover, the leadership of the SBV plays a 'triple role' as politicians, banking regulators, and representatives of state ownership in state-owned banks. These overlapping and ambiguous roles give rise to many serious regulatory conflicts, as discussed below, where we explain how aspects of Vietnam's implementation of Basel standards are instances of mock compliance (Walter, 2008). In sum, the current institutions, whether in the guise of politicians or personnel, show widespread outright forbearance by the SBV, particularly during the time of the banking crisis between 2008 and 2012.

Since the mid-2000s, Vietnam's economy underwent many changes with long-lasting implications for the financial system. Inheriting a high growth and stable economy, the ambitious new Prime Minister wanted to accelerate GDP growth even further by loosening both fiscal and monetary policy (Kazmin and Mallet, 2008). As a result, inflation reached 28% in 2008, while abundant credit inflated stock and real estate bubbles in the 2007–2008 period. When the bubble burst, a series of banks held huge amounts of bad debt, mostly guaranteed by real estate, the market value of which was now much lower, threatening the collapse of the banking system.

To make matters worse, also during this period, the SBV decided to upgrade rural commercial banks to urban commercial banks, forcing their charter capital to increase rapidly in a very short time. As a result, the domestic private banks quickly became the largest sector (Figure 13.1). However, in order to meet charter capital requirements, many smaller banks borrowed from each other or partnered with state conglomerates, thereby leading to cross- and pyramidal-ownership structures. In addition, the rapid GDP growth over this time was accompanied by a myriad of unscrupulous credits, which further exacerbated the rise in bad loans in the banking sector, especially for those that had recently become urban commercial banks.

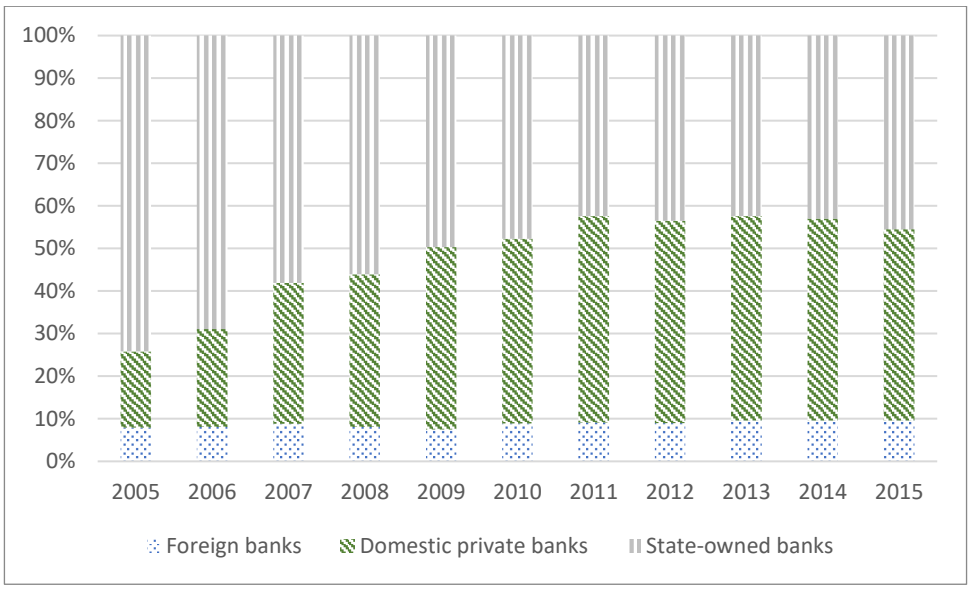


Figure 13.1. Deposit Market Share by Bank Ownership
Source: Authors' calculations based on the State Bank of Vietnam's Annual Reports, State Bank of Vietnam (2017)

In 2009, the real estate bubble burst, the stock market plummeted, and state economic groups suffered heavy losses. As a result, the banking system went through a serious crisis. At the end of 2011, non-performing loans (NPLs) in the banking system were up to 13% according to Fitch Ratings (National Assembly's Economic Committee and UNDP, 2012). Many banks suffered from liquidity shortages, and some banks were in principle bankrupt.

In the wake of the financial crisis, the SBV took steps to address financial instability, focusing on the banking sector. In 2011, the SBV classified Vietnam's credit institutions into four groups, and imposed a credit growth ceiling on each group (State Bank of Vietnam, 2012a). However, in order to preserve 'system stability', the SBV did not publish the list of institutions in each group. Banks in Group 1 and Group 2 are considered 'healthy', and therefore given a ceiling credit growth of 17% and 15% respectively. Banks in Group 3 are 'medium risk' and given credit growth of up to 8%. Finally, those in Group 4 are 'high risk' and are not allowed to extend any credit. Facing the risk of a banking crisis, the highest priority of the SBV in this period was not to implement modern financial standards such as Basel, but rather to ensure the safety of the banking system, control interest rates, and ensure its leadership role of state-owned commercial banks through various financial repression measures.

Since 2014, the economy has been recovering, although the NPL ratio is still high at around 10%. The economic recovery has facilitated the resumption in implementation of Basel standards. Moreover, the SBV is now keen to implement Basel standards in order to improve the risk management of banks and avert future bankruptcies.

The Adoption and implementation of Basel standards in Vietnam

As described above, there have been three distinct periods in the adoption and implementation of Basel standards in Vietnam. In the first period (1999–2006), Basel I was informally adopted – at this stage, the SBV never announced the adoption of Basel standards explicitly, but incorporated some elements of Basel I into its banking regulations. In the second period (2006–2013), the SBV strongly endorsed the adoption and implementation of Basel I, and outlined a roadmap to achieving Basel II compliance by 2010. However, the banking crisis during 2008–2012 and the resulting shift in politicians' preferences turned Basel implementation into nothing more than mock compliance in this period. Since 2014, as the economic situation improved and economic integration regained

momentum, the preferences of politicians, regulators, and banks have shifted again, and this time they are conducive to a more genuine implementation of Basel II, and even some elements of Basel III. The adoption and implementation of Basel standards in Vietnam are summarized in table 13.2.

Basel component	Adoption	Implementation	Date in force
Basel I	**Informal adoption** *(There was no public commitment to Basel I, but banking regulations were in line with Basel I standards)*	Decisions 297 (25 August 1999) *Simple rules on prudential ratios require Tier 1 at 8%*	9 September 1999 (+ 3 years of grace period)
		Decision 457 (19 April 2005) *Rules on prudential ratios—define CAR (including Tier 1 and Tier 2) at 8%*	4 May 2005 (+ 3 years of grace period for State-owned banks)
Basel II	**Formal adoption** Prime Minister's Decision 112 (24 May 2006) *Basel I as the supervision standards by 2010* *Implement Basel II guidelines and standards after 2010* *(Decision 112/2006-PM)*	Established Banking Inspection and Supervision Agency under the SBV in 2009 Revised Law on the State Bank of Vietnam and the Law on Credit Institutions (16 June 2010)	1 January 2011
		Circular 13/2010 (20 May 2010) *CAR separate and consolidated at 9%; total liquidity reserves (15%) and 7 days (100%); requirement on stress-testing and scenario analysis*	1 October 2010
	Prime Minister's Decision No. 254 dated 1 March 2012 *Pillar I: Issue Basel II compliance standards* *Pillar II: Develop risk management systems consistent with the principles and standards of Basel Committee* *Pillar III: Disclose information according to Basel Committee principles*	SBV's *Official Correspondence No. 1601* (17 March 2014) *Standard approach (credit, operational, and market risks)* *10 Pilot Banks* *Other Banks*	 By 2015 By 2018
		Circular 41/2016/TT-NHNN dated 30 December 2016 *Regulating capital adequacy ratio (CAR)* *Credit risk and market risk: SA* *Operational risk: BIA* *Pillar II: ICAAP (Being drafted)*	 1 January 2020 1 January 2019

	Prime Minister's Decision No. 1058 (19 July 2017) *Basel II, pillars I and II by 2020* *Roadmap*	SBV decision No. 1533 dated 20 July 2017 *Action plan in detail*	2017–2020
		Prime Minister's Decision No. 986 (08 Aug 2018) *Banking development strategy – BCP and Basel II SA*	2020-2025
Basel III	**Informal adoption** *(No public commitment to Basel III, but banking regulations were in line with Basel III standards)*	Circular 36/2014 dated 20 November 2014 *CAR at 9% and liquidity ratio:* *(proxy) LCR 30 days: 50% for VND, 10% for other currencies;* *(proxy) NSFR: 10%*	2 February 2015

Table 13.2. New roadmap for Basel implementation

1999-2006: The informal adoption of Basel I

Both the Law on the State Bank of Vietnam and the Law on Credit Institutions were first issued in 1997. Two years later, the SBV promulgated Decisions 296 and 297 to introduce Basel-like standards for Vietnam such as customer credit limits, minimum capital requirements, and asset classification in four risk categories. Under Basel I, banks are required to hold a minimum of 8% of risk-weighted capital, including both Tier 1 and Tier 2 capital. However, as revealed in our interviews, due to a misunderstanding of the definition of Tier 1 capital in the Basel I standards, Decision 297 required banks to hold a minimum of 8% of Tier 1 capital. As a result, commercial banks faced fundamental difficulties in dealing the aftermath of the Asian Financial Crisis, and were unable to meet the minimum capital requirement.

There are two particularly interesting points regarding the implementation of Basel-like regulations in this period. First, the lead time between the issuance of implementation regulations and the effective date was very short – less than a month for both Decisions 297 and 457 (see table 13.2). This raises the question of whether the SBV really understood the difficulties banks faced when they had to implement these standards, or whether the SBV issued regulations just to be able to say it had without much about their enforcement. Secondly, with Decision 457, state-owned banks were granted a grace period of three years. While this means that the SBV understood that these banks could not meet these standards immediately, it also reveals the relatively preferential treatment state-owned banks enjoyed relative to their privately-owned peers.

2006-2013: The formal adoption of Basel I and Basel II

It was not until 2006 that Vietnamese regulators officially referred to Basel I and II in Decision 112 of the Prime Minister. This decision stipulated a plan for the 2006–2010 period to improve regulations on banking security, supervision, and management in accordance with Basel I, and to implement Basel II guidelines and standards after 2010. The project, which was implemented in the context of Vietnam's preparations for joining the WTO, aimed to develop the banking industry by deepening its integration and strengthening its competitiveness. However, no legal document existed that specified a roadmap to ensure the implementation of Basel II.

The Banking Inspection and Supervision Agency under the SBV was established in 2009, marking an important step towards the implementation of Basel standards. The revised Law on the State Bank of Vietnam and the Law on Credit Institutions of 2010 made important changes to the definition of the status and functions of state-owned banks, including clear definitions of important concepts such as banking operations, principles of bank governance, internal control, and information transparency.

When Circular 13 on the safety ratios was issued in May 2010, developed countries had been on their way to adopt Basel III. This Circular is more ambitious than Basel II, since it sets the minimum capital adequacy ratio (CAR) at 9%. However, it does not consider operational risk, or market risk, or Basel III standards for a capital conservation buffer and countercyclical buffer requirements. Circular 13 encountered a lot of opposition from banks because the lead time given to them was only five months. Once again, the SBV appears to have understood that it takes time and a great deal of effort for banks to implement Basel standards, which they could otherwise only comply with using manipulated data.

Although regulatory reforms were made on paper, implementation of Basel standards and compliance with Basel Core Principles was limited, reflecting the regulators' priority of controlling the banking system and preventing it from collapse, as well as the lack of competent SBV technocrats. Available evaluations show that by the early 2010s, most Basel Core Principles were complied with either partially or not at all. According to the self-assessment conducted by the SBV (NFSC, 2018), "the banking supervision system says 4/25 principles are compliant, 9/25 are largely compliant, 11/25 largely non-compliant, and 1/25 not compliant".

Indeed, SBV's mock compliance with the Basel standards is evident in the fact that it has permitted the use of compromised and falsified data by banks. For instance, during the time of the banking crisis, the SBV largely overlooked the CAR of banks. This results in an ironic paradox: stronger and larger banks often reported a CAR of around 10%, while many weaker and smaller banks, which were later acquired or restructured, reported a CAR above 10% or even up to 30% (figure 13.2).

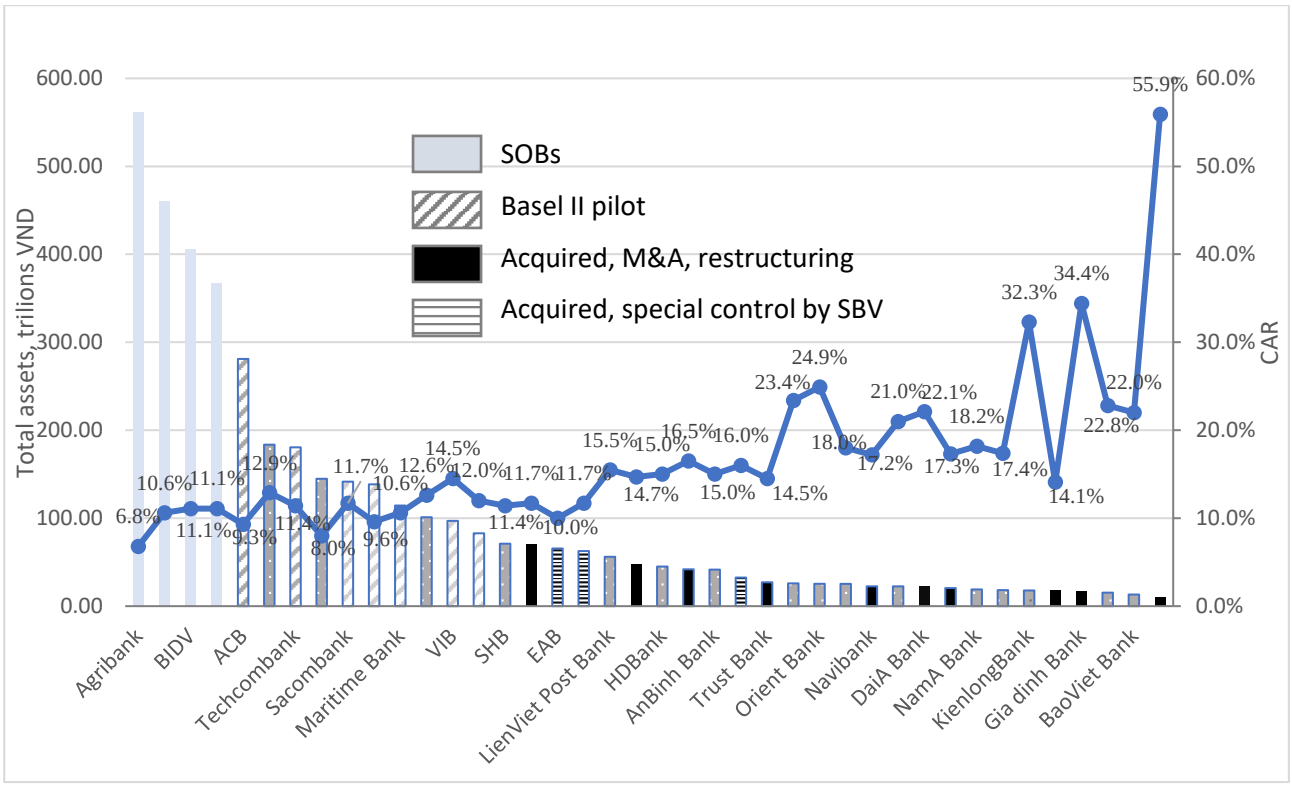


Figure 13.2. Capital Adequacy Ratios in 2011
Source: STOXPLUS data (30-Sep-2012). Vietnam Banks - A Helicopter View - Issue 4. Asset and Capital Quality

The second piece of evidence of the SBV's forbearance towards regulation is that it turns a blind eye to banks' NPLs. On paper, most banks in Vietnam have met the NPL ratio requirements (i.e. less than 3%). However, NPL figures from other sources seem to be at odds with official figures (figure 13.3). According to the SBV, the official average NPL ratio in June 2011 was 3.2%, while according to Fitch it was about 13%. In 2012, the bad debt shown in bank reports fluctuated around 4.4%, while the supervisory agency reported 8.6%, and other independent institutions estimated it at around 15–17%. Later, the SBV also admitted the bad debt had occasionally been 17.2% in 2012.[2]

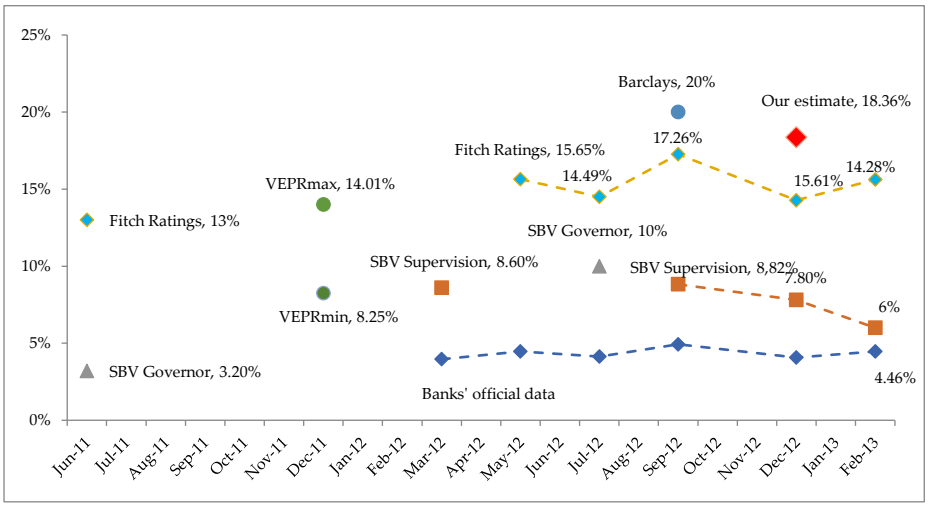


Figure 13.3. Non-Performing Loans in Times of Crisis (2011–2013)
Source: Vu-Thanh et al. (2013)

Thirdly, in this period, when the banking system was in trouble – liquidity risks and bad debts were high, and some banks were bankrupt at times – the SBV decided to wholeheartedly support these banks in every way it could. This included adjusting the rules to help them hide bad debt, and establishing the Vietnam Asset Management Company (VAMC) to help banks freeze bad debts and clean up their accounting books.

Interestingly, faced with the banking system's severe liquidity problems and bad debts in the 2008–2012 period, the Prime Minister's Decision No. 254 from March 2012, titled 'Decision on Approving the Scheme of Restructuring the System of Credit Institutions for the period of 2011–2015' referred to Basel II as the solution to the problem. The focus was "to issue capital adequacy standards in line with Basel II, providing standards for disclosure of information by credit institutions in line with reality in Vietnam and the principles of the Basel Committee". However, in the context of widespread troubles in banks and capital shortages, Basel implementation was essentially impossible, and perhaps merely cosmetic. Indeed, in this period, the State Bank even promulgated regulations that assisted banks in reclassifying debts (see SBV's Decision No. 780, State Bank of Vietnam, 2012b) to order to improve their operational safety ratios and keep their NPL ratio within limits.

2014 onwards: The acceleration of Basel II

In the third period, the implementation of Basel standards accelerated. Basel II was strongly emphasized in the SBV's Official Correspondence No. 1601 in March 2014, regarding

[2] Report No. 36/BC-NHNN dated April 4, 2017 of the SBV to review the enforcement of legal regulations to handle weak credit institutions.

implementing capital adequacy regulations. Specifically, ten domestic banks were selected to carry out the capital and risk management pilot under Basel II standards.[3] It was expected that by 2015, these ten banks would follow the standardised approaches with respect to evaluating credit risk, market risk, and operational risk under Basel II, and would be fully in line with Basel II standards by 2018. Foreign-invested banks and banks with 100% foreign capital were expected to implement the same Basel standards as those adopted by their parent banks, and from 2015 they were required to implement standards at least as stringent as Basel II. All other domestic private banks were expected to implement basic Basel standards II at a minimum by 2018. In sum, according to the roadmap laid out by the SBV in 2014, all banks in Vietnam were expected to be implementing the basic standards of Basel II by 2018. Circular 36 (November 2014) regulated the safety ratios of credit institutions and was considered a stepping stone for further development of Basel II in the sector. This Circular also adjusted liquidity risk requirements and brought them closer in line with Basel III.

Despite these intentions, by the end of 2015, after the assessment of data gaps[4] and the quantitative impact study (QIS) of ten pilot banks, the original plan was abandoned because the original ten banks did not meet the requirements and there remained a serious lack of enforcement by the SBV. In our interviews, pilot banks pointed out that there was a significant difference between the CAR calculations in the SBV's guidance and international standards.[5] Indeed, the SBV did not truly force the pilot banks to follow the roadmap because its immediate concern at that time was 'crisis management' (i.e. avoiding bank failures) rather than improving banks' governance. At the same time, banks got used to the SBV's 'compromise', in the form of *ad hoc* forbearance or modification of regulations – sometimes right before their effective dates – and did not make serious efforts to comply.

By 2016, the goal of preventing banks from failing was viewed as accomplished, at least according to the government's judgment, and the SBV returned its focus to strengthening banks' governance, in order to prevent future failures. In November 2016, the National Assembly issued Resolution No. 24 on the Economic Restructuring Plan for the period 2016–2020. Its aim was to "generally complete the restructuring of credit institutions, step up settlement of bad debts and gradually apply Basel II to credit institutions. By 2020, it is expected that commercial banks have their own capital satisfactory to Basel II including at least 12–15 commercial banks in which Basel II is successfully applied."

Following this National Assembly Resolution, in December 2016 the SBV issued Circular 41, which will enter into force by 1 January 2020, and which prescribes the capital adequacy requirements for commercial banks. It is worth noting that this time it is not only the ten pilot banks that are subject to the new regulation, but all commercial banks (including foreign-invested banks and 100% foreign-owned banks) that are required to participate. Circular 41 is considered to be very close to Basel II standards, and even refers to elements of Basel III, as well as the most up-to-date Bank for International Settlements (BIS) discussions on incorporating Basel criteria for a standard approach and the internal ratings-based approach. The resolve to implement Basel II seems to be stronger than in previous periods. The Prime Minister and SBV approved the plan to restructure credit institutions and deal with NPLs – the so-called Project 1058 – and Basel II was highlighted as a benchmark for improving the financial and governance capacities of credit institutions. Banks also appear to be taking implementation more seriously. Although progressing at

[3] These banks are BIDV, Vietinbank (CTG), Vietcombank (VCB), Techcombank (TCB), Asia Commercial Bank (ACB), VPBank, Military Bank (MBB), Maritime Bank (MSB), Sacombank (STB), and International Bank (VIB).

[4] According to an SBV leader who is in charge of Basel implementation, banks' current data can only meet about 45% of Basel II requirements. Also, more information is needed to develop internal credit rating models and systems.

[5] According to the National Financial Supervisory Council, applying Basel standards to calculate CAR for ten pilot banks shows a much lower ratio than the current one, mostly due to increased risky assets. For the four State Owned Commercial Banks (SOCBs), the current CAR is about 9%, while it would be lower than 8% if Basel II were used.

different rates, in the last few years the group of pilot banks have demonstrated considerable efforts to implement Basel II in a more genuine way than just for the sake of meeting the requirements of the SBV.

The acceleration of Basel implementation is part of a wider trend by the SBV to apply international financial standards in Vietnam. The SBV has also begun to introduce international standards on anti-money laundering (AML), credit rating agencies, CAMELS standards, anti-dollarization, and the reduction of cash transactions.

The Political Economy of Basel Adoption and Implementation in Vietnam

Although Vietnam has a unitary political system, within the Vietnamese Communist Party there are factions with different views on state-owned banks and financial reform. While reform-minded politicians, who are often more internationally oriented, expect to use international yardsticks such as Basel standards to impose discipline on state-owned banks and reform the banking system, conservative-minded politicians fear that imposing 'capitalist rules' on the state-owned banks not only makes the Party look bad, but also exposes the weaknesses of these 'leading' state-owned banks. These conservatives, therefore, face a dilemma: they are aware that in order to reinforce the legitimacy of the Party-State's performance, economic integration (i.e. opening trade, investment, and finance) is inevitable; at the same time, they fear that economic integration will erode the primacy of the state-owned sector, and, therefore, Vietnam's socialist orientation.

The SBV is a ministerial-level agency under the government, which in this Leninist state, makes it subservient to politicians, meaning it has hardly any autonomy (Vu-Thanh, 2011). In addition, the SBV is expected to pursue multiple goals simultaneously: it plays the role of both a central bank and a government bank; it is supposed to stabilize the currency value as well as ensure the safety of the banking system; it is also given the political task of "contributing to the socio-economic development along the socialist orientation"; and it is the regulatory body that supervises the credit institution system and, at the same time, the representative of state ownership in state-owned banks. These multiple goals and mandates give rise to many conflicts in banking regulation. Moreover, since leaders of the SBV are political appointees, when these conflicts emerge, they are supposed to follow the Party's instructions and safeguard its legitimacy.

Commercial banks in Vietnam can be classified into three groups according to their ownership: state, domestic private, and foreign. In Vietnam state-owned banks, despite their ineffectiveness and lack of transparency, are always considered by the party-state as an important instrument for controlling the monetary market and ensuring macroeconomic stability. Meanwhile domestic private banks have grown very quickly since the early 2000s, to become the biggest actor in the banking sector in Vietnam today. This group can be divided into two subgroups. The first consists of relatively weak banks (those with small assets and high NPLs), most of which were upgraded from rural banks in the early 2000s. The second subgroup is made up of the relatively strong banks (i.e. large assets, moderate NPLs) that have the ambition to expand by searching for foreign strategic shareholders or advancing into international markets. The third group is made up of foreign banks, and currently accounts for only about 10% of market share. As noted above, private banks, both domestic and foreign, have virtually no voice in the policy process.

The remainder of this section provides a political economy explanation of how and why Basel implementation has changed over time in Vietnam, with a particular focus on the second period (i.e. 2006–2013). The summary of our analysis is presented in table 13.3.

	Economic context	Politicians		Regulator	Banks				Basel standards	
		Reformist	Conservative	(SBV)	Weak POBs	Strong POBs	Foreign	SOBs	Adoption	Implementation
Period 1 1999-2006	Active integration (BTA 2001, conclusion of WTO 2006) High growth, bright perspectives	+	+/-	+	~	~	NA	~	+	+
Period 2 2007-2013	Not much integration Growth slow down Banking crisis	+/-	-	+/-	-	-	~	-	+	-
Period 3 Since 2014	Active integration (TPP 2015, AEC 2015, EVFTA 2016) Growth recovery Bank consolidation	+	+/-	+	-	+	~	+	+	+

Table 13.3. Preferences of major actors with respect to Basel adoption and implementation
Note: [+] means 'support Basel'
[-] means 'not support Basel'
[+/-] means 'conflicting preferences'
[~] means 'indifferent'
SOBs: State-owned banks; POBs: private owned banks; SBV:

Informal adoption and slow implementation of Basel I

The period from 1999 to 2006 witnessed some of Vietnam's most important and successful market reforms since Doi Moi. As the country recovered from the negative impact of the Asian financial crisis, Vietnam stepped up its domestic reforms and international integration.

The reformist faction of policymakers took advantage of this exuberant domestic reform and international integration to introduce international standards in order to discipline state-owned banks and improve the functioning of the financial sector. The SBV, which is always subservient to the prevailing political will, informally adopted Basel I and laid out the roadmap for its implementation by issuing Decision 297 in 1999, and Decision 457 in 2005, to require banks to satisfy prudential ratios. It could be argued further that since things appeared to be going well, and no one, including the reformist faction was asking many questions, even if SBV officers knew at the time that there were a lot of inefficiencies, they had an incentive to keep quiet or otherwise risk harming their own careers as political appointees.

Having little experience with banking reforms of the likes of Basel, the SBV imposed very demanding requirements on commercial banks. As mentioned above, Decision 297 required banks to meet Tier 1 capital requirements of up to 8%, while Basel standards required 8% for both Tier 1 and Tier 2 capital together. When no bank met this ambitious requirement, the SBV issued Decision 457, which was more in line with Basel I standards. However, the SBV gave banks only one month to meet this new regulation, a timeline that was impossible for the banks to meet.

In summary, the excitement of reform and the integration efforts of reformist politicians led the SBV to informally adopt, but prematurely implement, Basel I. It is not surprising to see that the SBV's Basel-implementing regulations merely existed on paper, without effective compliance from banks.

Mock compliance with Basel II

During the period 2006-2012, mock compliance with the adoption and implementation of Basel standards was prevalent. Why was this? We argue that this mock compliance resulted from conflicted preferences at various levels.

At the core of Vietnam's political economic system, there has always been an inherent tension between economic openness and political 'closed-ness'. The process of opening up and integration

at an international level over the course of Vietnam's joining the WTO in 2007 has had many implications for the financial system. One of these is that Vietnam is seeking to foster international- and market-oriented policies in a bid to improve the country's competitiveness and attract foreign investment. The adoption of international practices in corporate governance, accounting and auditing, and banking and financial systems is perceived to be vital to achieving these aims. From our interviews with a senior SBV officer who is a member of the SBV's Basel Task Force, and with several commercial banks' senior managers who are part of their respective Basel Project Management Offices, it was confirmed repeatedly that the first motivation to implement Basel comes from their need to 'speak the same language' as foreign partners in the process of international integration.

If economic openness is an essential means for enhancing the party-state's legitimacy, then political closed-ness is necessary for preserving its absolute power. This also implies that economic integration, and its accompanying adoption of international norms and best practices, is valued only as long as it does not interfere with the party-state's legitimacy and its control of the economy.

In the mid-2000s when the economy was booming, everybody was optimistic; economic integration was on the rise, and Basel II was formally adopted in the Prime Minister's Decision 112 in 2006. However, two years later, macroeconomic imbalances and the banking crisis took hold, and even the reformists lost their enthusiasm for implementing Basel standards – doing so would suddenly expose all the hitherto unaddressed weaknesses in domestic banks, both private and state-owned, and therefore exacerbate already-difficult banking conditions. As a result, the reformists and conservatives together reached a consensus to hold back further Basel implementation.

It is important to emphasize that weaknesses in the domestic banking sector during this period had a lot to do with the biggest state-owned enterprises – the so-called state economics groups (SEGs) or state general corporations (SGCs). In this period, these state conglomerates were given directed lending and allowed to invest in multiple sectors even outside their core businesses. Their heavy losses during the 2007-2008 crisis resulted in a large number of NPLs in the banking system. A proper implementation of Basel standards would inevitably expose these significant and non-transparent NPLs, and for this reason politicians avoided addressing the issue.

The SBV had an even deeper understanding of the detrimental consequences of implementing Basel II during the time of crisis. Indeed, as a ministry under the government, the SBV was supposed to keep politicians informed about the risks of properly implementing Basel standards. Moreover, as the ministry responsible for ensuring financial security, the SBV had the strongest incentive not to create or aggravate any financial instabilities during times of crisis. Predictably then, during this period the SBV repeatedly reassured the market that it would never let any banks fail.

As mentioned earlier, the SBV's ambiguous and overlapping roles gave rise to conflicting incentives, and these conflicts were intensified over this time. For example, a president or CEO of a state-owned bank who later became an SBV Governor or a high-profile politician would have tended to turn a blind eye to the weaknesses of their own bank at the time, for some of which they might have to take personal responsibility down the line. In other cases, it was difficult to maintain the SBV's objectivity, as it filled the roles of both the regulator and the owner of state-owned banks, especially with regards to costly sanctions and enforcement. These ambiguous and overlapping roles of the SBV therefore resulted in widespread regulatory forbearance on the whole.

During this period, banks were passive players that wanted to adopt a better system of risk management but were constrained from doing so by limited financial and human resources. Coupled with having to take the lead from the SBV, this made them reluctant to implement Basel, particularly during a systemic crisis.

Notably during this period, even if the politicians, regulators, and banks had wished to implement Basel II standards properly, they would have faced major institutional and technical challenges. The SBV has always lacked independence and its technical human resources have been limited. Low

institutional and governance quality throughout the banking system continue to pose important barriers to the effective implementation of international standards such as Basel. In addition, fully implementing CAR in accordance with Basel II would have forced the SBV either to recapitalize state-owned banks (at a time when its budget was already in distress), or allow participation by foreign investors (something the political leadership has long been averse to). Moreover, fundamental institutional problems persist: the banking database system is not centralized, credit transactions are not updated, cash transactions are still popular, there are no independent rating agencies, and the accounting system is not up to international standards. These factors together have led to a low level of data credibility, implying that regulators and even bank owners may not know exactly the bank's real financial position, and the data can be easily manipulated in order to comply with the SBV's requirements.

Our interviews reveal that in this period, even banks with strategic foreign shareholders did not have the right incentives to implement Basel II. In Vietnam, because of the fear of losing control and the desire to maintain the dominant role of state-owned banks, the government restricts foreign ownership in Vietnamese banks to less than 30% (no individual can own more than 5%, and foreign owners cannot own more than 20%). This level of ownership does not provide foreign shareholders with sufficient incentives to transfer technology and governance systems in accordance with their international parent bank's practices. Initially, some foreign counterparts suggested that Vietnamese banks adopt international practices, but after calculating the associated costs and benefits, they reconsidered and decided to follow the practice of Vietnamese banks. Moreover, even in cases where the foreign partners are in charge of risk management, they are unlikely to have sufficient and adequate data to do their job in the Vietnamese context, due to the differences in accounting practices and data manipulations commonly found in banks. Thus, in Vietnam, the implementation of Basel and other international practices – such as internal controls and International Financial Reporting Standards (IFRS) accounting – are rarely promoted or initiated by foreign shareholders.

A shift towards accelerated and more genuine implementation of Basel II

In a way, the context from 2014 onwards is somewhat similar to the period between 1999–2006: the economy began to recover from the crisis, brighter economic prospects returned, and Vietnam stood on the threshold of its highest level of international integration, joining several trade agreements in 2015/16. In this context, politicians and regulators decided to complete the unfinished business of Basel adoption and implementation.

The most important difference between periods 1 and 3 probably lies in the preferences of the banks themselves. After struggling with the crisis, strong banks restructured, weak banks had been consolidated or faced bankruptcy, and the others knew that they had to become competitive in order to survive, especially in the context of increasing market pressure from foreign banks as financial integration increased. These shifting incentives continue to have significant implications for the implementation of Basel standards, because ultimately, such standards need to be implemented by banks themselves.

As already mentioned, in 2014 when the SBV announced a roadmap for Basel II implementation, it selected ten domestic banks to participate in a pilot program.[6] In our interviews with these pilot banks, they all agreed that their participation in the program was perceived as a credible and positive signalling device to the market.[7] If, during the time of a bank crisis (e.g. 2008–2012), being

[6] In this period, although Basel III has not yet appeared in official regulations, some Basel III elements such as LCR and NSFR have been adopted. However, the exact definition of these concepts is somewhat different from Basel III. For instance, under Basel III, the minimum LCR required is 100% irrespective of the type of assets, while the minimum LCR under Vietnam's regulation is 50% for VND and 10% for foreign currencies.

[7] At the beginning, the initial pilot program consisted of only eight banks, but two other banks successfully lobbied the SBV to join.

in Group 1 (the 'healthy' group) was considered to be a positive thing, then since the roadmap for Basel II was announced, being a pilot bank selected by the SBV has similarly been interpreted as being one of the best banks in the market. This signalling device proves to be very valuable in creating a good reputation for banks' investments and trading partners, particularly in an environment characterized by pervasive asymmetric information, as is the case in Vietnam.

An interesting question is how these ten banks were selected. Responses from our interviewees reveal that the institutions were not selected on the basis of clearly defined and publicly available criteria. The biggest three state-owned banks were selected for an obvious reason, i.e. their size and leading position in the sector. However, some of the banks that were selected were not at all among the top ten biggest banks, measured either in terms of total assets or charter capital.

Another interesting question is to whom the banks were signalling. Obviously, the signal was not for the SBV's benefit, since it was the SBV itself that hand-picked these pilot banks. Neither was the signal intended for the depositors, because the SBV virtually guarantees that that no bank will ever fail in Vietnam. Interview answers suggest that the main targets for this signalling mechanism were foreign stakeholders and future partners. Most of ten pilot banks have foreign shareholders, and all of them have been rated by Moody's. In addition, these banks are either listed, or were about to be listed, on the stock exchange in Hanoi (HNX) or Ho Chi Minh City (HOSE).

The SBV's clear road map for Basel implementation, including in Correspondence 1601 in 2014, provided important impetus for banks to move forward with the regulations. Interviews with bankers, both inside and outside the Basel pilot program, show that since 2014, many banks started working with consulting firms to prepare their own road maps for Basel II implementation. Thanks to their proven resilience during the banking crisis, the ten pilot banks had a wider leeway to adopt Basel and improve their risk management and banking governance. However, even for these banks, strict application of Basel standards would inevitably have reduced their liquidity coverage ratio, CAR, and return on equity compared to the status quo. As a result, banks had little incentive to implement Basel until the SBV's Basel implementation roadmap became credible and banks believed they would be liable to strict SBV supervision.[8] Once this happened, the leading banks invested efforts in meeting the deadlines more sincerely, thereby creating pressure for other banks to keep up. Our interviews show that non-pilot banks have already prepared for Basel II by evaluating their data gaps. These banks understand that implementing Basel now will send a positive signal to the market, and that once the Basel regulation is officially issued, it will apply to the whole banking system, so it is better to start sooner rather than later.

Big banks, especially the ten pilot banks, need to raise more capital to meet the new CAR requirements. These institutions have found that Basel II offers a way of reducing their cost of capital. They all argue that if a bank adopts Basel II, it will become more transparent and its risk management system will be better, so that their credit rating could be improved, implying a lower cost of debt issuance and making it easier to attract international investors. As the domestic financial market is not big enough, these banks really need to raise capital from international investors, and are seeking strategic shareholders from foreign financial institutions to do this.

Expansion overseas provides further incentive for banks to support Basel II implementation, as is illustrated with the experiences of Vietinbank (one of the ten pilot banks). Vietinbank chose to establish its first representative office in Europe in Frankfurt (Germany) in April 2010. A year later, in July 2011, its first branch office was approved by BaFin, to be opened in Frankfurt (Tuyet, 2011). Its second branch office was opened in May 2012 in Berlin. One of our interviews revealed that the main motivation for Vietinbank to open these branch offices was to send a positive signal

[8] A rational roadmap is necessary for its credibility. Even pilot banks, especially the state-owned banks, experience great difficulties raising capital to meet the CAR requirement of Basel II. This is why Decision 41 (December 2016) on Basel implementation pushes the implementation deadline to January 2020 from 2019, and CAR has been reduced to 8% from 9% as required by Circulation 13 (2010).

and help it improve its reputation as the first and only Vietnamese bank to comply with European banking standards. Although the effort to comply with European standards in operating and managing these two branches does not imply that Vietinbank headquarters will necessarily implement Basel standards, this overseas venture has indirectly compelled the bank's Board to educate itself about international standards, and facilitated the discussion of Basel adoption in its strategic planning. Vietinbank is considered to be among the most advanced of Vietnamese banks in implementing Basel II.

Finally, competition has been providing strong incentives for banks to adopt and implement Basel standards. For a few leading banks trying to establish their activities in advanced economies, meeting the host country's standards (including Basel) is not a matter of choice (Nguyen, 2017).[9] For most banks, trying to keep up with increasing competition even in Vietnam is hard enough. Financial liberalization and economic integration create a much more competitive environment for domestic financial institutions. Indeed, ten years after joining the WTO, the number of foreign-invested and foreign-owned banks has increased rapidly (Tran, 2017).

In sum, shifts in the domestic banking sector and increased engagement with international finance have created new incentives for banks, especially the stronger ones, to support the implementation of Basel and other international standards. For weaker POBs, the adoption of Basel II is perceived more as "compliance". For stronger POBs, however, it is considered as a means to differentiate themselves from weaker banks and send a positive signal to their partners. The pressure to implement Basel comes not only from the SBV, but also from the intrinsic needs of banks, which view Basel as an opportunity to improve their governance and attract foreign strategic investors.

In 2016, a new political leadership took office and has being trying to signal a wave of reform. Whether it is Politburo direction or National Assembly resolution or a Government decision, virtually all policy messages refer to the priority of restructuring the banking sector. This is indeed an important factor driving the SBV's efforts to implement banking restructuring measures, including the implementation of Basel II. As the banks have somehow managed to bring down the NPL ratio, they are readier to implement Basel standards. Meanwhile from the SBV's perspective, the implementation of Basel is perceived as a mechanism for preventing further financial crises and has therefore been carried out in a more active and substantive manner. This time, the roadmap is more rational, considering the readiness of banks, and the implementation timeline has been delayed to 2020 and then until 2025.

Conclusions and Reflections on the Analytical Framework

This paper argues that regulators, politicians, and banks face conflicting interests and incentives when it comes to Basel adoption and implementation. The country's politics are domestically oriented and closed, but its economy is internationally integrated and open. Economic openness is an essential means for enhancing the legitimacy of the party-state's performance, while political closed-ness is imperative to retaining its absolute power. As for the regulator (the SBV), ambiguous and overlapping roles have given rise to conflicting regulatory policies. Finally, banks have been passive players who want to approach international standards, but are constrained from doing so by limited financial and human resources, and the SBV's discretionary interventions. Politicians are the most powerful actor when it comes to deciding banking regulations, and the approach to Basel standards reflects the preferences of the political faction that won the tug of war. These conflicting interests and incentives have given rise for the longest time to extensive forbearance in the enforcement of banking regulations, and to mock compliance with Basel adoption and

[9] Vietcombank, ACB, and BIDV have also been allowed by the SBV to open a representative office in the US. However, only Vietcombank has been approved recently by the US Federal Reserve. Vietcombank receives permit to open representative office in the US (2018, November 1st) (Nhan Dan Online, 2018).

implementation. With reference to the analytical framework, this is an instance of politically-driven mock compliance.

The existence of conflicting interests and incentives at all levels implies that the context in which Basel standards are adopted and implemented is critically important. In the case of Vietnam, economic difficulties unfolded during the 2008–2012 period with the mounting problem of NPLs, and then the adoption of Basel presented an obvious dilemma: implementation would help signal the government's continued reform efforts, but it would expose the substantial inherent weaknesses of most commercial banks, which could plausibly have triggered a series of bank runs.

It is instructive to compare the experiences of Vietnam and Ethiopia, due to their common socialist legacy and shared model of a developmental state. Indeed, the economic system of Ethiopia today is very similar to that of Vietnam before Doi Moi, and the two countries' financial systems were quite similar until the late 1990s. The Ethiopia chapter of this volume essentially argues that the shift from Basel I to Basel II would empower the market and market access in a way that is totally against the power of the regulator, and that Ethiopia decided not to implement Basel II and III because it wanted to retain control over its economy. As discussed earlier, the Vietnamese party-state also wants to exert firm control over not only the financial sector, but also the economy as a whole. The key factor that sets the Vietnamese and Ethiopian experience apart is that while Vietnam's politics remain closed, a political decision has been taken to open up the economy in order to stimulate economic growth. This fundamental political economic principle shadows almost every aspect of the Vietnamese economy, including the adoption and implementation of Basel standards. How this dilemma unfolds will determine not only the divergent paths Vietnam and Ethiopia take, but the economic futures of both countries entirely.

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