Chapter 4 Investment and Business Financing in Hanoi

Pham Van Hung
Vietnam Development Forum and
National Economics University

According to the World Bank's *Vietnam Development Report 2006*, insufficient access to finance is the leading obstacle to investment and business in Vietnam. In order to become more attractive for the business community, Hanoi, as the nation's capital and the second largest city of Vietnam, needs to improve access to formal finance.

In terms of density of financial institutions, Hanoi already has an advantage as it has the head offices of almost all important financial institutions, including the State Bank of Vietnam, state-owned commercial banks, and joint-stock commercial banks. Furthermore, infrastructure for financial transactions, such as telecom, information networks and payment systems, is relatively well developed in Hanoi. Thus, its financial sector is more developed than other provinces and cities in the country with the exception of HCMC.

In the recent past, Hanoi has achieved substantial financial development over a relatively short period of time. Financial deepening is occurring, bank credit is increasing, and the amount of deposits is growing. Nevertheless, demand for enterprise finance is rising even faster than its supply as the number of enterprises grows and many existing enterprises expand their business activities. As a result, insufficient access to formal finance continues to remain one of the most significant problems for enterprises in Hanoi, especially with small and medium ones.

This chapter investigates the degree of matching between demand and supply of bank credit in Hanoi. We are particularly interested in two aspects of investment and business financing: (i) the ability of business enterprises to access needed capital for investment; and (ii) the efficiency of allocation of capital by the financial sector. We look at both sides of business financing, namely enterprises that require funds and banks that supply them. Our results are based largely on our surveys conducted from August to October 2005. Due to the time and budget constraint, sample sizes were relatively small. We obtained 81 valid responses from enterprises out of 150 to which questionnaires were sent out, with the response rate of 54 percent. There were also 18 valid responses from commercial banks. Nonetheless, our conclusions were quite clear and in line with the findings of other surveys. Existing studies will be cited, when necessary, to verify our main conclusions.

1. An overview of Hanoi's financial system

Financial activities in Hanoi have expanded substantially in recent years, even though property rights remain unclear and economic courts are largely inactive. In Hanoi, as of December 2005, there are in operation 5 state-owned commercial banks with a total of 41 branches; 28 joint-stock banks and joint-stock bank branches; 5 joint-venture banks; 13 foreign bank branches; and 12 credit cooperatives (Table 1). There are also 64 foreign bank representative offices; 4 finance companies; and 5 leasing companies. In addition, the government of Vietnam and the Hanoi authority are developing a securities market in Hanoi. In volume, the formal financial system of Hanoi consists essentially of the banking sector, and access to formal capital is tantamount to access to bank credit. For this reason, the scope of our study is confined to the capital financing of the banking sector.

Table 1 Number of Formal Financial Institutions in Hanoi

	1995	2000	2005
State-owned commercial bank branches	18	23	41
Joint-stock banks	14	14	28
Joint-venture banks	4	5	5
Foreign bank branches	11	12	13
Credit cooperatives	12	12	12
Leasing and finance companies	9	9	9

Source: Hanoi Branch of the State Bank of Vietnam, 2005

Note: Only first-level state-owned commercial bank branches are counted. According to the Hanoi Branch of the State Bank of Vietnam, there are 11 branches of Industrial and Commercial Banks, 16 branches of Banks for Agricultural and Rural Development, 1 branch of Bank for House Development in Mekong Delta, 11 branches of Bank for Investment and Development, 2 branches of Vietcombank in Hanoi as of December 2005.

Despite an increase of new financial and banking institutions during the past ten years, Hanoi remains an under-banked city. The contribution of the banking and financial sector to GDP of Hanoi is not as high as its potential. In 2004, the share of banking and finance in Hanoi's GDP is only 3.5 percent. This level may be normal as a national average of a developing economy, but Hanoi as the capital of Vietnam, with per capita GDP about USD1,200, and the target in Hanoi's plan by 2010 to become a financial and monetary center of Vietnam, the contribution of 3.5 percent in municipal GDP is too small.

Table 2 Contribution of Finance and Banking Sector to GDP of Hanoi

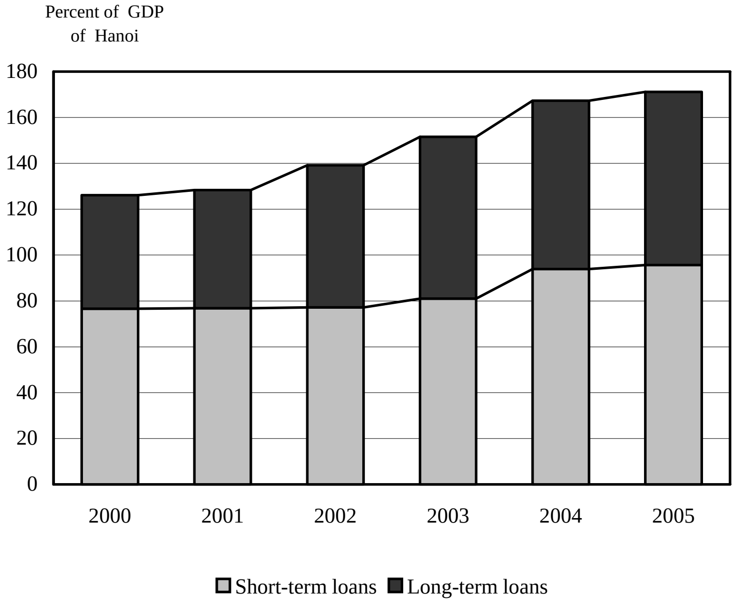
(Unit: billion VND unless otherwise noted)

	2000	2001	2002	2003	2004
GDP of Hanoi	31,513	35,717	41,944	49,090	55,996
Value-added of finance and banking in Hanoi	1,222	1,299	1,589	1,785	1,934
Share of banking and finance in Hanoi's GDP	3.9%	3.6%	3.8%	3.6%	3.5%
Cashflow through banks and treasury	59,956	69,746	112,623	158,822	278,501

Sources: Hanoi Statistical Office, *Hanoi Statistical Yearbook 2004*

Although economic transactions in Hanoi (and Vietnam in general) is popularly by cash, the situation has changed recently with the development of the banking system. Cash flows through banks and the treasury has risen sharply. People's confidence in the banking system of Hanoi has improved. According to the Hanoi Statistical Office, capital mobilized through Hanoi's banks was 40 percent of the total capital mobilized through the whole banking system of Vietnam and approximately 25 percent of GDP of the nation in 2004. However, since Hanoi's banking system mobilized 37 percent of the total capital supplied by the nation's banking system in 1994, it can be said that the importance of Hanoi's banking sector in Vietnam was relatively stable during the last decade. Hanoi must do more to stimulate capital mobilization to meet the target of becoming the financial and monetary center of Vietnam.

Figure 1 Banking Credit in Hanoi

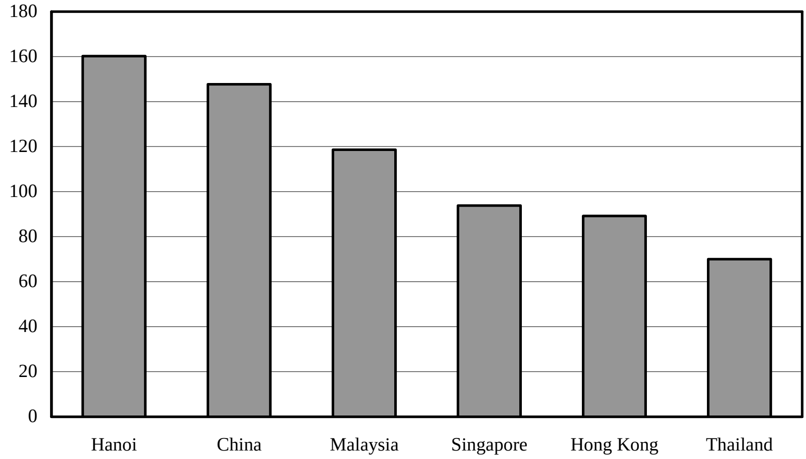


Source: Hanoi Branch of the State Bank of Vietnam, 2005

Total bank credit has expanded strongly in Hanoi. In 2005, it has reached 177 percent of Hanoi's GDP, and 96.8 percent of that credit was directed to financing business enterprises. This figure is even higher than that of Hong Kong, Singapore, China or Malaysia (Figure 2). However, despite a remarkable quantitative increase, the quality of bank credit still remains problematic due to the legacy of policy lending to state-owned enterprises and the lack of banks' ability to assess risks associated with loan applications. On the banks' liabilities side, deposit growth has averaged 21.2 percent in the last five years. From this, we may say that people's confidence in the banking system and their ability to access banking service are improving.

Figure 2 Bank Credit to Enterprises

(In percent of national or local GDP)



Sources: Hanoi Branch of the State Bank of Vietnam, 2005; and *Vietnam Securities Review*, No.7, (81)/2005

Another issue related to Hanoi's banking system is that bank loans only meet part of demand for bank loans despite the strong growth of deposits. In 2004, for example, the total collection of deposits of Hanoi's banking system was VND173,646 billion while total credit extended by the banks was VND93,710 billion. This means the ratio of lending to deposit taking was 54 percent. While it is normal for banks to lend out only part of their deposit collection, the peculiarity of Hanoi is that the banks lend out most of the remaining funds to other cities and provinces. This points to problems on the supply side of bank credit since demand for it is increasing rapidly.

Table 3 Mobilized Capital and Loans of Hanoi's Banking System

	2000	2001	2002	2003	2004	2005
Capital mobilization (VND billion)	74,484	98,160	122,051	147,145	173,646	192,012
Bank loans (VND billion)	39,745	45,850	58,387	74,399	93,710	106,285
Short-term loans (%)	60.8	59.9	55.5	53.5	56.1	55.9
Long-term loans (%)	39.2	40.1	44.5	46.5	43.9	44.1
Bank loans/mobilized capital (%)	53.4	46.7	47.8	50.6	54.0	55.4

Source: Hanoi Branch of the State Bank of Vietnam, and the author's calculation

Besides the banking sector, investment and business activities require diversified financial services such as leasing, insurance, investment funds, finance companies, and securities markets. However, with the exception of the insurance market that has boomed recently, these financial services remain underdeveloped. The Hanoi Securities Trading Center was established in March 2005 with the aim of serving small and medium enterprises[27]. However, this second trading center in the nation is only at its initial stage of development (the first securities trading center is in HCMC). The contribution of Hanoi's securities market to investment and business activities is limited as only nine enterprises are traded as of December 2005. This situation reveals the fact that, in many respects, Hanoi is still a city with an underdeveloped economy with a primitive financial system. Many shortcomings remain in access to formal finance, efficiency in the use of available funds, fairness in risk sharing among trading parties, confidence in the banking system, and support for the development of diverse financial services.

[27] Firms that have at least VND5 billion in chartered capital and 50 shareholders, and made profits in the preceding year.

2. The enterprise survey

To analyze the ability of enterprises to access formal capital in Hanoi, an enterprise survey was undertaken. In the entire sample of 81 enterprises, 85 percent was approached indirectly through a questionnaire. For the remaining 15 percent, face-to-face interviews were carried out for obtaining detailed information on key issues. Table 4 shows the types and numbers of surveyed enterprises.

Table 4 Surveyed Enterprises by Ownership

	Number	Share
State-owned enterprises	18	22.2%
FDI enterprises	7	8.6%
Limited liability companies	27	33.4%
Joint-stock companies	18	22.2%
Private companies	3	3.7%
Household businesses	8	9.9%
Total	81	100.0%

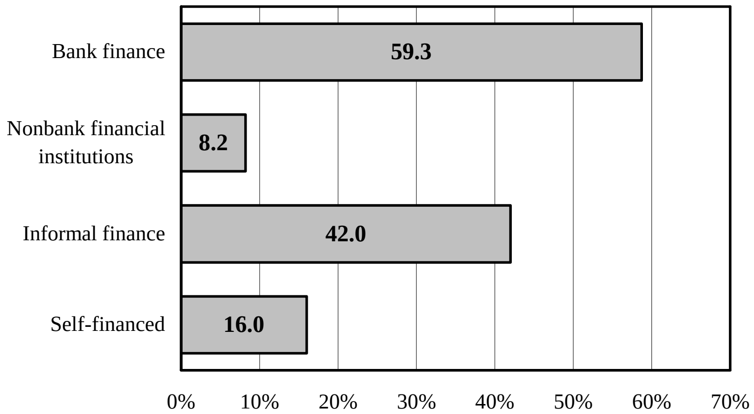
Among them, state-owned enterprises occupy 22.2 percent while private firms of various types are the remaining 77.8 percent, including FDI enterprises which account for 8.6 percent.

Structure of enterprise finance

Our results show that 16 percent of the surveyed enterprises are self-financed, which means that they operate by owners’ capital only. The other 84 percent had access to external finance. The ratio of enterprises with access to external finance in Hanoi is slightly higher than the national average of 80 percent (MPDF 2005).

As to bank access, 59 percent of the respondents receive bank loans while the remaining 41 percent cannot or will not borrow from banks. Again, Hanoi is better in this respect than many other provinces and cities. Hanoi's figure is higher than Hue (55.6 percent), Hai Phong (41.5 percent), Ha Tay (44.5 percent), Thanh Hoa (37.5 percent), and Nam Dinh (20.9 percent).

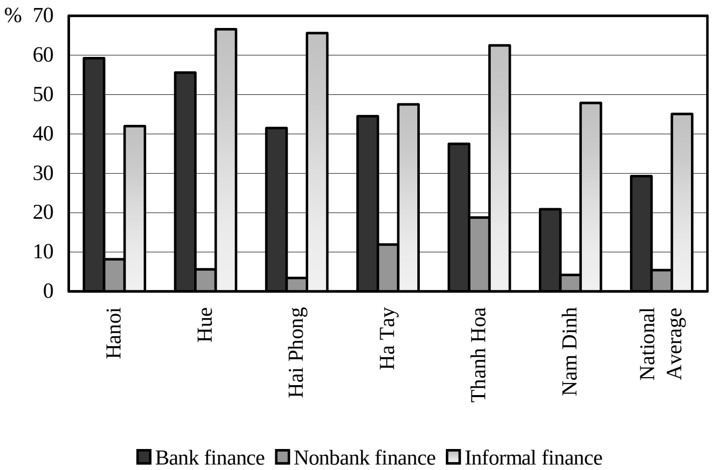
Figure 3 Business Finance in Hanoi



Source: The author's survey. Answers add up to more than 100 percent since multiple answers are allowed, except for the case of "self-financed"

The proportion of enterprises that are financed by informal financial institutions, such as money lenders, mutual assistance groups such as *hui* or *ho*, pawnshops, loans from relatives and friends, and so on, is relatively high at 42 percent. Some of the respondents said that their businesses were financed partly by customer advances. This can mean two things. The first possibility is that the cost of capital and lending risk are too high due to inherent problems on the borrowers' side. The second possibility is that formal financial institutions are under-developed so that even eligible borrowers are without bank access. However, reliance on informal finance in Hanoi is lower than many other provinces and cities, such as Hue (66.6 percent), Hai Phong (65.6 percent), Ha Tay (47.6 percent), Thanh Hoa (62.5 percent), and Nam Dinh (47.9 percent). As with bank access, Hanoi's financial sector is underdeveloped in the absolute sense but better developed relative to the rest of the country.

Figure 4 Financial Development of Selected Provinces and Cities



Sources: VDF survey, 2005; Admind J. Malesky (2004), *A study of private sector development beyond the higher performance cities and provinces of Vietnam*, IFC, Private Sector Discussion Paper No.18

Start-up finance

When new enterprises are established, they normally rely on the savings of owners and those of their families, relatives, and friends. Very few start-up enterprises have access to bank loans. All five start-up private companies in our survey also said that they did not borrow from banks. Although commercial banks are allowed to provide unsecured lending to private enterprises, this is only applied to enterprises with two consecutive years of profits. This legally precludes start-up enterprises with no collateral from accessing banking capital. Newly set-up companies always face the problems of limited assets as well as no or little history of relationship with financial institutions.

More generally, according to Kanichiro Suzuki and Michael Lacktorin (1998), the evolution of most enterprises begins with the “seed phase”, in which a firm may be little more than an idea, with primitive legal and operational structure. Its principal sources of capital are likely to be investments by the founders and family members. Equity investments by friends may also be available. During the next “growth phrase”, the firm is more advanced organizationally and manufactures products or sell services. The firm may even begin to generate a positive net cashflow which allows internal funds to become a new source of finance. Trade finance and a proper management of accounts payable may be additional sources of funds.

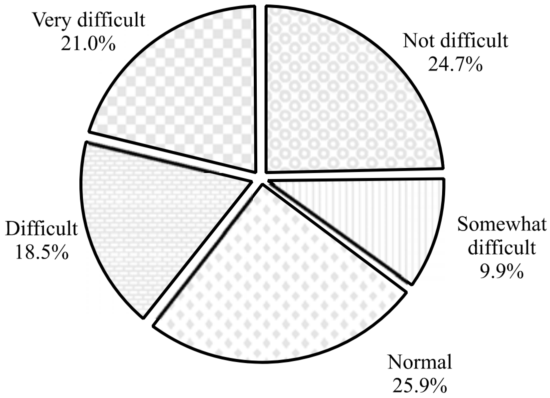
Bank loans are generally not available until the firm demonstrates stable growth. Commercial banks are conservative and will not lend until there is a good track record and a sufficient collateral or adequate guarantee. During the “stable growth phase” and the subsequent “late-growth phase”, asset-based financing and lease financing will also be added to the sources of funding.

With the situation of Vietnam in general and Hanoi in particular, the renewal process is going on and many private companies have been set up very recently, especially after the Enterprise Law was implemented in 2000. Thus, the inability of new private firms to access bank finance is normal. However, a proper policy framework must be installed to accelerate the development of firms into the next phase.

Ability to access bank loans: the perspective of enterprises

75.3 percent of interviewed enterprises reported difficulty in varying degrees in accessing bank finance (this includes all firms except those that said “not difficult”). Among them, 39.5 percent replied that it was “difficult” or “very difficult” to get bank loans. If each answer is given a score ranging from 1 to 5, with “not difficult” as 1 and “very difficult” as 5, the average score in Hanoi is 3.0, precisely the middle point in this scaling.

Figure 5 Enterprises' Perspective on Ability to Access Bank Loans

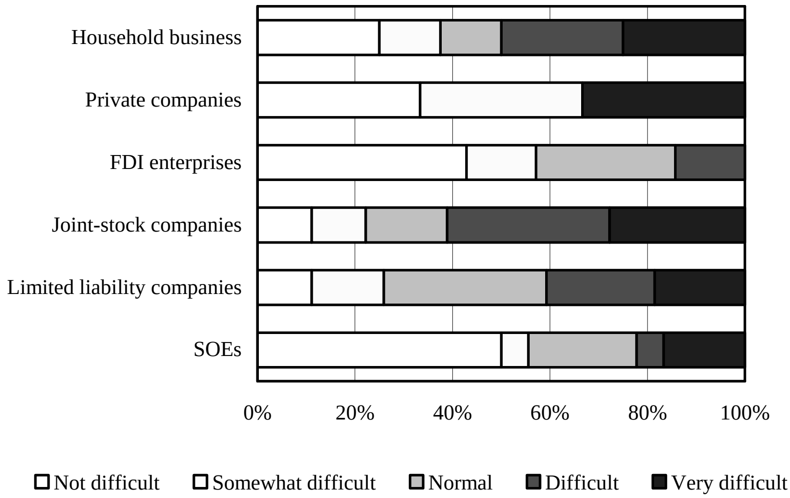


Source: VDF survey, 2005

The degree of difficulty in bank access depends on enterprise type. In particular, private firms often face problems when they try to access bank finance. Of all enterprises that answered that receiving bank credit was either "difficult" or "very difficult", 71.9 percent of them were limited liability companies or joint-stock companies. The ratio of limited liability companies that regarded accessing bank loans as "difficult" or "very difficult" was 40.7 percent, and the same ratio for joint-stock companies was 61.1 percent (Figure 6). Another group that meets difficulty in accessing formal finance is household businesses. Four household businesses out of eight interviewed stated that it was "difficult" or "very difficult" to borrow money from banks. Many of them have not even thought of applying for a bank loan. In our survey, only one household business said that it had actually borrowed money from a bank.

By contrast, state-owned enterprises and FDI enterprises find it not hard to access banks or formal financial institutions. Of all the enterprises which had easy access to banks, 45 percent of them were state-owned enterprises. Only 22.2 percent of state-owned enterprises in the survey responded that borrowing money from banks was "difficult" or "very difficult" (Figure 6). Especially in the case of large state-owned enterprises, no difficulty what-soever was reported when borrowing money from banks. As to FDI enterprises, 42.8 percent answered that they did not meet any difficulty in accessing bank finance. Only 14.3 percent of the FDI enterprises said that accessing banks was “difficult”. No FDI enterprise responded that it was “very difficult” to access banking capital. The FDI enterprise which reported difficulty was in the business of auditing and financial services. However, the service sector did not welcome foreign participation until recently. Thus, the difficulty of this firm may have been due to the attitude of domestic banks.

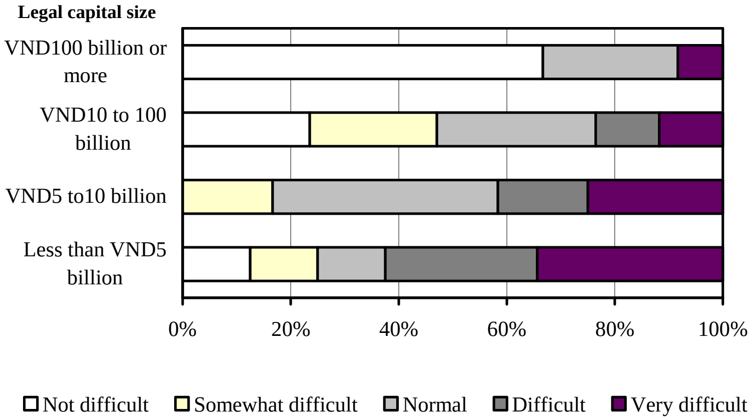
Figure 6 Level of Difficulty in Accessing Banking Capital by Sector



Source: VDF survey, 2005

The survey also reveals that the larger the company, the easier it can access bank finance. With the group of enterprises that have legal capital of VND100 billion or above, about 67 percent answered that there was no difficulty in accessing banking capital. By contrast, in the group of smallest enterprises with the capital of less than VND5 billion, only about 12 percent of surveyed enterprises responded “not difficult” while about 63 percent answered that it was “difficult” or “very difficult” to borrow capital from the bank (Figure 7).

Figure 7 Difficulty in Accessing Bank Loans by Enterprise Size

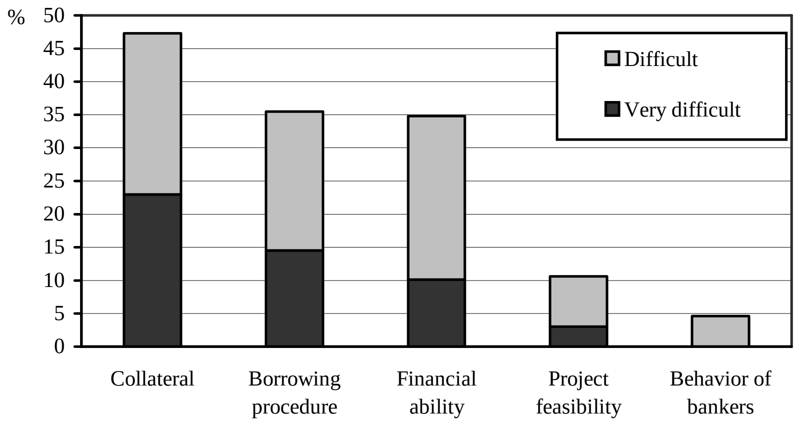


Source: VDF survey, 2005

Reasons for limited access to bank finance

Collateral problems were the largest obstacle for bank access. In our survey, as many as 85.1 percent of the enterprises reported some kind of problem associated with collateral in receiving bank loans, while only 14.9 percent said that it was not a cause of difficulty. Among enterprises that faced some problems, nearly half (47.3 percent) stated that the collateral problem was a "difficult" or "very difficult" factor in accessing bank finance. Almost all private enterprises (limited liability companies and joint-stock companies) said that credit officials charged with assessing collaterals consistently undervalued their assets significantly below their market values. For instance, the director of a mini hotel complained that his hotel, which had the market value of about VND3 billion, was assessed by a credit officer at VND20 million. There is no mechanism for appealing collateral valuation.

Figure 8 Enterprises' Perspective on the Reasons for Difficulty in Bank Access



Source: VDF survey, 2005

The second main reason for difficulty is cumbersome procedure to borrow from banks. 14.5 percent of enterprises considered this to be "very difficult". Most small and medium private enterprises said that procedure to borrow from commercial banks was complicated and non-transparent. Others responded that the time to process loan application was too long and enterprises might miss investment opportunities because of delay. Administrative procedure is especially complicated regarding the stipulation to sell collateral assets when borrowers fail to repay. About 20 percent of the interviewed enterprises had never applied for a bank loan. Some owners of new private companies even did not know how to approach banks for a loan. Reasons for not applying for a bank loan included the complexity of the process, long time to wait for the credit decision, and informal payment for credit officers. On the other hand, almost all enterprises said that there was no problem in the behavior of bankers.

The third main difficulty in obtaining bank loans is the limitation in financial ability and the lack of good corporate management on the borrowers' side, which are the problems of almost all Vietnamese enterprises. One-fourth (24.6 percent) of the surveyed enterprises admitted their financial ability and corporate management as a factor causing difficulty and 10.2 percent answered that it was a very difficult factor. Since approximately 90 percent of enterprises in Hanoi are small to medium size with limited financial ability and weak corporate management that do not meet international standards, banks are naturally not very willing to extend loans to them and may charge high interests even when they decide to lend. Under these circumstances, some private companies borrow money from banks indirectly through state-owned enterprises, although they have to pay a "service charge" for this arrangement.

3. The bank survey

To analyze the other side of bank loan problems, a survey of banks in Hanoi was also conducted from August to October 2005. The number of banks and first-level branches of state-owned commercial banks in our survey is 18. This includes 8 state-owned commercial bank branches, 8 joint-stock banks, and 2 foreign bank branches[28]. We also conducted face-to-face interviews with three banks to obtain further information.

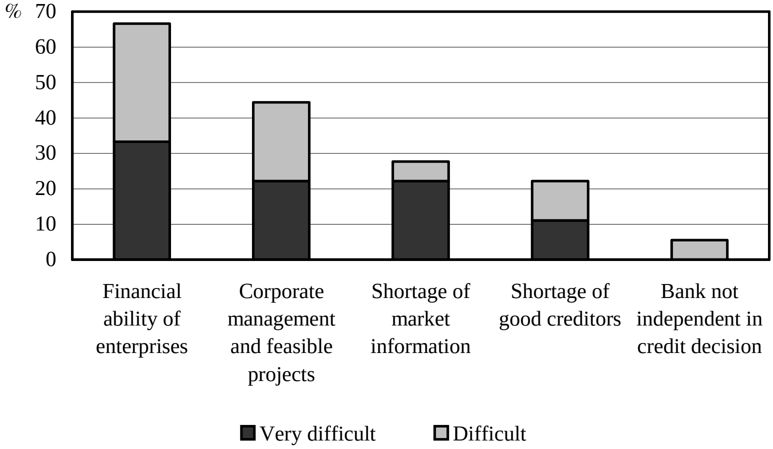
All of the surveyed banks responded that their operations have been profitable over the last five years. State-owned commercial banks have a clear advantage in size. For example, the legal capital of the interviewed private banks is typically in hundred billions of VND (TechComBank is the joint stock bank with the largest legal capital in its category but its size is only VND830 billion) whereas the average legal capital of state-owned commercial banks is about VND4,000 to 6,000 billion.

In 2001, a program to reform the banking system and improve the performance of state-owned commercial banks was adopted. The state-owned commercial banks in particular and the banking system in general have

[28] The sample size of the bank survey is small, but the total number of banks in Hanoi is also small (57)-see Table 1. Four state-owned commercial banks, with the national market share of about 80 percent, are all covered through first-level branches. Eight out of the fourteen joint-stock banks are also covered.

undergone important changes since then, in the areas of information management systems, loan approval procedure, credit risk management, and delinquent loan recovery. However, many other impediments in supplying capital to enterprises remain.

Figure 9 Banks' Perspective on the Reasons for Difficulty in Providing Enterprise Loans



Source: VDF survey, 2005

From the banks' perspective, the greatest difficulty in extending loans to enterprises is the financial capability of borrowing enterprises. 66.6 percent of the surveyed banks said that this was a "difficult" or "very difficult" factor. Among them, the half (33.3 percent) considered this to be "very difficult". In the enterprise survey, this was the third reason for the difficulty of obtaining loans. Besides this, banks are highly skeptical about the quality of financial reports of enterprises. The financial transparency of most private enterprises is lacking and their accounts are unreliable and fail to meet international standards. It is understandable that banks will be exposed to high risks if they supply capital to such enterprises.

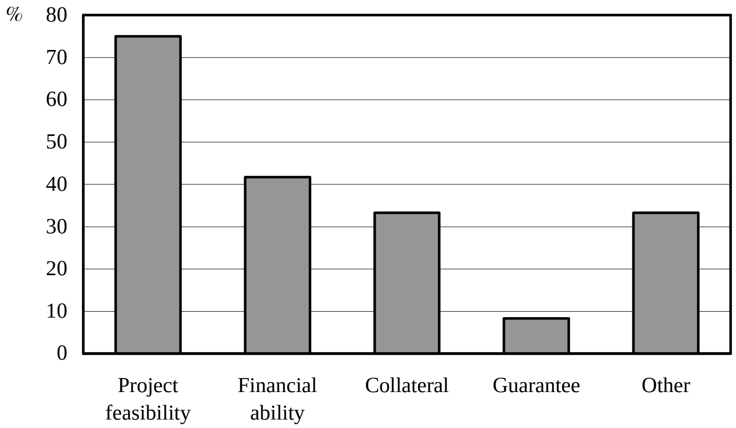
With limited financial ability, even the collateral of most enterprises, especially private enterprises, does not satisfy banks' lending requirement.

Some banks complain that the process to issue the “red book”, or the certificate of land use right, is irregular and very slow. But without it, private enterprises and individuals cannot seek loans from banks. Many enterprises and individuals have a problem in securing a “red book” because land use rights were inherited from previous generations without documentation or purchased through informal exchange. Since the market mechanism is in the initial stage in Vietnam, asset evaluation also creates difficulty for both banks and enterprises. Without established criteria, asset evaluation depends heavily on the views and discretion of individual creditors. Thus, collaterals are often valued far below their market prices. Private enterprises may be asked to pay “indirect cost” in the evaluation process. Some interviewees noted that informal payments were a leading facilitator in obtaining bank credit.

The second main reason for difficulty in extending bank loans to enterprises is poor corporate management and the shortage of feasible projects. 33.4 percent of banks answered that this was a “difficult” or “very difficult” factor. Banks are unwilling to lend because poor corporate management is the prime cause of loan misuse, repayment arrears, and defaults. In the worst case, poor corporate management can also lead to the bankruptcy or liquidation of the company. The fact that all banks in Hanoi now cite the feasibility of projects as one of the most important determinants of loan approval is a positive development. 75 percent of the surveyed banks said that this was the most important factor. However, there is a gap between the statement and actual behavior of banks. Some banks issue conservative regulations on lending and many credit decisions still depend heavily on collateral conditions.

The third difficulty for banks is the lack of market information as well as the shortage of professional credit officers. The ratio of banks that admitted to this problem was 22.2 percent. This shows that reliable market information is not available in Vietnam in general and in Hanoi in particular. Hanoi also lacks institutions and incentives that help bank officers to evaluate loan application properly or recover debt or collateral from delinquent borrowers. Commercial banks are without capacity for appropriate credit assessment. There is an urgent need to strengthen these areas.

Figure 10 Key Determinants of Bank Loan Decision



Source: VDF survey, 2005
Note: Guarantee means the support or warranty of a person or an organization for the loan.

Interference by non-business force is relatively low in Hanoi with only 5 percent of banks answering that it is difficult for them to make credit decisions because of interference by the government or other authorities. This situation of Hanoi is better than most other cities and provinces in Vietnam. As a rule, the State Bank of Vietnam (the central bank) has branches in all provinces and cities. While in principle the function of these branches is to perform banking supervision, the management of these branches is sometimes close to both the provincial people's committee and the provincial branches of state-owned commercial banks. This may result in credit decisions favoring the broader policy objectives of local authorities, rather than the pursuit of profit by state-owned commercial banks. Such decisions would probably fail to gain the approval of profit-oriented bankers but are likely to get the blessing of local authorities. The low level of interference by Hanoi's local authority partly comes from the fact that the number of banks and other financial institutions in Hanoi is higher than any other provinces or cities.

While direct political interference is negligible in Hanoi, indirect interference does exist. As many as half of the surveyed banks stated that supplying loans that met the target of the government was a priority. Vietnam upholds a national welfare principle in providing loans of state-owned commercial banks. This means that their lending may not go to the borrowers with the best commercial projects and business prospects.

There is a natural division of labor among banks in Hanoi (Table 5). State-owned commercial banks lend mainly to state-owned enterprises (from 60 to 88 percent). Joint-stock banks supply capital mainly to private-owned enterprises (49 to 82 percent). Foreign banks supply funds mainly to FDI enterprises (more than 80 percent).

Table 5 Structure of Corporate Borrowers of Selected Banks in Hanoi

		Share of borrowers		
		State-owned enterprises	**Private enterprises**	**FDI enterprises**
State-owned banks	Bank for Investment and Development, Cau Giay	60%	40%	0
	Incombank, Hai Ba Trung	88%	12%	0
	Vietcombank	65%	15%	20%
	Incombank, Ba Dinh	81%	19%	0
Joint-stock banks	EXIM Bank	30%	49%	21%
	VIBank	32%	57%	11%
	Phuong Nam Bank	18%	82%	0%
	ACB	25%	55%	20%
Foreign banks	Standard Chartered Bank	11%	4%	85%
	Bank of Tokyo-Mitsubishi	14%	5%	81%

Source: VDF survey, 2005

This division of market is mostly a natural outcome. State-owned enterprises have a longer relationship with state-owned commercial banks, and joint-stock banks with profit-orientation target private companies as their main customers. Foreign bank branches are not given permission to operate fully in the domestic financial market as Vietnam is still in the process of opening the banking sector to foreigners.

However, in terms of size, the four big state-owned commercial banks dominate the nation's banking sector, with about 70 percent of total assets and a collective market share of 70 to 80 percent. In this sense, there are no equal opportunities among different types of banks. In our survey, 12 out of 18 banks (66.7 percent) answered that treatment between state and non-state banking sectors was unequal, while 5 banks (28 percent) said that there was equal treatment between them. The government also states that the playing field is equal. However, there is usually a gap between policy and its implementation in Vietnam.

4. The allocation of Banking capital and the Quality of Credit in Hanoi

As a matter of fact, the banking sector in Hanoi is dominated by the state-owned commercial banks, which accounts for 80 percent of commercial banks operations in this city. There has been substantial growth of credit to the private sector since 1990, and although state-owned enterprises are still dominant users of credit, their share in bank credit has dropped to around 76 percent in 2005 from an average of 86 percent in 1991. Credit to the private sector consists essentially of short-term loans to the agricultural and commercial sector. Long-term lendings are provided mainly by state-owned commercial banks to state-owned enterprises.

Table 6 Proportion of Loans to State-owned Enterprises in Hanoi (2005)

Bank category	Loans (%)	Capital mobilized (%)
State-owned banks	69.9	76.1
Joint-stock banks	11.3	9.9
Joint-venture banks	1.7	0.9
Foreign branch banks	12.1	10.8
Other credit institutions	5.0	2.3

Source: Duc Nguyen, “Thay gi tu buc tranh thi truong von Hanoi,” *Vneconomy*, July 21, 2005

In addition to historical relationship, larger size and better financial ability and information are the reasons for the state-owned banks to prefer state-owned enterprises. This bias in credit allocation is highly risky and ineffective as loans to SOEs are provided with little or no guarantee. Such financing from banks can be considered an implicit subsidy to SOEs. The SOE bias in Hanoi is slightly higher than that in HCMC.

Table 7 Capital Financing from the Banking System to Enterprises: A Comparison

Type of enterprises	Hanoi	HCMC
State-owned enterprises	55%	50%
Private enterprises	29%	30%
FDI enterprises	16%	20%

Source: State Bank branch in Hanoi, and *Vneconomy*

This bias in banking capital allocation in Hanoi is not only proved by this survey with 72 percent of banks (13 out of 18 banks) answering that there was unequal treatment between these two sectors, but also by another survey by Markus Tausisig and Pham Thi Thu Hang (2004). They asked the following question to credit officers: *“If you receive two loan applications, one from a state-owned enterprises and another from a private applicant, that satisfy all basic lending criteria but you are only able to approve one,* *which enterprise will you choose?"* 80 percent of the surveyed credit officers said they would approve the loan to a state-owned enterprise; 18 percent said they would lend to the private firm, and 2 percent could not decide.

The bias is also reflected in the fact that the required collateral value appears to be higher for private firms compared with state-owned enterprises. According to the *Vietnam Development Report 2006* (World Bank, 2006), the average value of collateral required of private enterprises is equivalent to 173 percent of the loan value, compared with 130 percent in the case of state-owned enterprises. In our survey of 2005, private enterprises were usually allowed to borrow only 30-50 percent of their collateral value, whereas state-owned enterprises could borrow the equivalent of more than 75 percent of their collateral value or even face no collateral requirements at all. This is because private firms do not have the backing of the government.

Table 8 Allowed Loan Amounts in Percent of Collateral Value

	20-30%	**31-40%**	**41-50%**	**51-75%**	**>75%**
State-owned enterprise	0	0	0	40%	60%
Limited liabilities company	0	20%	30%	50%	0
Joint-stock company	0	20%	30%	50%	0
Private company	30%	10%	20%	40%	0
Household business	50%	0	30%	20%	0

Source: VDF survey (2005)

Because banking capital is biased in favor of state-owned enterprises, the situation may lead to increases in bad debt and credit risks of local banks. According to the State Bank of Vietnam, bad debt in the banking system of Vietnam was about VND20,000 billion, a large proportion of which was owed by state-owned enterprises. This situation is partly due to the lack of enterprises' financial information and weaknesses in the feasibility of projects (Securities Investment Review, No. 305, 2005). According to the State Bank branch in Hanoi, 99.84 percent of long-term bad debt in Hanoi was owed by state-owned enterprises and 99.99 percent of short-term bad debt was similarly due to state-owned enterprises. In our survey, 92 percent of the surveyed banks responded that failed projects were more common with state-owned enterprises than private ones.

5. Responsiveness of banks to Credit demand of Enterprises

From our two surveys of enterprises and banks, we can detect certain perception gaps between banks that are the suppliers of capital and enterprises that require it. As shown above, 39.5 percent of surveyed enterprises replied that access to bank finance was "difficult" or "very difficult". However, Hanoi's banking performance is above the national average, a fact that is also corroborated by other researchers. For example, the study by Vu and Haughton (2004) reports that the responsiveness of banks to the financial demand of firms in Hanoi is better than the nation's average, with the score of 3.5 for private enterprises and 4.8 for state-owned enterprises, on the scale that runs from 1 (worst) to 7 (best). When compared with other cities, Hanoi is better than Hai Phong but worse than HCMC in the eyes of private firms but the situation is the opposite with SOEs (Table 9).

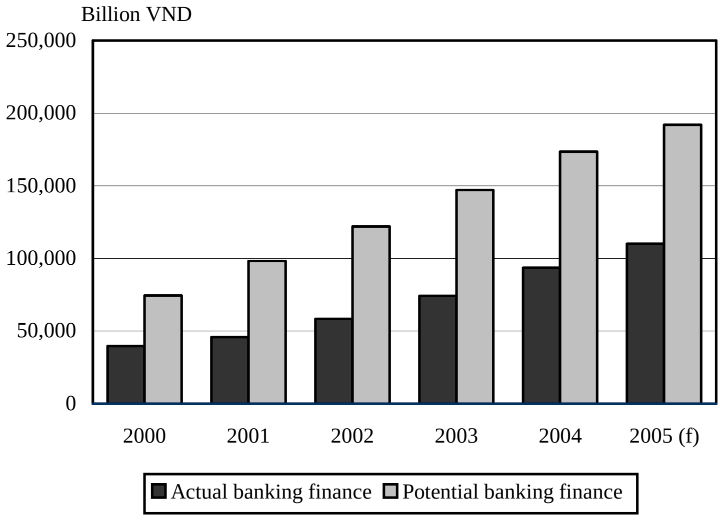
Table 9 Business Perception: Comparing Bank Performance in Three Cities

	Hanoi		HCMC		Hai Phong	
	Private	**SOEs**	**Private**	**SOEs**	**Private**	**SOEs**
Banks are responsive to firm demand	3.5	4.8	4.1	4.2	2.1	5.1
Cost of borrowing	4.1	4.4	4.1	4.4	2.1	4.5
Good projects can get bank financing	3.6	5.0	4.2	4.5	2.6	5.2

Source: Vu and Haughton (2004)
Note: Firms were asked to choose a number that most closely represents their perception of bank performance on a scale that ranges from 1 (worst) to 7 (best)

The reason for limited responsiveness of banks to firms' demand in Hanoi is not the shortage of funds. The potential supply of bank finance is relatively high in Hanoi, which is estimated at VND192,012 billion in 2005. As noted earlier, banks in Hanoi lend out only half of mobilized capital. This situation may be normal in other developed economies. But with Hanoi, it is really a situation that reflects the problem on the supply side of capital. Because securities and other financial markets have not been fully developed, bank deposits are expected to meet the demand for lending. Banks' investment in securities markets is negligible. Thus, much of bank deposits that are not lent out in Hanoi is lent out to enterprises in other provinces while the demand for capital in Hanoi has been increasing. This means that Hanoi's banking system should be able to do better in serving enterprise's demand for capital in this city.

Figure 11 Use of Mobilized Capital in Hanoi: Actual and Potential Bank Finance



Source: Hanoi Branch of the State Bank of Vietnam (2005)

Note: (f) - forecast

As the survey results from both enterprise and bank sides show, reasons for insufficient access to banking capital come not only from the banking sector but also from enterprises themselves and from the business and investment climate. In the perspective of enterprises, borrowing procedure is the second largest cause of difficulty when accessing to banking capital. Meanwhile, the collateral condition and enterprises' financial ability are among the largest causes of difficulty from the enterprise's perspective as well as banks' perspective. And the interesting point here is that these two factors (collateral and financial ability) are closely related. A company with limited financial ablity is frequently short of assets for collateral. This problem may persist for some time because most enterprises in Hanoi are new, which were set up in the process of *doi moi* and especially since the Enterprises Law was implemented in 2000. When they graduate from the "seed" phase, these enterprises may be able to access bank loans more easily.

Although many banks now claim that their credit appraisal is based on the feasibility of projects and the borrowers' credit worthiness and cash flows, collateral requirement still remains one of the main determinants of lending decision. But the problem here is that the legal framework for collateral assets is not clear and banks are fully aware of practical difficulties in seizing the borrower's collateral (especially land) in case of default. Thus, some banks have an internal rule to cap loans at 50 percent or less of the market value of collateral assets. This further puts some enterprises in a harder situation when they try to access banking capital.

To overcome the difficulty associated with poor corporate management, both enterprises and the government must make effort to create a more transparent business climate. The fact of Vietnam in general and Hanoi in particular is that transparency of the majority of enterprises is limited. This is caused by the accounting system that does not meet the international standard. The financial situation of enterprises is inadequate in both quality and quantity. This prompts banks to be very conservative with enterprises, especially with small and private ones. According to Markus and Hang (2004), "three-quarters of banks (72%) said that they don't believe the contents of most financial statement they see. Two-thirds (60%) said that the financial statements they see are different from the ones submitted to tax officials".

As our surveys found, the shortages of good projects on the part of enterprises and the lack of ability to appraisal feasible projects on the part of banks are other obstables of sound interaction between enterprises and banks. However, in the opinion of the author, this problem may be solved relatively soon as economic development proceeds further and the competitiveness of the Vietnamese economy reaches a higher level.

6. Conclusion and Policy implications

In recent years, the financial and banking system of Hanoi has achieved substantial progress with high growth of mobilized capital and credit. Banking credit relative to Hanoi's GDP is relatively high in comparison with other developing economies. However, formal enterprise financing in this city depends heavily on the banking sector while non-bank financial institutions and securities markets are underdeveloped. Access to formal finance remains insufficient to a segment of the enterprise community in Hanoi, notably the newly set-up small and medium private enterprises. Another concern is low quality of credit and misallocation of capital. The biase in credit allocation toward state-owned enterprises remains a problem.

In the years to come, the local government and the State Bank authorities should adopt the following measures to create easier access to formal capital:

- Diversify channels to supply funds such as leasing and securities markets. The Securities Trading Center in Hanoi should be supported so that it may operate efficiently. Overall reduction in the cost of finance in the country may be achieved through competition between the banking sector and the securities market. Gradually introduce new capital market instruments, including mutual funds, futures, and options. In the years to come, many new companies are expected to pass from the "seed" and "growth" phrase to the stable stage. If the market conditions permit, they can approach the capital market through the initial public offering (IPO) of their shares.

- Money brokers should be officially accepted in Hanoi. Money brokers will help enterprises access banking capital easier with lower cost by reducing the indirect cost.
- Create more competitive environment for all kinds of business. Banks will make better lending decisions in a competitive business climate. In a non-competitive environment, informal relationship will continue to play an important role in capital allocation. Hence, low efficiency. In a competitive environment, business financing is based on business principles. If banks practice good credit allocation, good firms are able to expand their businesses and create jobs for the economy.
- Coordinate with the Ministry of Finance to apply proper accounting and auditing standards to every enterprise in the whole city. This improves transparency and allows banks to supply capital to enterprises with more confidence.
- The legal framework of property rights, especially land use rights, should be improved because this is one of the most important factors for credit access in transition economies and because of Vietnam's heavy reliance on collateral-based bank lending. Regulations on collateral requirement need to be clear so that banks may sell collateral assets in case of default. Develop a legal framework that encourages proper loan valuation. Narrow the gap between policy and its implementation.
- Support enterprises to strengthen their ability to submit proper business plans and accurate financial reports. Set up a Center for Credit Information or a Credit Rating Agency under the authority of the State Bank of Hanoi.

REFERENCES

In English

1. Admind J. Malesky (2004), *A study of private sector development beyond the higher performing cities and provinces of Vietnam*, PSDP No.18, IFC.
2. Markus Tausisig, and Pham Thi Thu Hang (2004), *Private enterprise formality and the role of local government, ADB,* Hanoi.
3. Vu Minh Khuong, and Jonathan Haughton (2004), *The competitiveness of Vietnam's three largest cities: A survey of firms in Hanoi, Hai Phong and Ho Chi Minh City*, PSDP No.17, IFC.
4. Edmund J. Malesky, and Markus Taussig (2005), *Where is credit due? Companies, banks and locally differentiated investment growth in Vietnam*, World Bank.
5. IMF (2005), *Financial sector assessment: a handbook*, Washington D.C.
6. World Bank (2005), *Vietnam Development Report 2006: Business*, Hanoi.
7. World Bank (2005), *Taking stock: an update on Vietnam's economic development and reforms by the World Bank in Vietnam*, Hanoi, December.
8. World Bank (2002), *Banking Sector Review,* Vietnam.
9. Kanichiro Suzuki, and Michael Lacktorin (1998), *Small and medium enterprises financing in transition economies*, OECD publication.

In Vietnamese

1. Cao Si Khiem, Nguyen Quoc Trieu and Vu Tien Loc (2005), *Phát triển Hà Nội thành trung tâm tài chính*, VCCI, Hanoi.
2. World Bank and IFC (2005), *Môi trường kinh doanh năm 2006*, Hanoi.
3. State Bank of Vietnam, Hanoi Branch, *Báo cáo tình hình hoạt động của ngân hàng trên địa bàn Hà Nội 2005,* Internal Report.
4. *Tạp chí Thương mại* No. 94, November 2005.