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Banking Reform in the Lower Mekong Countries

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Abstract

This paper reviews recent banking reform efforts in the lower Mekong countries (LMCs), comprising Cambodia, the Lao People's Democratic Republic, and Vietnam. Linked by close economic and cultural ties, the three LMCs face the dual challenge of economic development and transition to market-based economies. Two-tier banking systems were formally introduced in the late 1980s. However, state-owned banks with weak balance sheets continue to dominate the banking systems of Vietnam and Lao P.D.R. Cambodia's main challenge is to reconstruct a banking system after decades of civil strife. Based on progress made and brief cross-country comparisons, the paper identifies key challenges and options for further reform.

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BANKING REFORM IN THE LOWER MEKONG COUNTRIES

A. Introduction

This paper reviews recent banking reform efforts in Cambodia, the Lao People's Democratic Republic, and Vietnam, the lower Mekong countries (LMCs). Amid close economic and cultural ties, the three LMCs face the dual challenge of sustainable development from a low-income base and transition from centrally planned to market-based economies. Moreover, as in China, reforms in all three countries have been gradual, and, with the exception of Cambodia, controlled by Communist governments. Taking stock of progress made so far, including by using other transition economies and China as reference points, the paper concludes by identifying challenges and options for advancing reforms toward sound, commercial banking systems.

While the banking sectors were substantially reorganized at the outset of the transition period in all three LMCs in the late 1980s, further evolution during the 1990s was generally quite modest (Table 1). In all three countries, the monobank system was formally replaced by a two-tier banking system in the late 1980s. Defining the new roles and responsibilities for second-tier banks and creating independent institutions were no trivial achievements. However, in part as a legacy of the past, a banking system emerged, in particular in Vietnam and Lao P.D.R., that has been dominated by state-owned commercial banks (SOCBs), accounting for more than 70 percent of all bank deposits. Foreign bank branches and semiprivate joint-stock banks (JSBs) have operated on a limited local scale, serving niche markets, although, at least for Vietnam, they have been quite numerous. In Cambodia, the state-owned Foreign Trade Bank (FTB) retained its role as a key player, while lax licensing requirements led to a proliferation of weak joint-venture banks, whose problems eventually hampered the return of confidence in the banking system after episodes of political disturbances.

Operations of the dominant SOCBs in Vietnam and Lao P.D.R. have been characterized by weak balance sheets, in part reflecting a legacy of directed lending. The large SOCBs have maintained an exposure to state-owned enterprises (SOEs) significantly above average with lack of reforms in the state-sector leading to a buildup of nonperforming loans (NPLs). In Vietnam, the state-banks had accumulated NPLs totaling D 23 trillion,[2] representing about twice their capital, 5 percent of GDP, and 15 percent of all outstanding credit to the economy by end-2000. About two-thirds of the NPLs were to SOEs.[3] Similarly in Lao P.D.R., NPL ratios ranged from more than 20 percent to about 70 percent across the SOCBs, with about 70 percent of all NPLs considered state related, that is, lent to SOEs or for policy purposes. Generally weak lending practices and excessive exposure to the SOE sector had thus become a key source of vulnerability in the countries' financial system. The need for a more proactive corporate- and financial-sector restructuring increased further at the beginning of this decade, as competition following market-opening measures (the ASEAN Free Trade Area, the United States Bilateral Trade Agreement (USBTA), and, in the future, the World Trade Organization) was set to intensify.

[2] Based on banks' own reports and domestic accounting standards (VAS), these estimates were tentative at best given weaknesses in banks' accounting data that hamper a consistent and stringent assessment of NPLs across all banks.

[3] Consisting mainly of directed loans and uncollateralized NPLs.

By contrast, after decades of civil strife, Cambodia's main challenge was to reintroduce a banking system.[4] Given the limited role of SOEs in the economy, the banking system's exposure to state-owned enterprises has played only a minor role, while growth of joint-venture and foreign banks reduced the role of the only SOCB. However, the proliferation of new banks due to lax licensing requirements put a heavy strain on Cambodia's supervisory and regulatory capacity, limiting profitable banking opportunities, public confidence, and bank intermediation.

B. Approaches to Banking Reform

Vietnam

Reform efforts initiated in 2001 were centered on restructuring the four large SOCBs and putting them on a commercial footing. The strategy was framed by the authorities' decision to retain full ownership and control of the banks and not to rely on any outside agents of change, such as strategic foreign investors. Beyond restructuring the SOCBs, banking sector reforms also aimed at strengthening the regulatory, supervisory, and institutional frameworks for more efficient banking.[5] In addition, the authorities have also pursued consolidation of numerous small and undercapitalized JSBs.

By relying on banks' internal capacity for change, the success of the reforms was to rest on three key components: (i) phased and conditional recapitalization with public funds,

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[4] The Khmer Rouge (1975–79) were set to build an agrarian, moneyless society.

[5] International experience shows that a successful transition toward a sound commercial banking system depends on progress in all these areas (De Juan, 1996).

based on SOCBs' meeting bank-specific operational and financial reform targets, above all, regarding resolution of NPLs and measures to improve credit risk management; (ii) phaseout of policy lending; and (iii) improved accounting and disclosure standards, through International Accounting Standards (IAS) audits and loan classification in line with international standards. These principles were adopted by the State Bank of Vietnam (SBV) in its overall bank restructuring framework. In line with this gradual approach, the framework also provided for a phasing-in of prudential standards, such as on required capital adequacy ratios.[6]

Lao P.D.R.

Banking reform efforts in Lao P.D.R. have been largely modeled along the Vietnamese approach, albeit with less emphasis on banks' internal capacity for change. At present, key immediate measures to avoid further deterioration of banks' balance sheets consist of credit ceilings, prohibition of lending to defaulting borrowers, and a commitment to avoid any new noncommercial lending. International resident advisors have recently been placed in the banks to ensure implementation of these stricter lending measures. In particular, advisors have to certify that new loans (exceeding a certain threshold) are approved on commercial criteria. However, it should be noted that they cannot prevent noncompliant loans. Advisors have also been critical in the application of more transparent loan classification and provisioning. An international banking supervision expert has also been advising the central

[6] An 8 percent capital adequacy requirement was adopted in 1999 but not enforced.

bank for more than a year on improvements of its supervision function, while measures to strengthen on-site supervision have been part of IMF program conditionality.

Over the medium term, measures are to focus on providing incentives for improving performance, including an injection of bank capital combined with a phased implementation of stricter banking regulations, and changes to management in the case of continued deterioration of performance. More specifically, the reform program envisages to upgrade the role of resident advisors to that of co-managers of the banks, if current bank management turns out to be unable to improve performance. Moreover, efficiency gains are expected from the consolidation of the two smaller SOCBs into one bank in late 2002, lifting restrictions on competition from foreign banks, and opening up one SOCB to strategic foreign equity partnership.

Cambodia

Facing a situation of rebuilding rather than transforming a banking system, reforms in Cambodia consisted of (1) a program to re-license only viable commercial banks under a new banking law; (2) strengthened banking supervision; and (3) restructuring the only SOCB with a view to eventually privatize it. Under the new banking law and licensing requirements, banks were set to be liquidated if classified as nonviable or failing to meet corrective measures, including an increase in minimum capital requirement. At the same time, banking supervision was to be strengthened by a series of new regulations, in particular on capital adequacy and loan classification and provisioning, and strengthening the supervision capacity of the National Bank of Cambodia (NBC), including through a resident advisor. Restructuring of Cambodia's only SOCB focused first on introducing commercial business criteria, by appointing an outside director with international banking experience, and then on privatizing the bank, after recapitalization, through inviting a strategic foreign investor.

C. Progress in Banking Reform

While banking system restructuring has made considerable progress in Cambodia, it is still at an early stage in Vietnam and Lao P.D.R., so that a comparison of reform experiences can only be tentative at best. Overall, progress in Cambodia, where the challenge was rather to develop a viable banking system with an emphasis on a solid legal and supervisory framework, appears to have been significant with banking system health visibly improved. By contrast, in Vietnam progress has proved particularly difficult in those areas of SOCB restructuring directly affecting banks' relationship to SOEs. While Lao P.D.R. has faced challenges similar to that of Vietnam, specific technical assistance through resident advisors appears to be relatively effective, in part because of the relatively small size of the problem banks. Turning to the key dimensions of the restructuring programs, the situation emerging is as follows.

Cleaning up balance sheets and recapitalization

In Vietnam, resolving NPLs, in particular to SOEs, has been slow. Although resolution of collateralized NPLs was sped up,[7] helping banks to meet the first quarterly NPL resolution target in March 2002, SOCBs missed subsequent targets by a wide margin as they failed to resolve uncollateralized NPLs to SOEs. Banks do not have a mandate to trigger SOE loan

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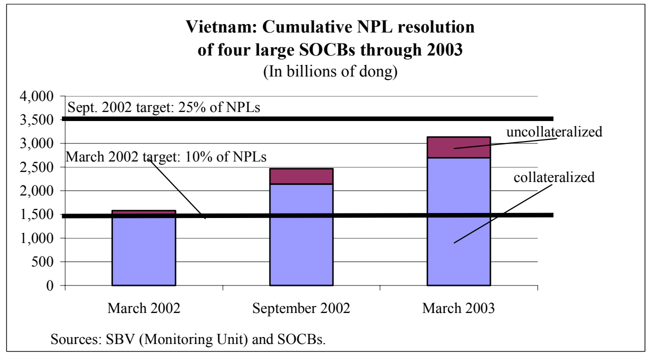
[7] Resolution of collateralized NPLs, which are typically to the private sector, was sped up by streamlining regulations on the sale of collateral, permitting banks to bypass the state auction center.



workouts, and restructuring loans to SOEs has been hampered by the entanglement of government agencies and officials at the national and local levels with SOCBs' management. This notwithstanding, all SOCBs became eligible for state-funded recapitalization. The already limited incentives for reform, given government ownership of the banks, were thus diluted further.[8]

In terms of cleaning up balance sheets, the Lao P.D.R. reform program is designed along the lines of that of Vietnam. Resolution of NPLs is to become a key criterion for phased and conditional recapitalization. But setting the criteria is still pending an assessment of the stock of NPLs. As in Vietnam, successful NPL resolution will depend on the political consensus to enforce hard budget constraints on the state enterprise sector, although it plays a somewhat less important role in the economy. As a first step, the process of resolving "triangular debt," arising from government arrears to banks' SOE borrowers, has started in 2003 through the issuance of debt clearance bonds, albeit at below-market interest rates, through the Ministry of Finance.

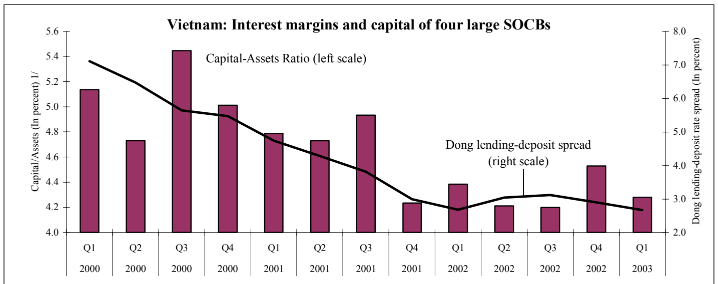
In Cambodia, efforts to clean up banks' balance sheets were more drastic and led to the closure of 15 banks under a re-licensing program distinguishing between insolvent and

[8] Two phases of recapitalization have been completed by June 2003, providing banks with nonnegotiable recapitalization bonds of D 5.3 trillion (nearly 1 percent of GDP).

viable banks and imposing high minimum capital requirements (Table 2).[9] In addition, the only state bank was recapitalized to meet the new capital requirements under the law. As a result, Cambodia's banking system appears well capitalized with an average capital asset ratio (CAR) of over 50 percent in September 2002. While this may suggest too little risk taking and excessive curtailing of new lending by the restructured banks, it should be noted that, based on partial data, banks' asset quality has remained generally poor, with NPLs still representing about 12 percent of total loans at end-2002.

Putting banks on a commercial footing

Notwithstanding that a change in lending behavior is expected to take time, an initial assessment suggests that Vietnamese SOCBs continue to give priority to asset growth over profitability and capital adequacy. In spite of their continued dominance of the banking sector, SOCBs have allowed interest rate margins to erode substantially as they have largely refrained from increasing lending rates while offering higher deposit rates to finance rapid credit growth. As a result, capital asset ratios (measured using domestic accounting standards) have declined further, and the cost of SOCB restructuring—driven by the need to clean up balance sheets and restore adequate capital—has likely risen. Moreover,



Sources: SBV; and Fund staff estimates.
1/ Capital before injection of recapitalization bonds in 2002 Q3.

[9] This program is similar to the restructuring of semiprivate small joint-stock banks in Vietnam, whose number was reduced from 48 to 35 under a program supported by the IMF's Poverty Reduction and Growth Facility with a view to strengthening banks' capital base through consolidation or liquidation.

while some of the new lending to SOEs has been shifted to specialized policy-lending institutions, in particular the Development Assistance Fund (DAF), SOCBs remain by far the single largest provider of credit to SOEs.

By contrast, credit growth in Lao P.D.R. has dropped markedly. International resident advisors have been placed in the state banks to ensure implementation of stricter lending requirements. More specifically, advisors have to certify that new loans (exceeding a certain threshold) are appraised on commercial criteria. Resident advisors also provide critical technical assistance in familiarizing credit officers with market-based credit risk management practices. However, while credit decisions appear to have been strengthened considerably in the two remaining SOCBs, there are indications that the sharp restraint on credit may be adversely affecting economic activity, although non-SOCB credit has continued to grow.[10]

In Cambodia, efforts to strengthen commercial decision making focused on the one remaining SOCB, the Foreign Trade Bank (FTB). After separation from the NBC in August 2000, a Board of Directors was established to provide operational independence, with the first outside director with commercial banking experience appointed in June 2001. To complete this separation, the FTB announced in January 2003 that it will be partially privatized and will seek a strategic international investor. However, for the system as a whole, lending activities remain relatively limited, with loans only accounting for about one-third of banks' total assets. This points to factors beyond banks' financial health that continue

[10] A credit policy has been in effect in The Lao P.D.R. since March 2002, which would limit new lending (except for undisbursed loans) if flow NPLs (i.e., new NPLs since 2000) exceed 15 percent.

to hamper Cambodia's financial development, including a weak corporate sector, absence of reliable borrower information, and contract enforcement.

Improving the regulatory framework, accounting standards, and banking supervision

Moving loan classification closer to international standards and subjecting SOCBs to IAS audits have been key elements of a strategy to promote greater transparency in Lao P.D.R. and Vietnam. In December 2001, Decision 1627 was adopted in Vietnam, requiring banks to classify the entire loan balance as overdue if any interest and/or principal payment becomes overdue. Furthermore, to help assess the true size of NPLs and accurately monitor improvements in banks' performance, the four large SOCBs have been undergoing IAS audits of their financial statements beginning with the year 2000 accounts. Based on these audits, banks have also been instructed to implement an initial plan for phasing in loan loss provisions. However, implementation of the new loan classification remains nontransparent[11] and plans to address key qualifications of the IAS audits have not yet been carried out. By contrast, adequate loan classification standards had already been in place in Lao P.D.R., but resident advisors have been playing an instrumental role in bringing banks' accounting practices in line with these standards. At the same time, 2001 and 2002 audits at both international and domestic accounting standards were completed by international auditing firms at end-2003, providing an independent assessment of the financial situation of SOCBs and their progress toward reforms.

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[11] For example, neither some SOCBs nor the supervisors have so far been able to quantify the impact of the new classification scheme on the amount of overdue loans.

Efforts to strengthen banking supervision are still at an early stage. In Vietnam, the allocation of supervisory responsibilities among the various departments involved at the SBV, the lead agency in banking supervision, is complex and may need simplification. Enforcement mechanisms where banks violate prudential and other regulations need to be tightened. In addition, supervision by the central bank may be affected by the SBV's co-ownership function at the SOCBs, which appears to undermine credibility of enforcement as well. Similarly in Lao P.D.R., strengthening banking supervision, especially on- and off-site inspections to monitor bank developments in a timely manner, is part of the overall reform strategy to improve the banking environment over the medium term, but pending specific measures of implementation and enforcement.

By contrast, strengthening accounting standards *and* banking supervision has been a centerpiece of reforms in Cambodia early on. Comprehensive legal changes, including the new central bank and financial institutions law, provided an adequate legal framework for banking supervision in the late 1990s, which was soon supplemented by detailed regulations on prudential norms (affecting capital adequacy, liquidity, exposure limits, and loan classification and provisioning) and regulations on prompt corrective action, spelling out procedures and disciplinary actions by the NBC. Moreover, supervisors have been equipped with detailed manuals on standardized procedures for off-site banking surveillance and on-site inspections. With the re-licensing process completed, substantial technical assistance and increased staff resources, the NBC has been gradually enhancing its supervisory activities in recent years.

D. International Comparison with Transition Economies and China

Macroeconomic stability and rapid monetization have led to bank intermediation levels in Vietnam that are well above those not only in the two other LMCs, but also many transition economies (Figure 1). Controlling for its stage of development, Vietnam's intermediation levels are well comparable with those of China, which have consistently exceeded by far those of other transition economies. By contrast, intermediation levels in Lao P.D.R. and Cambodia have remained relatively low, reflecting in part limited access to banking services in rural areas and a limited level of confidence in the banking system. Moreover, high levels of dollarization remain from a legacy of macroeconomic instability, and, in the case of Cambodia, political turmoil.

In terms of achieving financial deepening, bank restructuring has led to a wide range of results across transition economies in Central and Eastern Europe, the Commonwealth of Independent States (CIS), and East Asia. The more successful reformers, such as the Czech Republic, Poland, and Hungary, after some decline in the transition, show relatively high levels of bank intermediation from households to the private sector. At the other end of the spectrum are the former CIS republics, where despite several years of reform, the role of the banking sector remains extremely limited. Output declines, a severe loss of confidence in the banking system, and a shortage of creditworthy companies have all contributed to intermediation levels that are significantly below those of Vietnam.[12]

[12] Another indicator of banking system performance—spreads between lending and deposit rates, to the extent they reflect actual transaction rates—may indicate that Vietnamese banks operate at relatively low margins. While this could point to relative efficiency, insufficient loan loss classification, and provisioning requirements combined with limited commercial decision making, as mentioned above, make a comparison difficult.

Regarding progress in addressing structural constraints, Vietnam and Lao P.D.R. appear to be much more similar to CIS countries and China, while Cambodia resembles more the successful reformers of Central and Eastern Europe (Table 2). As in Vietnam and Lao P.D.R., state-owned banks with weak lending practices subject to influence from privileged state-owned enterprises, continue to dominate the banking industries in many CIS countries. Moreover, accounting standards and disclosure requirements fall generally short of international best practice and banking supervision remains limited, in part owing to considerable constraints in human resources. By contrast, Cambodia, not unlike Central and Eastern Europe and the Baltics, vigorously pursued implementation of a strong regulatory and supervisory framework in compliance with international standards. Moreover, in all the Central and Eastern European and Baltic countries, opening the banking sector to foreign private investors was a key restructuring measure that contributed to success, a step that Cambodia has also taken and is now set to complete with the privatization of its only SOCB.[13]

The reform experiences of Vietnam, and to a lesser degree of Lao P.D.R., so far, appear to match most closely those of China. In both Vietnam and China, gradual reforms combined with strong economic growth and relative macroeconomic stability have led to some of the highest bank intermediation levels. In this light, state ownership appears to have played a positive role in a strategy to promote financial deepening by bolstering confidence

[13] The accession process to the European Union (EU) has also provided a significant impetus to institutional reform. For an in-depth review of SOCB reforms in the transition economies of Eastern Europe and the CIS countries see Sherif and others (2003).

in the banking system and providing wide access to banking services. However, this has also led to significant NPLs in the state enterprise sector, in particular in China and Vietnam, where SOEs have traditionally played a key role in industrialization. At the same time, in all three countries the banking systems remain dominated by state-owned banks and internationally acceptable accounting standards are being gradually phased-in; in China's case this consisted of the adoption in 2002 of a five-tier loan classification system and phased-in provisioning. An important difference between the countries is that, in China a significant portion of NPLs was transferred to a centralized Asset Management Company (AMC), whereas NPL resolution remains the responsibility of individual banks in Vietnam and Lao P.D.R. However, while NPL transfers to an AMC can speed up the cleaning of banks' balance sheets, experience in other cases in the region and elsewhere suggests that the success of AMCs in bringing down the cost of reform is mixed.

The cost of banking reform still appears to be relatively modest for the lower Mekong countries, but could rise significantly with delays in reforms. Although a cost assessment at this stage is hampered by the paucity of comparable data on NPLs, loan loss provisioning, and capital, the ratio of measured NPLs to GDP still appears relatively low in comparison with other transition economies.[14] Comparing NPLs with government revenues would also suggest manageable fiscal implications, but an assessment of bank restructuring cost on fiscal sustainability goes beyond the scope of this paper. In any case, apart from the size of the initial banking sector problem, looking forward, the cost of reform crucially depends on the

[14] For an overview of bank restructuring costs see Tang and others (2000) and Zoli (2001).

credibility and timeliness of hard budget constraints imposed on both banks and the corporate sector. Effective implementation of hard budget constraints in turn is supported by reforms in bank management, through profit orientation and enhanced credit risk management, governance, and the regulatory framework. Based on international experience, delays in addressing structural weaknesses, in particular at the interface to the corporate sector, are likely to increase the ultimate cost of reform.[15]

In this light, the similarity with China does not bode well for the future costs of banking reforms in Vietnam and Lao P.D.R. At present, the burden of NPLs and the need for recapitalization are still modest when compared with China. However, this mainly reflects much lower intermediation levels. The Chinese example suggests that SOCBs in Lao P.D.R. and Vietnam are unlikely to "grow out of their problems" if they fail to implement commercially sound decision making and reduce exposure to ailing SOEs. This underscores the need for banking reforms to be supported by reforms of the SOE sector. It also helps to explain why China recently announced that it will undertake more sweeping reforms, in particular the opening up of two leading SOCBs for foreign equity partners.

The Lower Mekong Countries and China—Selected Banking Indicators in 2003

	China	Vietnam	Lao P.D.R.	Cambodia
Total credit to GDP	165.5	51.8	11.1	8.0
NPLs to GDP	20.6	7.8	3.0	1.1

[15] For a discussion of the intricate links between enterprise and bank reform in Eastern Europe see van Wijnbergen (1998) and Borish and others (1996).

E. Challenges—Maintaining Reform Momentum

While Cambodia has made significant progress toward developing a privately owned banking system with a strong regulatory framework, the transition to a market-oriented two-tier commercial banking system is still far from complete in Vietnam and Lao P.D.R. Even though reforms in these two countries are constrained by reliance on state ownership, more can be done to induce and enable banks to become commercially sound. Key elements to bring forward reforms in Vietnam and, to a lesser degree, in Lao P.D.R. could thus include:

- **Strengthening incentives for managers and staff to ensure commercially based decision making.** As long as state ownership precludes a market for corporate control to exercise commercial discipline, governments should set explicit performance benchmarks and compensate banks' management and staff accordingly. Performance should be based in particular on profits after adequate provisioning for risks and nonperforming loans.[16] The design of performance contracts is a complex issue, given institutional and political constraints (e.g., differential treatment of banks compared with other civil service agencies). Against this background, commercial decision making is being strengthened in Lao P.D.R. through resident advisors, providing management control independent of the government. With the adequate incentive structure, the need to invest in training and technology, to provide for adequate loan loss reserves, and, above all, to price credit risk

[16] In Vietnam, the current compensation scheme of SOCB management rewards balance-sheet growth while not penalizing risky businesses. SOCB managers' salary, like that of other SOEs, is tied to the size of their enterprise and some profit-related portion, which however is unadjusted for risks.

adequately, should become central objectives. Moreover, to create room for strengthened incentives to work the political influence on banks, including by party committees and agencies at the local level, will need to be curtailed.

- **Building capabilities for sound commercial decision making, in particular improved credit risk management.** Twinning arrangements with internationally reputable partners could prove particularly useful for transferring critical management know-how. In addition, efforts to train thousands of credit officers and managers need to be strengthened, including through increased technical assistance. In this regard, the sheer size of the banks poses a greater challenge in Vietnam than in Lao P.D.R., where resident advisors are already in place to certify that loans are being extended on commercial criteria.

- **Strengthening creditor rights by providing banks with more effective means to resolve NPLs, especially to loss-making SOEs.** While it remains to be seen how Lao P.D.R. SOCBs will deal with SOE NPLs, it is already evident that Vietnamese banks need a stronger mandate. Efforts to reform the banking system will thus also depend on progress in reforming the state enterprise sector and the enforcement of hard budget constraints, in particular in Vietnam with a comparatively larger SOE sector. As the case of China suggests, without significant SOE reforms the NPL problem of the banking sector is at risk to grow in tandem with the deepening of the financial markets.

Providing banks both with incentives and key instruments to operate commercially would be supported by measures that create an environment more conducive to reforms, including:

- **Creating a level competitive playing field.** In both Vietnam and Lao P.D.R., the current framework still hampers competition, by restricting on the type of deposits foreign bank branches can offer, the branch network, and the acquisition of domestic banks. While Vietnamese commitments under the USBTA would result in a phase out of competitive restrictions on U.S. banks, these should apply to all foreign banks to promote a more competitive domestic banking environment.[17]

- **Strengthening bank supervision.** Without improved supervision, progress in bank restructuring cannot be independently assessed, a necessary condition for reform incentives.

- **Strengthening accounting standards.** As long as banks can hide problems, the incentives for reform will remain ineffective. In Vietnam's case this means that improved loan classification standards need to be fully enforced, while IAS audits would provide an independent assessment of banks' performance. In Lao P.D.R., recently completed external audits will help improve transparency and resident advisors are expected to help implement the improved accounting standards. Banks' recapitalization needs should be

[17] The most important concessions under the USBTA include: (1) phase-in of national treatment in the dong deposit market; (2) national treatment in equity participation in privatized SOCBs; and (3) majority foreign ownership of banking institution after three years of the agreement.

based on the IAS accounts to transparently reflect the past and future cost of their operations to taxpayers and further increase accountability.

Turning to Cambodia, the main challenge is to promote financial intermediation. Despite a stronger regulatory framework and improvements in banks' financial soundness, lending activities have remained limited by international standards, suggesting that the financial health of the banking sector by itself is not enough to promote Cambodia's development. Looking ahead, Cambodia needs to: (1) develop a system of reliable borrower information, requiring firms to use a common set of accounting standards and produce financial statements; (2) strengthen contract enforcement; (3) improve the availability of financial services in rural areas; and (4) push ahead with upgrading the FTB's management, including through eventual privatization. These challenges have been recognized in the NBC's *Financial Sector Blueprint for 2001–10*.

F. Concluding Remarks

In both Lao P.D.R. and Vietnam, SOCBs remain wholly state owned and their transition to commercially oriented banks relies essentially on their internal resources and the credibility of incentives set by the government. While reforms are still at an initial stage, the need for reinforcing efforts already emerges in Vietnam in three critical areas: (1) strengthening the incentives for reform of banks and their management, including through performance contracts and strict recapitalization conditions; (2) improving credit risk management in line with international practice, supported by substantial technical assistance (including through twinning arrangements); and (3) providing banks with more effective mechanisms to resolve NPLs. If China's example is any guide, without these critical changes

Vietnam's banking sector problems are only likely to grow further. By comparison, progress in Lao P.D.R. appears to be facilitated by the relatively limited role of SOEs in the economy and thus banks' exposure to the state sector. The smaller size of banks has also helped resident advisors to play a more effective role in putting SOCBs on a commercial footing and strengthening their accounting frameworks. Moving beyond the existing approach in Vietnam and Lao P.D.R. would likely entail privatization of a large SOCB by seeking a strategic foreign equity partner, an approach that is now under consideration in China. As for Cambodia, the challenge lies less in reforming banks but in continuing the development of a commercial banking system that helps promote efficient investment and growth.

Table 1. Lower Mekong Countries and China: Selected Banking Indicators /1

	Vietnam	Cambodia	Lao P.D.R.	China
Breakup of monobank system	1989	1989	1989	1984
Number of:				
State-owned commercial banks (SOCBs)	6	1	2	4
Joint-stock banks	35	3	3	11
Foreign banks 2/	29	9	8	13
Market share of SOCBs in percent of:				
Credit to the economy	72.6	9.5	53.5	55.8
Credit to state-owned enterprises (SOE)	91.1	0	74.1	...
Total deposits	74.0	19.3	73.6	58.6
	(In percent of GDP; unless otherwise indicated)			
Total deposits	56.0	14.4	17.2	182.8
Credit to the economy 3/	51.8	8.0	11.1	165.5
Credit to SOEs	17.1	0	4.4	...
Credit to the private sector	34.7	8.0	6.7	...
Nonperforming loans (NPLs) 4/	7.8	1.1	3.0	20.6
Average annual credit growth 5/	25.9	15.6	30.0	18.4
Memorandum item:				
Government revenues	22.9	10.4	10.9	18.6

Sources: Country authorities; and IMF staff estimates.

1/ As of end-2003; or latest date available.
2/ Including joint-ventures.
3/ Excludes credit to the government.
4/ Estimates based on partial NPL data for SOCBs. For China, estimates are as of end-2003, based on four tier classification of NPLs, and for the whole banking system.
5/ Simple average for 1999-2003 (except China: 2000-03), before valuation adjustments.

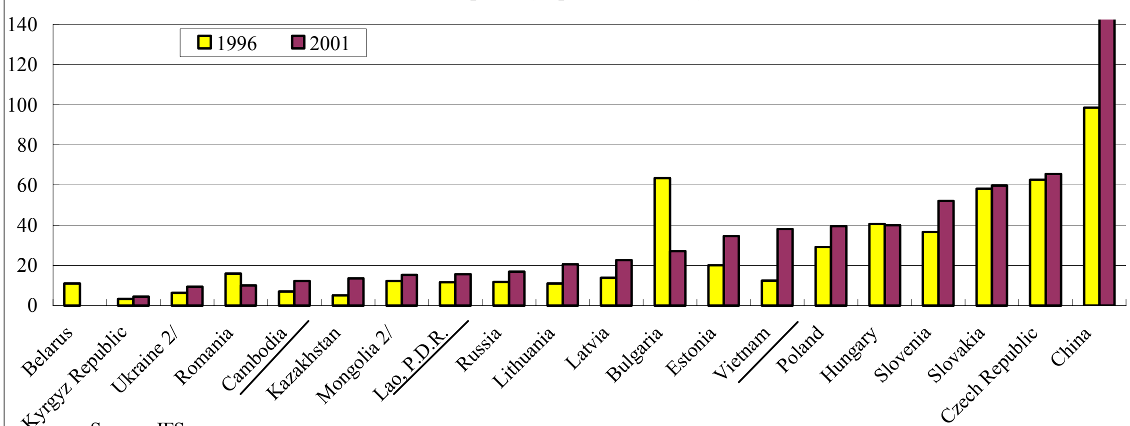
Table 2. Issues in Banking Reform—An Overview

	Market structure	Incidence and Nature of Problems	Cost of Bank Restructuring (in percent of GDP)	Selected restructuring measures				State of Transition to Market-Oriented Banking
				Recapitalization	Privatization	Accounting and Disclosure	Capital Adequacy	
Vietnam	Segemented: Four large SOCBs dominate system (more than 70 percent of credit); more than 20 foreign banks and more than 30 semi-private joint-stock banks only compete in local niche markets.	Undercapitalized or insolvent banks; NPLs at 4 dominant SOCBs representing about 15 percent of loans in 2000, or about 5 percent of GDP.	Tentative estimates range between 4 percent and 7 percent of GDP.	In progress for SOCBs and conditional on NPL resolution and operational targets	Not applicable.	SOCBs subject to IAS audits; loan classification enhanced and adequate provisioning to be phased in.	8 percent; adopted in 1999 but not enforced for SOCBs; supervisors unable to make risk-weighted assessment.	Dominated by 4 SOCBs representing about three quarters of banking system credit and deposits.
Cambodia	In 1999, there were 2 SOCBs, 7 foreign banks, and 22 private banks. Following restructuring, there are 1 SOCB, 3 foreign banks, 9 private banks, and 4 specialized institutions.	Rapid increase in number of weak banks due to lax licensing requirements combined with macro-instability resulted in loss of confidence and marginal levels of bank intermediation.	In November 2003, the estimated cost of bank restructuring was about 0.46 percent of the average nominal GDP in 2002–03 (US$3,851 million).	One remaining SOCB (Foreing Trade Bank) fully recapitalized to meet minimum capital requirement (US$13 million).	One remaining SOCB (Foreign Trade Bank) was legally separated from NBC in December 2000, and an outside director appointed to the Board in 2001. The process to seek foreign strategic equity partner started in January 2003.	One remaining SOCB (Foreign Trade Bank) subject to a program external audits with a view to remove qualifications.	20 percent; due to stricter prudential regulation, in particular increase in capital requirements, average CAR for restructured banks about 54 percent in 2002.	Nearly completed.
Lao P.D.R.	Two SOCBs dominate the banking system, representing about three quarters of total bank deposits and nearly 60 percent of total bank credit.	First recapitalization in mid-1990s not linked to operational restructuring, resulting in increasing NPLs, about 70 percent state-related.	Not available.	Phased and conditional through 2002–05, with the threat being replacement of management and enhanced role for international advisors.	Two smaller SOCBs were consolidated with a view to seek strategic equity partner for one of the two remaining nationwide SOCBs over the medium term.	International advisors ensure implementation of loan classification in line with international standards. SOCBs are subject to IAS audits.	8 percent. Overall, prudential regulations and standards to be raised/phased in gradually.	State banks continue to dominate banking system, but their share has been declining.
China		At end-2001 NPLs of state-owned banks (two-thirds of the financial system) averaged more than 30 percent of total loans (excluding 14 percent of loans transferred to AMCs in 1999–2000).	Not available.	In 1999–2000 transfer of 14 percent of total (about 17 percent of GDP) loans to an AMC. Other capital injections not strictly linked to improved efficiency.	Not applicable.	Adoption in 2002 of new loan classification and phased-in provisioning approaching international standards.	Adoption as targets (8 percent) with the Commercial Bank Law in 1995; riks weights generally consistent with the Basle Capital Accord except for treatment of large SOEs.	State banks continue to dominate banking sector with gradual improvements in NPL resolution and operational efficiency, while interest rates remain partly administered.

Sources: Borish and others (1996), Karacadag (2003), Tang and others (2000), Zoli (2001); and IMF country reports (various issues).

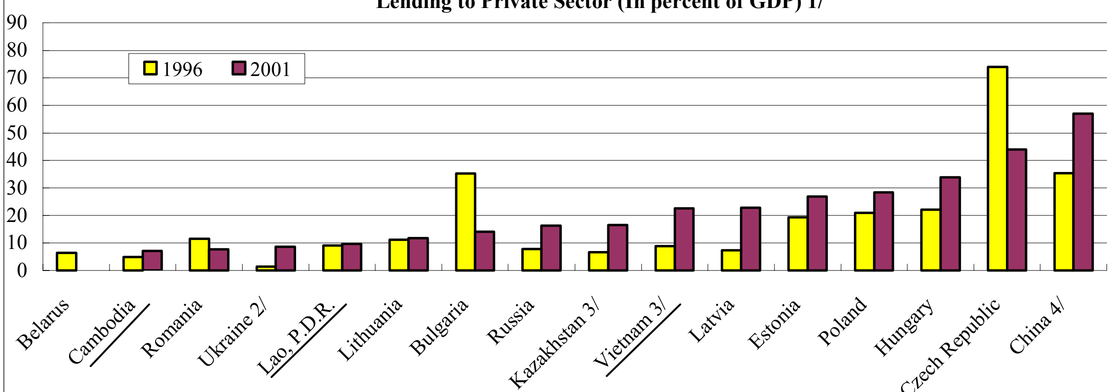
Figure 1: Banking System Performance in Selected Transition Economies

Total Deposits (In percent of GDP) 1/



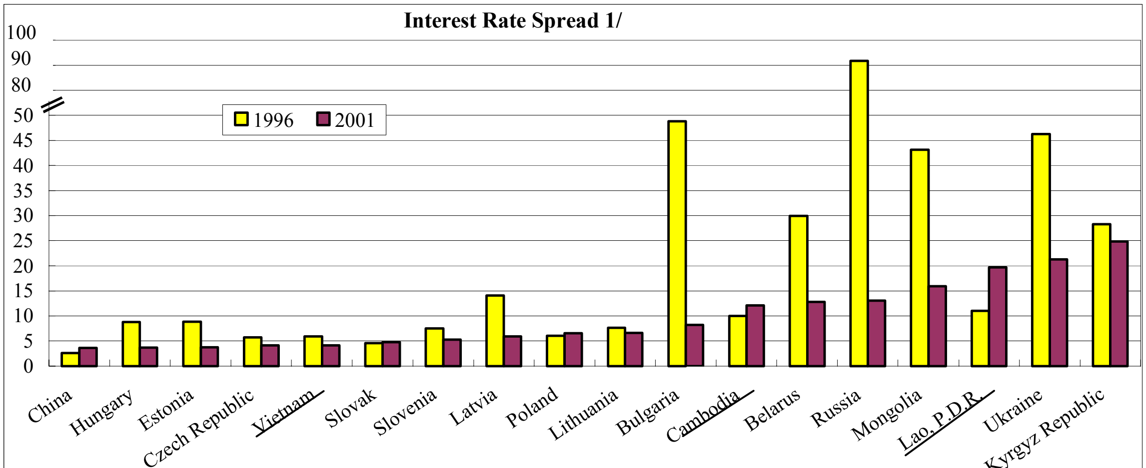
Source: IFS.
1/ As of year end. 2/ Latest available data pertains to 1999.

Lending to Private Sector (In percent of GDP) 1/



Source: IFS.
1/ As of year end. 2/ Latest available data pertain to 1999.
3/ Defined as lending to non-SOEs. 4/ Credit of state-banks to non-SOEs in 1996 and 2000.

Interest Rate Spread 1/



Source: IFS. 1/ Lending rate minus deposit rate in local currency.

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