

SME Finance signals future growth

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GROWTH IN NUMBERS OF PRIVATE ENTERPRISES AND SMES

Since Doi Moi was first initiated in 1986, many private enterprises have emerged in a wide variety of industrial sectors. The number of small and medium-sized enterprises (SMEs) in particular, have dramatically increased. In 2005, the number of newly established private enterprises was 39,659 compared to 292 new one member limited liabilities companies. When enterprises are classified by number of employees, 96.1 percent are SMEs, and when classified by registered capital, 86.6 percent were SMEs in 2005.

On the financial side, credit to the economy by Deposit Money Banks (DMBs) has increased 33.8 percent annually in the three years from 2002 to 2005, and reached near to VND600 trillion as of June 2006. Looking at extended credit by the lending sectors including State Owned Commercial Banks (SOCBs) and other banks, the latter contributed 36 percent to the credit growth from 2002 to 2005 although the outstanding share as of 2002 was just 24 percent. When the debtors sector is divided between State Owned Enterprises (SOEs) and other sectors, the latter group contributed 71 percent to the credit growth during the period 2002 to 2005. This shows that the loan market has shifted and is being led by non-state-owned sectors rather than state-owned sectors.

Despite the significant contribution of the private sector, most particularly SMEs, to the Vietnamese economy, its share in investment has remained low. Investment from domestic private enterprises has been constant at around 25 percent while SOEs have increased their share in investment from 42 percent in 1995 to 56 percent in 2002 and 52.2 percent in 2005. The low investment of the private sector implies a lack of access to finance.

DIFFICULTIES IN SME FINANCE

The difficulties for SME finance include a lack of information for credit assessment, risk-sensitive lending practices and dependence on collateral, and lack of customer oriented business practices.

Lack of information

Most bankers point out that financial statements from SMEs are unreliable, or worse still, many fail to provide banks with a financial statement at all. This is partly because the resources of the 888 designated accounting auditors provided by the Ministry of Finance (MoF) are insufficient to cover the 250,000 enterprises currently registered in Vietnam. The MoF admits that the business sector requires 3,000 auditors by 2010. Most SMEs also find it very difficult to retain qualified accountants to look after their books. One SME owner said: "I am fortunate to have a capable accountant so I have no difficulty in providing financial information to the bank. My business would be at risk if I failed to keep that staff member, because I couldn't replenish the vacancy soon."

Risk sensitive lending practices and dependence on collateral

The banks strict lending practices are due to regulatory requirements; inability to appraise creditworthiness of borrowers; limited capacity of risk management and lack of reliable financial information.. Decision No. 493-2005 / QD-NHNN and Decision 13-2007 / QD-NHNN spell out how to classify assets and the definition of non-performing loans (NPL). Here, banks are expected to shift the methodology of loan classification from article 6, where loans shall be classified simply according to the days overdue, to article 7, where loans shall be classified according to qualitative method based on an internal credit rating system supposedly adopted from a global standard. The NPL ratio might deteriorate in some cases if article 7 is applied. Under these circumstances, banks tend to contain credit risk by using cautious lending practice such as credit allocation where loan amounts might be a few billion VND at the branch level, and dependence on collateral where the amount over the collateral value is minimized. Even aggressive banks might manage a non-collateral amount around 10-20 percent as a standard. Some banks are also cautious when providing medium and long-term loans under the requirements such as the ratio of short-term funding used for medium and long-term lending, and liquidity ratio, stipulated in Decision No. 457-2005 / QD-NHNN.

Lack of customer oriented business practice

Banks that have established a presence in Vietnam have pursued a business model which focuses on lending to SOEs rather than SMEs. This practice still affects the current business style, in which banks wait for customers to select an organization with better credit risk. This is significantly different from other customer-centric business styles where bank staff go to branches to promote and assist SMEs to become more bankable in view of financial presentation and business consultation. In this context, one of the big issues in SME finance might be systematic education of banking staff for further practical views and capability. Also, credit approval processes, which in some cases require the

unanimous agreement of a credit committee at branch level, and document requirements, might be improved by a shorter and more efficient process.

Towards better lending practice

In order to cope with the lack of information, particularly an absence of proper financial statements, most leading banks have already initiated internal credit ratings. However, the methodology of credit rating in some banks is unsophisticated, such that the rating grades SME customers according to their credit-worthiness, that is, relative ratings rather than absolute ratings. This is partly because most banks lack historical samples of credit events, not enough in terms of sample volumes and period of observation. Hence, those credit ratings remain to be just one of the references when the banks determine terms and conditions of SME loans. Hardly acceptable considering that credit ratings are the dominant factor when appraising loans at an international standard. In this regard, Vietnamese banks may need assistance to develop a credit risk database for SMEs.

To compensate for lack of information, bank staff often perform on-site assessments and monitoring. Although the use of soft information collected by on-site assessment might be effective in appraising credit risk of SMEs, it is not sufficient alone, and needs to be supplemented with the financial information, albeit limited.

Regarding the collateral, most leading banks are comfortable about using receivables and movable assets such as inventory, machinery and equipment. This is called Asset Based Lending (ABL). As a background, Civil Code dated 14 June 2005 and Decree on Security Transactions (No. 163-2006-ND-CP) has improved banks' handling of movable assets as security property, which includes more transparent priority order of secured creditors, private sales of collateral items, and flexible agreement on enforcement by contract, and such . Some banks have developed strategies such as liquidation, and alliance with auction companies, and logistics companies. ABL is not simply a collateral measure, but a lending practice that may potentially enable banks to compensate for lack of information and lack of collateral, because ABL requires periodic monitoring and information exchange between SMEs and Banks.

The difficulties of SME finance in Vietnam might be overcome by using all of these strategies, i.e. credit appraisal based on a credit rating supplemented by soft information collected by on-site assessment, and backed up by ABL.

Financing SMEs is critical

Bank finance to SMEs will influence not only their business success, but also the Vietnamese economy in the coming years. Firstly, with the development caused by WTO accession and SOE reform, performance of SMEs will have a significant impact on economic performance as a whole. Secondly, if banks remain too cautious in credit risk practices, and we have a situation of high money supply, the State Bank of Vietnam will be challenged to maintain a balance between controlling asset price and general price inflation on the one hand, and fuelling competitiveness and growth of real economy on the other.