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A Comparison and Evaluation of New Regulation on People Credit Funds Rating in Vietnam

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Abstract

Purpose - The purpose of this research is to make a comparative assessment of People Credit Funds (PCFs) ranking in Vietnam between the Circular No. 42/2016/TT-NHNN dated December 20, 2016 with the Decision No. 14/2007/QD-NHNN dated 09/4/2007 issued by the Governor of the State Bank.
Research design, data, and methodology - This study is mainly based on the Circular No. 42/2016/TT-NHNN dated December 20, 2016 and the Decision No. 14/2007/QD-NHNN dated 09/4/2007 issued by the Governor of the State Bank on PCFs ranking.
Results - The study paper has shown positive changes in PCFs ranking in Vietnam in accordance with the Circular No. 42/2016/TT-NHNN, such as increasing Capital Adequacy Ratio (CAR), maintaining CAR, improving assets quality, developing indicators of governance, management and control capability. These changes have implications for the development and efficient performance of PCFs in Vietnam.
Conclusions - The classification and evaluation of PCFs will contribute to its healthy development. These finding support PCFs to understand more about rating methodology, significance of rating system and the importance of improving their rating. PCFs in Vietnam desire to develop their business effectively, they need to understand exactly and comply fully with regulations related to their field of operations.

Keywords: People Credit Fund, Rating, Circular, Decision.

JEL Classifications: A10, G21.

1. Introduction

The operation of PCFs in Vietnam is of great importance in solving the problem of investment capital demand for agriculture, rural areas, handicraft production and poor farmers. The growth of PCFs has contributed to the enhancement of financial relationships in the rural areas, addressing the capital need for local people. With the advantage of geographical distance and transaction time, the PCF system acts as a midwife and launch pad for the development of all economic sectors, of rural infrastructure and the improvement of living standards. The PCFs ranking not only helps the Related Authorities to evaluate, inspect and supervise the PCFs' operation but also to recognize its strengths and weaknesses to gradually improve, develop and meet the needs of the people and society.

The PCF system in Vietnam is growing steadily in the basic indicators. The PCF system promotes efficiency in activities such as capital mobilization and lending, which is fully recognized. The Government and the State Bank of Vietnam (SBV) are really concerned about the safety and sustainability of the PCFs' operation. The project on restructuring the system of credit institutions for the period 2011-2015 issued in conjunction with Decision No. 254/QD-TTg dated 01/3/2012 of the Prime Minister stated that: "...enhancing the regulation of safe operation, and facilitate the development of people's credit funds. Strengthen, reorganize, improve the safety and efficiency of existing people's credit funds, and together with sustainably expand new people's credit funds in rural areas". The

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ranking and improvement of the assessment criteria of PCFs in Vietnam has been paid special attention by the SBV. The Circular No. 42/2016/TT-NHNN dated 30/12/2016 of the SBV on PCFs ranking, amending and supplementing Decision No. 14/2007/QD-NHNN of the SBV which become effective from May 1, 2017.

The new circular increases the value of asset quality and governance operations of PCFs according to CAMEL principles, updating the prudential requirements of PCFs as the new Internal Rate of Returns (IRRs) on PCFs have been changed since 2007 to 2016.

2. Comparative Analysis between the Circular No.42/2016/TT-NHNN with the Decision No.14/2007/QD-NHNN

The new circular rates more to asset quality and governance issues of PCFs according to CAMEL principles, updating the prudential requirements of PCFs as the new IRRs on PCFs have been changed since 2007 to 2016.

(1) Adjusting scores for 05 criteria

- Total scores for criterion of owner's equity drops from 15 to 10 points.
- Total scores for assets quality criteria increases from 25 to 30 points
- Total scores for criteria of capacity in governance, management and control (management) increases from 25 to 30 points
- Total score for criteria of business performance decreases from 15 points to 10 points.
- Total scores for liquidity remain unchanged at 20 points.

(2) The item "Management" has been changed to much more comprehensive, covering all aspects of governing, management and supervisory board. The scores for internal regulations, operational charter and compliance with SBV regulations/law are increase.

The changes between the Circular No.42/2016/TT-NHNN with the Decision No.14/2007/QD-NHNN is presented below:

2.1. Adjusting the Norms of Capital criteria (Article 6)

2.1.1. Paragraph 1 of Article 6 in the <Table 1> has been adjusted as follows:

(i) Supplement, reclassify the value set of criteria on charter capital compared to legal capital as of "from 400% of higher"...

(ii) the lowest value defined is 200% instead of the lower rates of "from 100% to 200%", "100%" and "below 100%" as prescribed at Decision 14.

Based on the analysis results of the Banking Supervision Agency (BSA), 100% of PCFs reached the criteria of having charter capital of 300% higher than legal capital. Therefore, to ensure the actual operations of PCFs are more accurately reflected (after establishment, the scale of PCF's equity increased by the contribution from old and new members), the above adjustments and supplementations are appropriate.

2.1.2. Clause 2 of Article 6 has been revised in the <Table 1>

(i) Add 2 value rates to the capital adequacy ratio criteria as "10% and above" and "from 9% to 10%". (ii) Only the lowest value of 8% is stipulated, lower rates will be deleted (ex 6% or 7%).

(iii) Maximum score of capital adequacy ratio is 5 instead of 6 as defined at Decision 14.

According to the results of the data analysis conducted by BSA, approximately 94% of PCFs have capital adequacy ratio of above 8%, thus adding value rates above 8% shall help better reflect the level of capital adequacy among the PCFs. Meanwhile, in Decision 14, PCFs which have Capital adequacy ratio (CAR) of below 8% (as of 31 December) – lower than the current rate – are still marked 4 points or 2 points. Therefore, the defining of the lowest rate of 8% and removal of lower rates will help reflect the level of unsafe of PCFs in a more accurate and cautious manner (lack of capital to offset losses when risks occur).

2.1.3. Additions to Clause 3 of Article 6 of the <Table 1>

"Capital adequacy ratio remained in compliance with SBV provisions continuously during the year shall make 2 points. Each violation of capital adequacy ratio shall be deducted with 1 point, at a maximum of 2 points (violating at any time of the year)". The criteria of capital adequacy ratio at Clause 1, Article 6 of the draft Circular is calculated as of the end of the year. However, Clause 1, Article 5 of Circular 32/2015/TT-NHNN dated 31 December 2015 stipulating limits, prudential ratio in PCF operations states that PCFs must regularly maintain the minimum capital adequacy ratio of 8%; at the same time to remove the provision "not complying with provisions on prudential ratios" stipulated at Item c, Clause 3 of Article 8 from the criteria on governance, management and control capacity stated in Decision 14 in order to avoid duplication, the addition of "always maintain the capital adequacy ratio" is reasonable.

<Table 1> Adjusting the Norms of Capital Criteria

Circular 42	Decision 14
Article 6. Scoring of capital criteria Maximum score of capital criteria is 10 points, minimum score is 0 points and includes 3 indicators with the following points: 1. Charter capital vs. legal capital: a. From 400% of the legal capital or higher is 3 points. b. From 300% to below 400% of legal capital is 2 points. c. From 200% to below 300% of legal capital is 1 point; d. Less than 200% of the legal capital is 0 point. 2. The capital adequacy ratio a. 10% or higher is 5 points b. From 9% to below 10% is 3 points c. From 8% to below 9% is 1 point d. Less than 8% is 0 point 3. The capital adequacy ratio continuously maintained in compliance with SBV requirements during the year is 2 points. Each violation of the capital adequacy ratio shall have 1 point deducted, at the maximum of 2 points (for violation at any time of the year.	**Article 7. Scoring of equity criteria** Maximum points for equity is 15 points; minimum 0 point, with two indicators included: capital adequacy ratio and charter capital vs. legal capital. Details as follows: 1. Capital adequacy ratio (this ratio is determined according to SBV's provisions) a. From 8% or higher is 8 points b. From 7% to below 8% is 5 points c. Form 6% to below 7% is 2 points d. Less than 6% is 0 point 2. Charter capital vs. legal capital a. From 300% of legal capital or higher is 7 points b. From above 100% to below 200% of the legal capital is 5 points d. 100% of the legal capital is 4 points e. Less than 100% of the legal capital is 0 point.

<Table 2> Adjustments to the Indicators of Asset Quality Criteria

Circular 42	Decision 14
Article 7. Scoring of asset quality criteria Asset quality criteria has a maximum score of 30 points; minimum 0 points, with 3 indicators with the following points: 1. NPL/total loans outstanding a. 0% is 14 points b. From above 0% to below 1% is 12 points c. From 1% to less than 2% is 10 points d. From 2% to below 3% is 8 points e. From 3% to below 4% is 4 points f. From 4% or higher is 0 points 2. Irrecoverable debts/total outstanding loans a. 0% is 10 points b. From above 0% to less than 0.5% is 9 points c. From 0.5% to less than 1.5% is 5 points d. From 1% to less than 2% is 4 points e. From 1.5% to below 2% is 3 points f. From 2% and higher is 0 point. 3. Notable debts/total loans outstanding: a. 0% is 6 points b. From 0% to less than 1% is 5 points c. From 1% to less than 2% is 4 points d. From 2% to below 3% is 3 points e. From 3% to below 4% is 2 points f. From 4% or higher is 0 points.	**Article 8. Scoring of asset quality indicators** Maximum points for asset quality indicator is 25 points; minimum 0 points, with 3 indicators: NPLs/total outstanding loans, Irrecoverable debts/total outstanding loans; Notable debts/total outstanding loans. Specifically: 1. The NPLs/total loans outstanding a. 0% is 10 points b. From above 0% to less than 1% by 9 points. c. From 1% to less than 2% by 7 points d. From 2% to below 3% by 5 points e. From 3% to below 4% by 3 points f. From 4% to below 5% by 1 point. g. From 5% or more is 0 point. 2. Irrecoverable debts/total outstanding loans: a. 0% is 10 points b. From above 0% to less than 0.5% by 9 points c. From 0.5% to less than 1% by 7 points d. From 1% to less than 1.5% by 5 points e. From 1.5% to below 2% by 3 points f. From 2% to below 2.5% by 1 point g. From 2.5% or more is 0 point. 3. Notable debts/total loans outstanding a. 0% is 5 points b. From above 0% to less than 3% is 3 points c. From 3% to below 5% by 1 point. d. Between 5% and above is 0 point.

2.2. Adjustments to the Indicators of Asset Quality Criteria (Article 7)

<Table 2> indicates Clause1 and 2 of Article 7 are adjusted as follows: (i) combine the value rates of "from 4% to below 5%" with "from 5% up" to become "from 4% up" for NPL/total loans outstanding indicator; (ii) combine the value of "from 2% to less than 2.5%" with "from 2.5% up" to become "from 2% up" for irrecoverable debt/total loans outstanding indicator.

Results of analysis made by BSA shows that the division of indicators into various small values does not make sense given most of the PCFs have criteria reflecting asset quality of 0% or shortly after 0%. Therefore, the combination of above values to reduce the number of values is appropriate, facilitating the scoring and rating of PCFs.

2.3. Adjustments to the Indicators of Governance, Management and Control Capacity (Article 8)

The Article 8 in the <Table 3> has been adjusted as followed: (i) supplement the Article 2 on not complying the request of Credit Institution Law, regulations of SBV on member's capital contribution, transfer, repayment of capital contribution, conditions for members and area of operation; (ii) reduce the scores to the maximum level for regulation of not issuing full internal processes and policies, PCF operational charter and not implement accordingly with all these internal processes and policies, PCF operational charter; (iii) increase the scores to the maximum level for complying the regulations on operation and supplement much more regulation on PCF operations; (iv) remove the regulation on not sustaining the prudential ratios as this regulation has been moved to Article 6 (equity), item c Clause 3 of Article 8 (regulation on operation), Article 8 (liquidity and solvency).

From the result of surveying and analyzing the reports on solving the weak PCFs and operational status of PCFs, the biggest risks of PCFs are operational compliance risk and moral hazard risk (there are potential risks which strongly affect the safety and soundness of PCFs). The scores increase for indicator of governance, management and control capacities and add the operations of PCFs are relevant, which help to identify the PCFs having potential problems in governance, operation, administration and control

<Table 3> Adjustments to the Indicators of Governance, Management and Control Capacity

Circular 42	Decision 14
Article 8. Scoring the indicator of Governance, Management and Control capacities Score for the indicator of Governance, Management and Control capacities is 30 points, minimum 0 point, including 4 following indicators 1. Comply with Law on Credit Institutions, regulations by SBV on standards and conditions for Board of Directors, Supervisory Board or Inspectors in charge, Directors: 3 points Each member of Board of Directors, Supervisory Board or Inspectors in charge, Directors fails to satisfy the condition stipulated in Laws on Credit Institutions or violates Regulations by The State Bank of Vietnam: deduct 3 points, maximum 6 points. 2. Comply with Laws on Credit Institutions, Regulations by SBV on member's capital contribution, transfer, repayment of capital contribution, conditions for members and area of operation: 2 points. Each violation: deduct 1 point, maximum 2 points. 3. Comply with Laws on Credit Institutions, Regulations by SBV on operating: maximum 23 points. People's credit funds which violate these is subjected to score deduction as follow: a. Failing to issue fully and standardize internal regulations on the operation of the Board of Management as well as other regulations necessary for the banks operation (credit, guarantee, accounting and other operations). Each violation will result in a deduction of 1 point, maximum 2 points. b. Disobey internal regulations on the operation. For each violation: 1 point will be deducted, maximum 2 points. c. Do not comply with regulations on: credit extension, lending limit, classifications of debts, setting up and use of provision; treasury and payment; accounting; financial revenue and expenditure; finalization and profit distribution; raising capital and providing-service fees; warranty service; purchase, disposal, management and use assets; property and fund safety work, involved in ensuring safety fund system of PCFs; deposit insurance; anti-money laundering; credit information; implementation of requirements and recommendations of the state agencies; the management and use of permits. Each violation (occurred at any time during the year): deduct 1 point, maximum 13 points. d. Customer lending cases aimed profiteering, misappropriating money and property of the PCFs: deduct 6 points. 4. Executive information reporting regime: obtaining maximum 2 points. PCFs which violate these is subjected to score deduction as follow: a. Do not fully implement or perform slowly the Regulations of SBV on Provincial branch where Banking supervision and inspection department (hereinafter called Branch of State bank of Vietnam) is not present. b. Inform, report data inaccurately more than twice: deduct 1 point.	**Article 9. Scoring for the indicator of management** Maximum points for management indicator is 25, minimum 0, consisting of: 1. Members of the Board of Directors, Supervisory Board, General Manager (CEO) are competent as per requests of the laws and SBV regulations. Total points are 3, divided equally to 3 subjects: Board of Director – 1point; Supervisory Board – 1point; General Manager (CEO) – 1point. If each subject does not meet the requirement: deduct one point. 2. Members of the Board of Directors, the Supervisory Board, CEO responsible and properly perform their tasks and exercise their powers as per laws and SBV regulations. Total points are 6, divided equally to 3 subjects: Board of Director – 2 points; Supervisory Board – 2 points, CEO – 2 points. If each subject does not meet the requirement: deduct 2 points 3. Comply with laws and SBV regulations in operation, total score is 16 points. If PCF does not comply, the points will be deducted as followed: a. Violating regulations on opening bookkeeping; account opening and usage; accounting; financial revenue and expenditure; finalization and distribution of profits. Each violation will result in a deduction of 1 point, maximum 4 points. b. Violating regulations on: deposit mobilization; credit profile establishment and maintenance ; lending and debt collection conditions and requirements; checking the use of loan. Each violation will result in a deduction of 1 point, maximum 4 points. c. Violation of the regulations on loan classification; risk provision fund extract and use; fixed asset purchase, investment and management; safety work on property and vault. Each violation will result in a deduction of 1 point, maximum 4 points. d. Other violations: Each violation will result in a deduction of 1 point, maximum 4 points.

2.4. Adjustments to the Indicators of Business Performance (Article 9)

The Article 9 in the <Table 4> is adjusted as followed: (i) Put up the low value of 2 indicators of profit/total revenue and profit/total average assets; (ii) add one more indicator of net profit/chartered capital “from 10% up”. The reason is that putting up the low-value indicators together helps to reduce number of indicators, making the scoring and rating of PCFs. Also, the addition of the net income/capital from 10% or more is suitable, as the data analysis result showed that 91% of PCFs had net profit/charter capital over 8%.

2.5. Adjustments to the Indicators of Liquidity (Article 10)

The Article 10 in the <Table 5> is adjusted as followed: (i) add the Clause 3 on ratio of short-term funding sources for medium and long term lending. The reason is in Circular No.32/2015/TT-NHNN, PCFs have to maintain the “Ratio of short-term funding sources for medium and long term lending”. However, this ratio has not been issued in the Decision No.14. In the coming time, PCFs have to calculate and maintain this ratio; in parallel, this ratio is supplemented for affecting the liquidity of PCFs.

<Table 4> Adjustments to the Indicators of Business Performance

Circular 42	Decision 14
Article 9. Business performance Maximum score is 10 points, minimum score is 0 point and including 3 components specified as follows: 1. Income/total revenue ratio a. Attaining from 10 up: 4 points b. Attaining from 5% to less than 10%: 3 points c. Attaining from 1% to less than 5%: 2 points d. Attaining from 0% to less than 1%: 1 point e. Attaining below 0%: 0 point 2. Income/total average asset ratio: a. Attaining from 2% up: 4 points b. Attaining from 1.5% to less than 2%: 3 points c. Attaining from less than 1% to less than 1.5%: 2 points d. Attaining below 1%: 0 point 3. Net income to equity ratio a. Attaining from 10% up: 2 points b. Attaining from 8% to less than 10%: 1 point c. Attaining below 8%: 0 point	Article 10. Business performance: Maximum score is 15 points, minimum score is 0 point and including 3 components specified as follows: Income/total revenue; Income/total assets; Net income/charter capital. In details: 1. Income/total revenue ratio a. Attaining from 12% up: 6 points b. Attaining from 10% to less than 12%: 4 points c. Attaining from 5% to less than 10%: 3 points. d. Attaining from 1% to less than 5%: 2 points e. Attaining from 0% to less than 1%: 1 point f. Attaining below 0%: 0 point 2. Income/total average asset ratio a. Attaining from 2.5% up: 6 points b. Attaining from 2% to less than 2.5%: 4 points c. Attaining from 1% to less than 2%: 3 points. d. Attaining from 1% to less than 1.5%: 2 points e. Attaining from 0% to less than 1%: 1 point f. Attaining below 0%: 0 point 3. Net income to equity ratio a. Attaining from 8% up: 3 points b. Attaining from 6% to less than 8%: 1 point c. Attaining below 6%: 0 point

<Table 5> Adjustments to the Indicators of Liquidity

Circular 42	Decision 14
Article 10. Scoring liquidity criteria Liquidity criteria has maximum score of 20 points; minimum score of 0, including 3 indicators with scores as follows: 1. Liquidity ratio for the next working day a. The indicator is always greater than or equal to 1: 8 points b. If the indicator is less than 1 once: 4 points c. If the indicator is less than 1 twice: 1 point d. The indicator is less than 1 three times or more: 0 point 2. Liquidity ratio during the next 7 working days a. The indicator is always greater than or equal to 1: 8 points b. If the indicator is less than 1 once: 4 points c. If the indicator is less than 1 twice: 1 point d. The indicator is less than 1 three times or more: 0 point 3. The ratio of short-term funds used for medium and long-term lending a. The indicator is always smaller than or equal to 30%: 4 points b. The indicator is more than 30% once: 2 points c. The indicator is more than 30% twice: 1 point d. The indicator is more than 30% three times or more: 0 point	**Article 11: Scoring liquidity criteria** Liquidity criteria has maximum score of 20 points; minimum score of 0, including 2 indicators. Details is as follows: 1. For PCFs a. The ratio between assets that can be used to make payments immediately and liabilities that must be paid immediately in the next working day (this ratio is determined in accordance with the regulation of SBV) - The indicator is always greater than or equal to 1: 10 points - The indicator is less than 1 once: 5 points - The indicator is less than 1 twice or more: 0 point b. The ratio between the assets that can be paid immediately and the liabilities that must be paid immediately in the next 7 working day (this ratio is determined in accordance with the regulation of SBV) - The indicator is always greater than or equal to 1: 10 points - The indicator is less than 1 once: 5 points - The indicator is less than 1 twice or more: 0 point

2.6. Other revision

(i) Use the terms “criteria” and “indicator” consistently

The Circular uses the term “criteria” (qualitative) for the 5 factors of PCFs to be assessed (e.g., equity; asset quality; management. governance, control capacity; earnings and liquidity); and “indicator” (qualitative and quantitative) for ratio and element (such as CAR, bad debts/total loans outstanding, profits/total revenues etc.) of each factor above.

(ii) Delete Article 3 on terminology

Contents of Article 3. Term explanation is stipulated on specific documents of SBV. Therefore, the Circular put term explanation Annex 2 in order to make it easier to keep track and compare indicators.

(iii) Change the ordinal of Article 3 and 4

The Circular moves the Article 3 on classification approach before Article 4 on Documents and information for classification in order to make it more logical (approach is first described and data and documents used for the approach is mentioned next). The ordinal is similar to that of the new circular on classification of foreign credit institutions and bank branches.

(iv) Revie, supplement Article 12 on classification

Add the item on downgrading a PCF 1 category if it has 1 factor or 2 indicators or more of 1 factor scored “0”. This item is to score PCFs correctly, helping to warn and recognize problematic PCFs early.

(v) Other revision

Adjusting the time for PCFs to complete classification as April 30 of the next year (to make it consistent with the deadline requirement of 90-day after fiscal year end for independent audit report).

- Add the article on required documents (for subjects, purpose, time, complete time of sudden classification, time and contents of reports, the time SBV branches, banking supervisory offices receive approved sudden classification results in their respective areas); announcement and use of sudden classification results.
- Clarify classification time (including classifying time, report time, time for approving classification results)
- Clearly stipulate sudden classification
- Stipulate responsibilities of PCFs, SBV branches, banking supervisory offices specified at articles guiding classification procedure, classification handling, announcement and use of classification results.
- Revise the contents of Form 01 and 02 of Decision 14 to make them consistent with the changes of the Circular.

3. Evaluating the Differences between Circular 42 and Decision 14

The articles of Circular 42 revising and supplementing Decision 14 are as follows:

- The factor that is meaningful in management and supervision of PCFs (for example management, governance, control capacity) has increased total score, reflecting their more important role in the safeness and soundness of PCFs. Contrarily, the factors that does not correctly reflect the safeness and soundness of PCFs (for example earnings) have reduced total score.
- The score of each indicator in 01 factor is adjusted in accordance with the principle that the more important indicator, better reflecting the PCF status has higher score compared to those of other indicators.
- The score levels of each indicator are adjusted to make them more suitable with the current operation of PCF system, helping to make better classification among PCFs.
- The scope of violation in operation (reflecting weak management, governance and control capacity) of PCFs is expanded with the deduction of 1 point for each violation. The points deducted are also increased. For example, if PCF staff that lent to relatives or wrong borrowers to get benefits embezzles money and assets of PCFs, 6 points are deducted. More serious violation shows the high level of moral hazard, operational risk of PCFs, and PCFs are deducted more points, leading to lower classification results, thus reflecting better PCFs’ level of risk.
- Some indicators reflecting prudential status of PCFs are added (for example: the ratio of short-term funds used to make medium and long-term loans in accordance with Circular No.32/2015/TT-NHNN dated December 31, 2015 on prudential ratios and limits of PCFs) are added in scoring PCFs.

With stricter approach as mentioned above, in cases where PCFs does not have high score (for example 58 points) and are classified at D category by Decision 14, they will be definitely classified at D category (total score less than 60) by Circular 42. If PCFs have many weaknesses in management, governance and control and have low score (for example 10 points) by using Decision 14, their score using Circular 42 will be lower than or equal to 10 points.

4. Conclusions

The study has identified changes in PCFs ranking in Vietnam according to Circular No. 42/2016/TT-NHNN and the

Decision No. 14/2007/QD-NHNN. It is clearly seen that the evaluation and ranking of PCFs is extremely important in increasing efficiency within the PCF network and helping the related authorities to manage and provide support them easily. Building and developing the PCF model is a right policy that is in line with the realities of Vietnam. After many years of establishment, PCF have affirmed their role not only domestically but internationally. PCFs have effectively assisted individuals, households, small- and medium-sized enterprises to develop production, expand services, create jobs, contribute to poverty reduction and reduce evils in the rural areas. Internationalization process poses major challenges for financial sector polices, underlining the importance of further progress with financial sector performance. As a vital part of financial institutions, the newly established PCFs are self-managed and self-financed; yet their success is due to the central bank designing the new system, preparing its regulatory framework, providing training and supervision and enforcing prudential standards, while abstaining from undue interference.

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