

BUSINESS ISSUES BULLETIN

Translated from original Vietnamese document

VIETNAM

THE BUSINESS INFORMATION CENTER AT THE VIETNAM CHAMBER OF COMMERCE AND INDUSTRY

No.21 (24) August 2007

LEGAL AND INSTITUTIONAL REFORM FOR SECURED TRANSACTIONS:

Opportunities for asset-based lending in Vietnam

Greater access to credit is crucial for more widespread business growth in Vietnam, particularly for the small and medium enterprises (SMEs) that now generate 60% of GDP. Most of these firms are unable to finance their operations through formal channels because they cannot meet the collateral requirements of Vietnam's financial institutions, as Vietnamese banks rarely lend without property as collateral. A recent IFC survey of lending practices shows that 93% of banks prefer real estate as security for commercial loans.¹ However, the assets of most businesses, particularly SMEs, are usually movable assets, such as inventory or receivables. These moveable assets, which are worth billions of dollars, could be put to productive use and contribute to economic growth if businesses could use them to secure the financing they need to upgrade and expand. This bulletin will discuss reforms needed in the legal and institutional framework for facilitating asset-based lending in Vietnam.

The legal framework for financing movable assets has improved

Reforms brought about by the 2005 Civil Code and Decree 163² have helped enable collateral-based lending. First and foremost, they have made it possible for all kinds of movable property to be used as collateral. Vietnam now allows for mortgages to be created from tangible and intangible assets of any nature, including future assets. Second, they have helped simplify procedures for creating security interests. Parties are now able to address their rights and obligations in a lending agreement that includes definitions of guarantees and covenants, events of default, and remedies. Third, priorities between the different creditors have been clarified. A general rule has been put in place that favors the first creditor registered with top priority for claiming collateral in the event of debtor default.³ Each of these changes has been crucial for facilitating collateral-based lending, and their effective implementation should bring new opportunities for secured lending.

The secured transactions registry system needs to be web-based for easy public access

In modern commercial transactions, security interests are created on a non-possessory basis, meaning that the borrower

keeps and uses the collateral that has been offered as security to a lender. Therefore, legally registering and fully recognizing prior security interests in movable property to be used as collateral is critical for the protection of the rights and interests of all related parties, as well as for helping creditors assess and mitigate risk.

In Vietnam, the secured transactions registration system was established in March 2002 under the National Registration Authority for Secured Transactions (NRAST). The system registers security interests on all movable assets and leasing transactions, with the exception of ships and aircraft. While this is currently the only system for most security interests in movable assets, an IFC survey reported that most financial institutions regard it as flawed and complicated to use. Drawbacks in the system include: 1) a paper-based rather than electronic system; 2) uncertainty as to whether the registry has the authority to publicize all types of security interests; 3) instances of discretionary treatment of applications by registrars; 4) burdensome and time-consuming registration requirements; 5) a registration process that favors regular over occasional registrants; and 6) incomplete access to information due to a half-day time lag between receiving an application and

synchronizing it in the database.

Upgrading the current collateral registry from a paper-based system to an easy-to-access secure website will benefit all parties by greatly enhancing information flows and providing financial institutions with quick and accurate information for making informed lending decisions. Now that the system is being upgraded in Vietnam, it is important to recognize and benefit from the experience of other developing countries that shows it is more cost effective and reliable to utilize off-the-shelf software (which has been tested elsewhere) than to develop a unique system independently.

An accelerated security interest enforcement process will help promote asset-based lending practices among credit institutions⁴

In the recent IFC survey, judges and lawyers said that the enforcement of security interests in movable property is rare due to high costs, delays, and uncertainties in results. Financial institutions felt that enforcement of security interests in default cases takes far too long - from 3 to 36 months to obtain a judgment from the court, and an additional year on average to enforce the judgment. While the legal framework allows parties to agree on their own remedies and out-of-court enforcement, creditors state that when dealing with a defaulting debtor, they

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This bulletin is published with support from the Mekong Private Sector Development Facility (MPDF), a multi-donor funded initiative managed by the International Finance Corporation (IFC), the private-sector arm of the World Bank Group.

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(1) Vietnam: Increasing access to credit through collateral (secured transactions) reform, IFC-FIAS, June 2007

(2) Decree 163-2006/ND-CP.

(3) See the 2005 Civil Code, Sections 318 to 325, and 342 to 357. Note that the priority rule applies only to competing claims under transactions listed in Article 318.

(4) Security interest enforcement is a process by which a creditor, upon default by the debtor, exercises the right to sell or otherwise dispose of the property in which the security interest has been taken and apply the proceeds to satisfy the secured debt.

The legal framework for financing movable assets has improved



- Before the promulgation of the 2005 Civil Code, the enforcement of security interests on collateral was difficult. Procedures were complex and there was no efficient mechanism for protecting creditors' rights. The 2005 Civil Code and implementing decree No 163/2006/ND-CP have made improvements. Now secured creditors have the right to seize or sell collateral privately (not through an auction) if the debtor defaults.

Furthermore, both the Civil Code (Article 336-338) and Decree 163 allow parties to agree on how to enforce the security interests (whether it be at the signing of the contract or at any time over the contract's duration) and recognizes that the realization of secured property to recover a debt is not considered a property trading activity by the secured party.

The 2005 Civil Code also broadens the scope of the registration of secured transactions. Previously, only security interests on mortgages, pledges, and guarantees could be registered. Now, additional security interests can be registered, including advance deposits, security deposits, escrow accounts, contracts for purchase (either through deferred or installment payments), property leasing contracts (with terms of more than one year), finance leasing contracts, and contracts assigning rights to reclaim debts. These improvements illustrate Vietnam's gradual application of good practices of secured transaction laws.

Ms. Nguyen Thuy Hien, Head of the National Registration Agency for



- Decree No 163/2006/ND-CP provides detailed guidance on the priority order of secured creditors on collateral related to contracts for purchase through either deferred payments or installments, or property leasing contracts, and so on. According to the decree, in such situations, the seller holds the ownership right and the lessor shall be given the highest payment priority upon disposal of the

secured asset if they register their security interest within fifteen (15) days of the acquisition or lease contract. If the seller or the lessor fails to register, or registers after the 15-day limit, or after the secured transaction is registered, the secured party shall have the highest payment priority upon disposal of the secured asset. The general rule of "first come, first served" should be applied; in other words, the first registered should have first priority on collateral in case of default. In case secured creditors fail to meet the deadline for registering their interests, the secured transaction will be considered an "improper" interest, and secured creditors will not be able to claim priority on the collateral. An organization or individual person taking the security through using assets acquired under a deferred payment or installment payment, or leased assets, but after the contract for such acquisition or lease has already been registered shall not be considered the bona fide secured party.

*Mr. Nguyen Thanh Long, Legal Department
State Bank of Vietnam*

The secured transactions registry system needs to be web-based for easy public access

- The secured transactions registry system has yet to be fully integrated. There are four different agencies involved in the registration of secured transactions: the Vietnam Maritime Bureau for ship mortgages, the Vietnam Civil Aviation Administration for aircraft, Land Use Rights Registration Offices for immovable property, and NRAST for moveable property. The only advantage of the current system is that these specialized bodies have professional knowledge and expertise of their specific assets. There are, however, a number of weaknesses in the current system. These include: i) the inability to ensure the transparency of assets; ii) the inability to clearly identify the responsibilities of registrars; iii) inconsistent, unintegrated registration procedures and formalities; and iv) too many agencies involved in the same job. This last weakness runs counter to the need for reforms that streamline the administrative process.

*Mr. Nguyen Van Manh, Deputy Manager
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- The law does not require ownership of movable assets to be registered, so public information on security interests related to these assets is very important for both lenders and other stakeholders. The fact that only secured transactions on mortgages, pledges, and leases need to be registered does not ensure that enough information on the credit status of an asset will be available. Various types of transactions can establish an interest on an asset, such as selling the goods through agents or seizing assets by court decision. These transactions may then also involve the right/interest of a third party on the assets in question. It is important for these third parties to be well

informed on the associated risks. For this to happen secured transactions registration legislation needs to be improved to include all related transactions on moveable assets.

Ms. Nguyen Thuy Hien, Head of National Registration Agency for Secured Transactions (NRAST), Ministry of Justice



- The backoffice of the secured transactions registration system of NRAST (which covers all movable property other than aircraft and ships) has been computerized. The central database server is located in NRAST and is connected to Registration Offices in Hanoi, Ho Chi Minh City, and Da Nang. Registrations from these offices are transmitted to the NRAST server, and requests for information on assets can be made at any of these offices

(regular clients can also send requests by fax). Unfortunately, this system is still predominantly paper-based, which means that clients must fill out paper forms which the registry clerk then has to enter into the computerized database. But even then, once the data has been registered at the center, we still have to wait for the overnight synchronization of NRAST databases before the registration information becomes readily available. As a consequence, information provided by the registry during the minimum one-day gap between the entry of the application and the overnight database synchronization may not be up-to-date.

Information technology must be used to optimize the system's accuracy, speed, accessibility, and cost effectiveness. Clients need to be able to register secured transactions directly into the database and be confident that when they conduct their own searches, they are receiving up-to-date and accurate information.

*Mr. Tran Dong Tung, Vice Director
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(NRAST), Ministry of Justice*



- It is necessary to keep in mind the purpose of Vietnam's efforts to reform the secured transactions legal framework. The underlying need is for businesses to have access to capital so they can start up and grow. We want to make more money available to businesses at lower interest rates. To do that, financiers must be able to rely on two things. The first is a legal framework that provides for the simple

creation of security interests in movable property, a clear scheme for determining and preserving priority in movable property of all kinds, and effective enforcement of repossession rights in the case of default. The second is an efficient and reliable registry that makes security interests transparent. Both the legal framework and the registry are vital for success. Efforts to upgrade the legal framework to meet international standards date back to the adoption of the new Civil Code in 2005. So now it is the registry that demands our attention.

The fundamental quality of a secured transactions system is transparency of security interests in movable property. If lenders know what security interests exist on property they may want to use as collateral, their risk is lowered. This subsequently allows them to lend more and at lower rates. The purpose of the registry is to provide that transparency by publicizing the security interest. When a financier publicly registers an interest in movable property, it is entitled to priority on the property as of the date of registration. Those are the only two functions of the registry: publicity of interests, and

establishment of priority - nothing more. So the design of the registry needs only serve these two functions.

The registry that best serves these functions is a notice registry. A notice registry does not require registration of agreements and proof; it only needs a simple notice that identifies the debtor (borrower), provides the name and address of the secured party (financier/lender), and describes the property (collateral) that is used to secure the obligation. No formalities are required, and decisions about accepting or rejecting a notice are so clear that the computerized system can make them. Therefore, a notice registry can be fully electronic and operate on the internet. Vietnam's existing registry for security interests has not worked well because it is complicated, expensive, and paper-based. However, the country is on its way to having a modern electronic notice registry. Once this is done, it will be fast, simple, and inexpensive for financiers to register and ensure their priority order in collateral. The reduced risk that will follow will permit financiers to finance more businesses at much lower interest rates. The ultimate beneficiaries will be the business community and the overall economy of Vietnam. It will be interesting to watch the developments carefully over the coming months. We should see more businesses getting the financing they need to succeed.

*Mr. Everett Wohlers
IFC consultant specializing in secured transactions*

- All financial institutions need accurate and up-to-date information on borrower credit status. There have been cases where we have had to deal with certain borrowers who, with the "cooperation" of another financial institution, have tried to trick the system. When this happens, it is unfortunate that the information available from the Credit Information Center of the State Bank of Vietnam (CIC) is only partially helpful. In several cases the information had not been updated. So improvement of the credit information system, especially regarding secured transactions, will definitely help banks to better evaluate risk and expand financing for enterprises.

*Mr. Hoang Ngoc Thanh, Vice-Director
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An accelerated security interest enforcement⁶ process will help promote asset-based lending practices among credit institutions

- Enforcement of security interests in moveable property is a challenge, especially when the defaulting debtor is unwilling to cooperate. Furthermore, auctions of repossessed collateral are constantly subject to bid-rigging. Financial institutions need the support of state agencies, including the courts and the enforcement agencies to streamline the security interest enforcement process.

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- In principle, a speedy, effective, and inexpensive enforcement procedure is essential for creditors to realize the full value of collateral. To achieve this, regulations should introduce summary enforcement proceedings and simplify administrative procedures so that the secured creditor can quickly and effectively exercise their right on the collateral. Many countries have introduced summary proceedings whereby collateral enforcement is resolved quickly when it winds up in court. Only two pieces of evidence need to be presented to a court in a summary proceeding: a valid security agreement, and evidence of

default. This method of enforcement of collateral takes half the time required that other judicial measures take.

*Ms. Nguyen Thuy Hien, Head of National Registration Agency for
Secured Transactions (NRAST), Ministry of Justice*

- Currently, courts handle most of the enforcement of security interests. However, there is no specific agency within the court system that deals explicitly with the enforcement of security interests. Therefore, proceedings usually take an extended amount of time before the lender is allowed to sell the collateral for remedial purposes. As a result, slow proceedings may substantially reduce the value of an asset or render it impossible to sell at that point in time. Therefore, it would be better to allow lenders to have the right to sell the collateral upon debtor default, supported by a state agent, and/or allow parties to agree on their own remedies to be enforced out-of-court.

*Mr. Le Minh Hai, Credit Department
Saigon Bank*

(6) Security interest enforcement is a process by which a creditor, upon default by the debtor, exercises the right to sell or otherwise dispose of the property in which the security interest has been taken and apply the proceeds to satisfy the secured debt.

Credit institutions need to recognize the economic potential and new business opportunities in the recent reforms

● Enforcement of security interests in moveable property is a challenge, especially when the defaulting debtor is unwilling to cooperate. Furthermore, auctions of repossessed collateral are constantly subject to bid-rigging. Financial institutions need the support of state agencies, including the courts and the enforcement agencies to streamline the security interest enforcement process.

*Mr. Hoang Ngoc Thanh, Vice-Director
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● There are reasons why banks are not really keen on movable-asset lending. Banks usually lack the required knowledge and expertise for valuing such assets, especially machinery and equipment. The sale of these assets can also be difficult, and the value of an asset may substantially depreciate during this time. Also, if inventory is used as collateral, it is difficult for a lender to manage that inventory when it is located in the debtor's warehouse.

When inventory is perishable, such as agricultural products or frozen food, there is the risk of unstable market prices and rapid depreciation. Finally, the debtor may sell or use the asset for another transaction resulting in a conflict in the event of debtor default.

*Mr. Le Minh Hai, Credit Department
Saigon Bank*

● Modern economies commonly use inventory as collateral for bank credits. This is rare in Vietnam due in part to poor warehousing infrastructure and the lack of professional warehousing services to support banks in managing this kind of collateral. Furthermore, difficulties in inventory classifications prevent creditors from accurately evaluating risks related to that collateral, especially when the inventory is used for multiple secured transactions (with different creditors).

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are most likely to succeed by suing, even though this entails a complicated and time-consuming judicial proceeding. According to banks, ineffective enforcement of security interests is largely due to the limited resources of the judicial system and the complexity of the current enforcement procedures and practices.

An effective security interest enforcement system should: i) include explicit authorization to pursue multiple enforcement remedies simultaneously (rather than consecutively) and without arbitrary obstacles; ii) apply expedited judicial proceedings if out-of-court enforcement mechanisms do not resolve the issue; and iii) allow for regular review and revision of procedures for auction, enforcement of judgment, and private remedies to reduce creditor risk, enhance creditor confidence, and subsequently increase credit opportunities for all borrowers.

Credit institutions need to recognize the economic potential and new business opportunities in the recent reforms

Vietnamese banks are now trying to develop inventory financing products, and have introduced products such as loans secured by export commodities like coffee, rubber, rice, pepper, etc. However, the present legal framework on secured transactions needs further improvement if it is to establish a clear and comprehensive priority rule that enables creditors to evaluate associated risk and expand their export financing business.

*Mr. Nguyen Thanh Long, Legal Department
State Bank of Vietnam*



● In Western economies, accounts receivable lending is playing an increasingly important role in bank lending operations. In this form of lending, the business pledges its accounts receivable⁷ as collateral to obtain a short-term loan (30, 60, or 90 days). Borrowers are usually SMEs, as they normally need to maintain effective cash flow for their operations, and the cost of financing for the borrower is far

outweighed by the benefits in developing their businesses.

The Vietnamese economy will benefit if banks and financial institutions offer receivables financing to borrowers down the supply chain. Without receivables financing, SMEs are stifled by their inability to improve cash flow through reputable bank borrowing. While SMEs are squeezed by the lack of credit from their suppliers, they are, in turn, forced into extending credit to their customers in the normal course of business. The market is there, the protection of the law is real, and the opportunity for banks to develop asset based financing products is exciting.

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The IFC survey on lending practices among Vietnamese banks shows that banks are unfamiliar with asset-based lending. While operational assessments and credit history are important factors in lending decisions, business loans in Vietnam are almost always secured. Moreover, the survey indicates that after real estate, banks prefer machinery and equipment, followed by negotiable instruments,⁵ motor vehicles, and inventory. While machinery and equipment are the most preferred movable assets, banks only accept them as supplementary collateral if the value of the primary collateral (real estate) is insufficient. Banks regularly complain that a lack of expertise in evaluating and controlling these movable assets is hindering them from movable asset-based lending. It follows, then, that investment in training and staff capacity building would greatly improve risk management and give banks the confidence to introduce new lending products that make the most of secured transaction reforms in the legal and regulatory environment.

(5) Negotiable instruments are such as stocks and securities, options and futures, and derivative products.

(7) money from its customers as a result of credit sales of merchandise or products/services