

# BUSINESS ISSUES BULLETIN

Translated from original Vietnamese document

VIETNAM

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

No.18 (21) February 2007

## THE STATE CAPITAL INVESTMENT CORPORATION:

### How Will it Achieve its Mandate?

The reform of State-Owned Enterprises (SOEs) has been a top priority in Vietnam's socio-economic development agenda over the last two decades. Much of the recent SOE reform effort has focused on disentanglement of regulatory and ownership functions of state agencies. The key objective of these efforts is to make SOEs accountable for their own profits and losses through reorganization, corporatization and limited ownership diversification, including equitization. Despite all these efforts, the state sector in Vietnam remains relatively inefficient and less competitive than the private sector. The major governance issue the dual role of the State as owner and regulator has not yet been satisfactorily resolved.

The establishment of the State Capital Investment Corporation (SCIC) is the most recent initiative of the Government of Vietnam to reform the state sector. According to its charter, SCIC is responsible for exercising the state's ownership function in all equitized and transformed enterprises and further divesting from assets transferred to its portfolio.<sup>1</sup> Most observers agree that the creation of the SCIC is a step in the right direction as it helps separate the ownership and regulatory functions of state agencies, thus reducing the scope for political interference in business operations while enhancing the process of privatization.

SCIC is a newly established entity, and, to date, Vietnam does not have the experience of running such a specialized and complex corporation. The key question that will need to be resolved is how the SCIC will achieve the mandate set for it. This bulletin discusses a number of issues and challenges that SCIC is likely to encounter and presents suggestions on how they might be addressed.

#### Managing a large diversified portfolio with controlling stakes

By acting as the owner of equitized SOEs on behalf of the Government, the SCIC is expected to help ease the current owner-regulator conflicts and increase transparency with regard to the state's use of resources. According to plan, more than 3,000 equitized and transformed SOEs are to be transferred to SCIC over the next three years.<sup>2</sup> A difficulty facing the SCIC will be to manage a portfolio of "controlling stakes" in a large number of companies from many different industries. As a controlling stakeholder, SCIC does not have an option to be a silent investor because doing so would create a vacuum of governance for its investee companies. The management of those companies would be left unaccountable for their performance, defeating the original purpose of creating the SCIC to better manage State assets. To achieve its purpose, SCIC would need to actively participate in the governance of investee companies and restructure them to

enhance the value. But doing so for thousands of companies in many sectors at same time is practically impossible. Therefore, it is highly recommended that the SCIC set a specific target for numbers of either non-strategic or well-performing SOEs to be let go, and develop clear criteria for the classification of enterprises in its portfolio for that purpose.

An additional challenge arising out of the diverse portfolio, if it consists of banks and non-banks, may lie in the temptation to influence portfolio banks lend to high-risk non-bank companies. If SCIC is mandated to manage both bank and non-bank assets, there is the need to establish an effective "Chinese wall" between the units managing these assets to ensure that conflicts of interest do not arise.

#### Potential conflicting objectives and priorities

With a chartered capital base of about VND 5 trillion (US\$315 million), SCIC has the authorization to make direct and indirect investments, which could include investment

in "risky projects" or "projects in unprofitable branches which need the State preferential policies or financial support" (approval by the Prime Minister is required), according to the current charter.<sup>3</sup> This raises two issues of concern among some experts. The first concern is that due to SCIC's investment activities, there may be an increase in the state sector rather than the decreased state engagement. The second concern relates to potentially conflicting commercial or social objectives, and how SCIC may manage these.

SCIC should, at least in its initial years of operation, focus on the management of the existing portfolio, e.g., improve corporate governance practices and shareholder value in its member enterprises, and further divest non-strategic enterprises. Towards this end, SCIC should set out clear objectives and criteria for investments so that their new investment activities, if any, initially be used to enhance the existing assets and facilitate the participation of, rather than crowd out, the private sector. In the medium-term, SCIC, could consider partially investing social sectors such as health and education, which initially may be unprofitable and need some state support in early stages.

#### Unclear corporate governance and reporting

According to its current charter, the SCIC is a special type of SOE, reporting directly to the Prime Minister and is supervised by the Ministry of Finance (MOF). The Managing

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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) This is a role that has previously been exercised by line ministries, provincial governments, and other state or quasi-state entities.

(2) This figure does not include state-owned commercial banks, economic groups, general corporations (90, 91). It is envisaged that these entities, once equitized - will also be transferred to SCIC.

(3) SCIC can enter into joint ventures, and mobilize funds to expand investments. It is also allowed to mobilize domestic and foreign capital sources through capital borrowing, issuing corporate bonds or project bonds, and/or setting up of investment trust funds.

## Managing a large and diverse portfolio



- One of the ways to help reform state enterprises is to let the government and related social organizations focus on the financial performance. Financial performance will then involve technology upgrades, market or training practices, and so on. If the SCIC decides to look at the financial and management factors of those SOEs in their portfolio, it will be a good move in the right direction. Over the past five years, state capital has not been managed in the most

efficient way, as it was needed for pursuing too many priorities, too many objectives. The establishment of the SCIC, with the mission of maximizing the value of state capital, can be considered a good signal that the public sector has decided to manage its capital in a uniform and objective manner.

*Mr. Dominic Scriven, Director  
Dragon Capital Investment Fund*

- It is planned that the SCIC will take over more than 1,000 SOEs over the next five years. Eventually, however, we will try to narrow our portfolio to 100-200 firms involved in key industries of the economy. The rest will be sold off to the public. According to the Government Decision<sup>5</sup>, the SCIC is responsible for managing state capital at SOEs that have completed their equitization process, which means that in principle, once equitized, all SOEs will be transferred to the SCIC despite the previous corporate types.

In order to effectively exercise the state shareholder rights in these diversified investment portfolios (in terms of scales and industries), the SCIC needs to have a reformed method of portfolio management. The SCIC will exercise shareholder rights through its representative at the invested companies, and follow the corporate governance principles provided by the Enterprise Law and the company charters. It is worth emphasizing that the SCIC will not infringe on the day-to-day operations of its managed SOEs, but focus on improving their corporate governance and structures. Guidance on the State Representative at state-owned enterprises will be developed soon. The SCIC has been partnering up with a number of leading financial consulting groups to develop internationally accepted corporate governance codes to be applied to all SCIC-managed firms. We plan to organize a number of training courses, seminars and other learning activities to build capacities for our representatives at SOEs. We believe that the SCIC, through this process, will actively promote the application of best practices in corporate governance in both SCIC-managed firms and all other firms.

*Mr Le Song Lai, Deputy Director  
State Capital Investment Corporation (SCIC)*

- The SCIC should have clear targets of how much of state capital and how many SOEs to represent. The 100 or 200 firms, as indicated by the SCIC's management, in my opinion are too many. Many of the enterprises in their portfolios might be in consumer goods producing, tourism, or trading - they don't need state dominance or control. So what is the purpose for the SCIC in keeping them? It could be better for the SCIC to plan to further divest state capital in firms in such non-strategic

sectors. Before selling off those firms, it would be great if the SCIC would help restructure the poor performers - for example, through the acquisition and merging process.

On the other hand, as a controlling shareholder, the SCIC can ensure that the other shareholders in those firms would be able to enjoy all their legal rights, such as participating and voting in shareholder meetings; obtaining relevant and sufficient information on the corporation in a timely and regular basis; transferring shares in a convenient way; and forcing the invested companies to comply with the local business laws. The state shareholder (through the SCIC) can request the invested companies to amend their charters. The SCIC can also take the lead in the development of a standard corporate charter (with particular regard for the organizing of the general shareholder meeting) and ask all of their managed companies to apply. It has been observed that charters and shareholder meetings in many joint-stock companies do not comply with local corporate governance regulations.

*Mr. Nguyen Hoang Hai, General Secretary  
Vietnam Financial Investors Associations (VAFI)*



- A distinction needs to be made between the different types of general corporations. All GCs are being transformed, either into parent-subsidary model companies or economic groups. For parent subsidiary model corporations, it is unclear how state capital will be managed. The SCIC charter indicates that it takes over the management of state capital once the parent company itself is equitized. But this remains to be seen. For economic groups, it is unlikely that the SCIC will take over

management of state capital since they report directly to the Prime Minister. However, the management boards of these economic groups now frequently include a Ministry of Finance official, and it is possible the Prime Minister will appoint someone from the SCIC to these positions.

*Mr Scott Cheshier, Specialist in Economics  
UNDP Vietnam*

- According to the General Statistics Office, by the end of 2004, the total capital amount of 100% state-owned enterprises was up to 278 trillion VND, and the amount of state capital in equitized enterprises was 27 trillion VND. It is estimated that by the end of 2006, this total figure will be 350 trillion VND (22 billion USD), accounting for about 35% GDP. By 2010, when the equitization plan is completed, even if only one-third of the state capital (not including economic groups) would be transferred to SCIC, the value of these state assets would rise up to 10 billion USD (equivalent to 12.5% of Temasek's portfolio). This is a huge amount of money to be injected into the economy through the diversified portfolio of investment that SCIC will be managing. Therefore, the SCIC will also play an important role in developing and stabilizing our capital market. However it should be clear that the top priority of the SCIC's operation is to maximize shareholder value, rather than to balance the capital market.

*Mr. Huynh The Du, Researcher  
Fulbright Economic Teaching Program*

## Potential conflicting objectives and priorities

- We should emphasize that the objectives of the SCIC are very clear and consistent, as the SCIC ultimately aims to improve the efficient use of state capital in equitized firms. However, in different periods and under different economic development policies, those objectives can be differently prioritized. That can explain the difference in the objectives of the SCIC and Temasek of Singapore. The SCIC has been set up at a point

when reforming state enterprises and speeding up the equitization process are the highest priorities of the Government of Vietnam. In that context, in addition to efficiently managing the state capital in equitized firms, the SCIC focuses on identifying new investment opportunities with high returns. In contrast, Temasek was set up when the equitization in Singapore had been completed or at least was no longer at the top of

(5) SCIC was established in August 2006 under Government Decision No 151/2005/QĐ-TTg.

the reform agenda. Therefore, most of companies in its portfolio are publicly-owned companies (listed) and are long standing in the market. And Temasek's ultimate role is to maximize their profits.

*Mr Le Song Lai, Deputy Director  
State Capital Investment Corporation (SCIC)*



- Temasek of Singapore, the SCIC of Vietnam, and Huijin (Central Huijin Investment Company of China) are all state investment arms to control the commanding heights of their respective economies. However, there are differences in their objectives. While maximizing the shareholder's value is the ultimate goal of Temasek, the SCIC and Huijin need to pursue other important goals.

Even if Adam Smith's theory of the invisible hand was precise and no market failures were observed, most governments around the world would still interfere in their economies. The key issue is how appropriate the state interference is. If the SCIC aims to reduce the state role in non-strategic sectors and strengthen its control over the commanding heights, its goals must be consistent rather than mutually exclusive. In other words, conflicting goals should be pursued by different agencies. Maximizing the value of state assets and investing in state-requested sectors are both critical tasks but may, to some extent, be contradictory. If there is no clear-cut designation for resource allocations and efforts to pursue those two goals, the SCIC will face the common dilemma of all other SOEs, that is to claim external factors or too broad a focus for their inefficient and unprofitable operations and the fundamental conflict between the ownership function and the management function remains unresolved!

In short, it could be better if the SCIC would pursue only the goal of maximizing the value of state assets, and pay a fixed amount of dividends to the state (on an annual basis). Whenever the SCIC is requested by the state to invest in a specific project (which might be important for the community and not profitable), the state should compensate the SCIC with a reasonable margin. This approach may also help the state scale down the costs of those investment projects with large social impact.

So, as to whether the private sector would be crowded out by the

SCIC's new investments? In my opinion, it may not be the case, as there will be huge capital demands from now through 2010, or even 2020 by our economy. The SCIC can meet only a small portion of this demand. We will need to look for other capital mobilization channels and the private sector will inevitably play an important role in this process.

*Mr. Huynh The Du, Researcher  
Fulbright Economic Teaching Program*

- In my country (UK), you also find strong debates about whether the government should or should not invest in areas where the private sector can have sufficient resources and capacity. In Vietnam, I think, the situation is different. There are a number of areas where the private sector doesn't have enough experience and capacity. So it is less true that the private investors are in danger of being crowded out because of the SCIC's new investment strategies. Moreover, in theory, the SCIC should help reduce the role of the state in the economy as it is expected that after taking over and restructuring a number of SOEs, the SCIC will sell out its holdings in them.

*Mr. Dominic Scriven, Director  
Dragon Capital Investment Fund*



- It is more appropriate that the SCIC focus its investments in industries strategically important to the economy, rather than to be too ambitious in its investment activities. In five years, it would be ideal if the SCIC would manage a portfolio of 50 state-invested enterprises and even further reduce this number over the long run. The state capital, which is limited, should not be allocated to profitable sectors which can be easily mobilized from the public. The state capital

should be used to invest in projects that private investors are not interested in, such as social infrastructure (hospitals, schools, underground car parking, roads, etc.). The SCIC can also play an active role in seeking and bridging strategic partners for other economic groups, general corporations, and state-owned commercial banks once those entities are equitized.

*Mr. Nguyen Hoang Hai, General Secretary  
Vietnam Financial Investors Associations (VAFI)*

## Unclear corporate governance and reporting

- The SCIC is not a publicly-owned institution, so its obligations are to its owners: the State, and only indirectly to the public at large. This means that the State, as owner, would want to have a very clear understanding of the way the SCIC is governed. But perhaps public disclosure is less relevant. However the SCIC, as a big shareholder, should ensure that the governance of those state enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness. The SCIC also has the responsibility to deliver a clear message of what the expectations of shareholders are to all companies in their portfolio where the SCIC is on the management board.

It is important that the leaders of the SCIC be responsible to the National Assembly and the government. They have to fully understand the rights, obligations and especially the targets of the SCIC. It is necessary to develop systematic benchmarking to help the SCIC monitor its performance regularly, in order to see whether it has performed well and whether it can achieve its targets. Targets here can be either financial returns or develop new strategic industries or both! The SCIC can do both but it should be clear how much resources to be allocated for each target.

*Mr. Dominic Scriven, Director  
Dragon Capital Investment Fund*

- The corporate governance of the SCIC follows a wide mandate. If certain strategic projects require investment, then the SCIC will be involved in the discussion about sources of funding. The SCIC charter is not creating an independent organization whose goal is to maximize returns. However, this does not mean that the SCIC will not evolve into such an organization in practice.

The SCIC financial reporting and disclosure obligations follow existing laws. These laws are adequate. The problem is not the laws themselves, but their implementation. The Ministry of Finance has approved auditors to facilitate the equitization process, so it would be difficult for the SCIC to avoid similar scrutiny. If the SCIC is to function properly, it will need to make its financial information available to the public.

*Mr Scott Cheshier, Specialist in Economics  
UNDP Vietnam*

- First, it is critical to transform the way the state supervises the SCIC. The SCIC should be given specific targets - for example, how much of a percentage increase should there be in the value of state assets annually - and the autonomy in its investment decisions to meet these targets. The SCIC has an obligation to "pay dividends" to the state shareholder.

Second, it is urgent that the principle-agent problem that the SCIC may face be resolved. In my opinion, in addition to a market-based compensation package for the management of the SCIC, a performance

- ▶ award fund must be set up to reward good performers in the management team. It has been proven a good strategy to retain good people and provide appropriate incentives for them to objectively and professionally run the SCIC and meet the ultimate goal of maximizing the state shareholder's value.

*Mr. Huynh The Du, Researcher  
Fulbright Economic Teaching Program*

- The governance structure of the SCIC complies with international corporate governance practices under which transparency and disclosure of financial information should be strictly observed and be one

of the key performance indicators. There are specific requirements of periodical and ad-hoc financial reporting, independent auditing, as well as for disclosure of financial information in the SCIC charter and financial management policies. The SCIC is the process of developing financial operation manuals for its investment activities. Beginning 2007, the SCIC will hire one of the "big four" international auditing firms to ensure the transparency and objectiveness of financial reports. The SCIC will also ask its (state-invested) companies to apply these financial reporting requirements as the first step toward being listed in the stock market.

*Mr Le Song Lai, Deputy Director  
State Capital Investment Corporation (SCIC)*

## Developing a capable workforce



- Talent attraction and retention are among the most important priorities set by the SCIC management. After six months of operation, the SCIC has recruited 50 professional staff with intensive experience in the field of finance and banking. The SCIC is cooperating with a number of domestic and international partners to develop training packages for staff using different funding sources. In the upcoming period, the SCIC will need more personnel, with estimates up

to 300 professional staff by 2010. To facilitate its operation, the SCIC plans to outsource high quality services such as auditing, legal counseling and information technology.

It is worth mentioning that the SCIC has a very strong team who are not permanent staff but SCIC's representatives at managed SOEs (most of whom are on the management board). The SCIC management is considering setting up an international-standards training center to serve the management team of our portfolio. Last but not least, human resources policies covering recruitment, compensation and benefits, and career development will be developed soon in order to make the SCIC better and well prepared in a competitive labor market.

*Mr Le Song Lai, Deputy Director  
State Capital Investment Corporation (SCIC)*

- As far as I know, the SCIC's vision is to become a strategic investor and a professional financial consulting firm. It could be challenging for the SCIC to pursue this vision, given its structure (as a state enterprise) and the public-sector compensation policies - which make the SCIC difficult to attract talent from the private sector. Currently, most of the board members are government officials (from ministries), which can't be said to be an independent and professional management team. Private investors are suspicious about what the difference would be between the way SCIC and local authorities (and ministries) to manage those SOEs.

*Mr. Nguyen Hoang Hai, General Secretary  
Vietnam Financial Investors Associations (VAFI)*

- Now the question is how the SCIC is going to behave and what their investment policies will be. Temasek plays a big role in developing national strategies and also tries to support the SOEs (government-linked corporations) in Singapore. If the SCIC is modeled after the Temasek, I would imagine, the Government of Vietnam would expect the same thing to happen here in Vietnam. The SCIC is probably the largest investment institution in Vietnam. It is expected that it play an important role in the world of investment institutions. The SCIC should contribute to setting good governance standards and best practices and share knowledge with the investor communities.

*Mr. Dominic Scriven, Director  
Dragon Capital Investment Fund*

*(Continued from page 1)*

Board is appointed by the Prime Minister, who has the authority to decide on all aspects of the SCIC, including its objectives, strategy, and orientation, as well as some of its investments.<sup>4</sup> The MOF, other ministries and provincial authorities can also "perform state management" over SCIC. This may potentially create a confusing corporate governance structure and allow for significant interference in SCIC's operations.

With SCIC being responsible for most of the state capital, there is a particular need for it to be accountable to the National Assembly and the public its ultimate shareholders. This means that SCIC should follow a clear disclosure and reporting system to ensure its transparency and accountability, at least equivalent to the level of transparency required of publicly-owned companies.

### Developing a capable workforce

The SCIC is pursuing a very ambitious agenda. It aims to become:

- (i) a dynamic shareholder able to fully exercise the ownership role and actively engage in the corporate governance of its portfolio companies;
- (ii) a strategic investor;
- (iii) a professional financial consultant; and
- (iv) a

corporation that is run in accordance with international corporate governance standards. In order to achieve this vision, SCIC will need, besides financial resources, strong human capacity. To operate commercially, SCIC will need to develop a pool of investment professionals with extensive experience in investment portfolio management. Attracting and retaining talent from the private sector will require SCIC to implement modern and commercial human resource policies, including competitive compensation and benefit packages, which can be very challenging for a state organization.

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Most of former planned economies which have gone through the transition to a market economy have faced similar challenges in commercializing their large numbers of SOEs. There are many lessons of both successful and failed attempts from around the world that Vietnam can learn from. The SCIC charter and strategies should be revised to reflect these lessons, adhere to sound corporate governance practice with high transparency and accountability and be compliant with international best practice so that state capital be managed in the most effective and efficient way.

(4) The Prime Minister i) approves the planning and list of key sectors where the State needs to concentrate investment capital and the corporation's plans to make external investment in geographical areas and regions with high political risks; ii) approves large-scale projects with the capital scope exceeding the corporation's investment capacity; and iii) decides on social and public-utility oriented investment projects of the corporation that need the State's financial support.