

Market Discipline of Commercial Banks: Reality in the US and Viet Nam

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Abstract

Market discipline is considered one of the three important pillars in order to remain the stability of banking system. The financial system will work efficiently when the effectiveness of market discipline and the role of market discipline in handling problem banks are controlled and monitored. This article will approach to the aspects of participants involved in the deposits and the loans that their actions have caused turmoil on financial markets. The first part of article will consider carefully the definition of the market discipline and those who will implement the necessary preconditions for effective operation. Then, the article will discuss the indiscipline in the United States during the financial crisis and the undisciplined movement of commercial banks in Vietnam for the period 2008 – 01/2016. Hence, the article will recommend some solutions to increase the discipline in the activities of commercial banks in Vietnam, such as strengthening the leading role of central banks in regulating the economy and the monetary policy to stabilize the general price levels; raising the importance of corporate governance in financial institutions; and finally, ensuring the transparency of information systems.

Keywords: Market discipline, commercial banks, deposit rate and lending rate

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Introduction

While market discipline is a term widely used in the supervision and administration of the bank, and market discipline has not been precisely defined, however, according to Lane (1993), market discipline is “the financial markets show the signals help the borrower to comply with the regulations on solvency”. While presenting "pillar 3" called "Market Discipline", Basel Committee (2003) mentioned directly to the disclosure of information. The extent of the information being related is a necessary condition but not a sufficient condition for the market to operate effectively.

Market discipline has the potential to reinforce minimum capital standards (pillar 1) and the supervisory review process (pillar 2), and so promote safety and soundness in banks and financial systems (Bank for International Settlements (BIS), 2001). Another approach to market discipline in banking is that it is commonly understood as a situation in which private sector agents face costs that are positively related to the risks undertaken by banks and react on the basis of these costs (Berger, 1991).

An approach to a research of Timothy in 1992, market discipline is understood that financial markets provide signals and appropriate constraints caused borrowers to act in accordance with ability to pay. For example, effective market discipline on fiscal policy would help the government avoid increasing the budget deficit which, if continued, will lead to insolvency. Market discipline of financial institutions, such as banks, this means that the organization cannot raise capital from depositors to lend again when the expected return is lower than the cost of capital, and no access to these funds after bankruptcy.

In the respect of Birchler’s research in 2001, market discipline means that the behavior of the borrowers must be sustainable - the borrowers must comply with the regulations and to continue to implement these regulations has occurred despite insolvent or sudden changes policy. Debt, in other words, do not pay indefinitely for loans (Horne, 1988 and Horne, 1991).

Landskroner and Paroush (2008) focused on evaluating the impact of market discipline on the optimal decisions of US banks. These variables selected include the change of risk, the level of deposit insurance and the level of market discipline. In particular, the degree of market discipline is defined and measured by the elasticity of the cost of uninsured deposits to adjust the capital structure according to the risk of bank assets. The results indicate that the competitiveness of the bank increased it will result in less funding by equity, interest rate and risk premiums higher. Satake and Uchida (2009) measured banks’ effective performance to investigate the market discipline by using the data of the Bank of Japan from 2000 to 2005. This study provides that the relationship of banks’ effectiveness and deposits at those banks is proportional. Also, depositors and securities investors or bank’s biggest creditors have the important role in market discipline mechanisms. Another research from 2000 to 2004 of Goday et al. (2005) used data from the privately owned banks to analyze the behavior of depositors before, during and after the crisis in Uruguayan. The authors examined the market discipline of depositors through a change in interest rates, growth in deposits and term deposits. The evidence showed that banks react to the action and market discipline of depositors to be effective, especially after the crisis periods.

Enforcement agencies to ensure market discipline

The main goal of the market discipline strategy is to increase the incentives for stakeholders in the banking enterprise to keep the level of risk being assumed by bank management. The of potential stakeholders appropriate for ensuring the greater discipline on banks includes: (1) depositors; (2) other creditors (such as subordinated debt holders); (3) the market for corporate control; (4) management; (5) private third-party insurers; (6) the government; and (7) shareholders. Many researches in the field of market discipline that conducted by foreign researchers in banking sector showed that the depositors will implement the market discipline (Eric, 1997 and Eduardo et al., 2004). Besides that, the central bank will be the management authority in the field of monetary and banking to ensure that the banking system is working efficiently and avoid the failures systematically.

The major point of the banking sector is to focus on factors' market in general and capital markets in particular. We can debate whether that should be considered deposits as inputs and loans output factor or what form the product on a service is provided, but the focus for market discipline is the raise of capital. In many cases, the functioning of markets in the enterprise management is almost the most important factor to deal with a problem bank. Bankers still retains control until the time of bank bankruptcy (and in the US, the agency has been designated as the recipient of the assets as Federal Deposit Insurance Corporation (FDIC)), although their operating decisions is somewhat limited when the problem tends to worsen.

An important element in any agreement to manage and monitor is the nature, timing and form of intervention by the supervisory authorities in the event of financial crisis on banks (Llewellyn, 2002a). The central issue is whether there should be intervention. Lessons from the bank's crisis in the developed and developing countries show that the need to have a clear strategy to cope with the possible bankruptcy of financial institutions.

In this regard, to consider issues relating to rules versus discretion in the case of banking crisis, it means the level of intervention should be limited by the rules defined (hence the intervention agency has no discretion on whether or not, how and when to intervene), or whether to decide in every situation. Initial advantage for self-determination is not possible to foresee all situations and circumstances in the future as a possible bank crisis and almost (or actually) bankruptcy. It can be appreciated that this is not the right policy to shut down a bank in such circumstances. However, there are strong arguments against this autonomy and consensus with the rules on intervention approach includes the rules of the program of prompt corrective action. First of all, this increases the reliability of the intervention agencies in the markets in which the participants, including banks, have high certainty that the corrective actions will be implemented. Secondly, to allow discretion may increase the delays, often ultimately leads to higher costs when implementing the intervention. Thirdly, along with the autonomy with potential risks related to the operators concerned about the risks that procrastination in the implementation of decisions for fear that this will be considered a failure of management.

The indiscipline of banks in the US

Since 1980, financial markets in the US and around the world have quickly developed the derivatives and expand the securitized loans and investment. Derivatives and securitization has contributed to increase source of finances and diversified-risk, but also led to the prices of bonds and stocks increasingly away from the true value of the collateral. Many of the activities to be covered through speculative activities of hedge funds, a type of investment fund holds nearly 3000 billion US dollars worth of assets but not to property disclosure for the public and almost not subject to the supervision of any public state agency.

In a document published on 06 March 2009, the International Monetary Fund (IMF) has argued that "the main cause of crisis situation is to loose in management the financial system, along with the failure compliance with market rules of the US government in recent times, which specific expression is the subprime loans situation. This demonstrates the indiscipline in business of banks.

Subprime lending is the form of loans commonly, especially in the US in recent years. The term "sub-standard - subprime" here is concerning the status of the borrowers. Under the guidance of the US Treasury in 2001: "The subprime borrowers often have poor credit history often have overdue payments, and may have serious problems such as going to court or bankruptcy. They can also have low liquidity on the index review as credit scores, debt-to-income ratio, or some other criteria". Without a formal document specified in sub-standard borrowers in the US but most borrowers have a credit score lower than 620, accounting for nearly 25% of the US population. Because the borrower's reputation is low and the financial status is not optimistic, so overall the subprime loans have higher interest rates than market rates and this has added to financial difficulties for borrowers, particularly when the market interest rates rise.

In the period 2004-2006, the subprime mortgages accounted for about 21% of the mortgages, increase versus the proportion 9% in the period 1996-2004, which in only 2006, the total value of sub-prime mortgage were increased up to 600 billion US dollars, equal to 1/5 the market value of US home loans. The strong development of the form sub-prime mortgage associated with the explosion of the US housing market is also a result of reduced interest rates to a record low, plus the relaxed lending standards and syndrome "prefer to buy houses" of the American people.

According to the IMF, an issue to be considered is the financial monitoring system of the United States was relatively loose, powerless and too limited scale. This agency said that the system of non-bank financing (shadow banking system) - a network with a high degree of mutual ties, including investment banks, hedge funds and real estate lenders ... was not under the supervision of the strict regulations (for examples, regulations on capital adequacy is usually applied to commercial banks).

Lehman Brothers Bank was 158 years old, bankrupt Monday 15/9/2008. One year previously, this is American fourth-largest bank with the number of employees is more than 26 thousands. After its capital mobilization efforts failed because the US government refused to guarantee Lehman Brothers declared bankruptcy. Total debt of Lehman

Brothers amounted to 768 billion US dollars (including 613 billion US dollars of bank debts and 155 billion dollars of bond debts). The damages that this bank has incurred as a result of making loans to purchase real estate into packets of risky real estate's bonds to provide to the market. When the economy declined, borrowers have not paid for the loans, and then the credit risk was transferred to packages of bond with the credit portfolio of real estate to be collateral assets. The crisis has made the declining of real estate's prices. This causes the decrease in value of collateral of bonds and increase in credit risk. The bankruptcy of Lehman Brothers was the largest bankruptcy in US history, and this collapse had a huge influence on the whole banking system in the US and a threat to the world financial system. That requires an unprecedented effort on the scale of globally governments to suppress the global financial crisis.

In 2010, following the collapse of Lehman Brothers, the turmoil is happening at Goldman Sachs. There was an occurrence of litigation between investors and the bank in the concealing of important information related to these securities is secured by collateral assets. Besides, the US Securities and Exchange Commission (SEC) raised the civil lawsuit to Goldman Sachs Investment Bank because it has not provided to investors the essential information about a financial products related to subprime debts at the time of US housing market began to sway. Goldman Sachs litigation involves a product called a Collateralized Debt Obligation – CDO, synthetic-named is Abacus 2007 AC1, was one of 25 CDO that Goldman Sachs underwrites for two years from 2006 to 2007 with prices worth up to 10.9 billion US dollars. To prevent risks, investors often have to buy "insurance" for the CDOs they own; in the case of CDOs lost value, the insurance company will compensate the loss. Go there appeared a financial product called Credit Default Swap - CDS (or credit swap contract). However the great characteristics of CDS is absolutely not be managed by any authority so any person should also be able to sell this product, which means the insurance for a certain property will not comply with the strict regulations of the insurance industry. Therefore, the bank's activities in the market did not follow the rules or any legal framework.

The indiscipline of commercial banks in Vietnam

Since the financial crisis in the US, the article has discussed the causes of this crisis. On the basis of those review causes, the article will evaluate the indiscipline in the operation of commercial banks in our country from 2008 to 22/01/2016, through the consideration of deposit rates and lending rates at banks in this period.

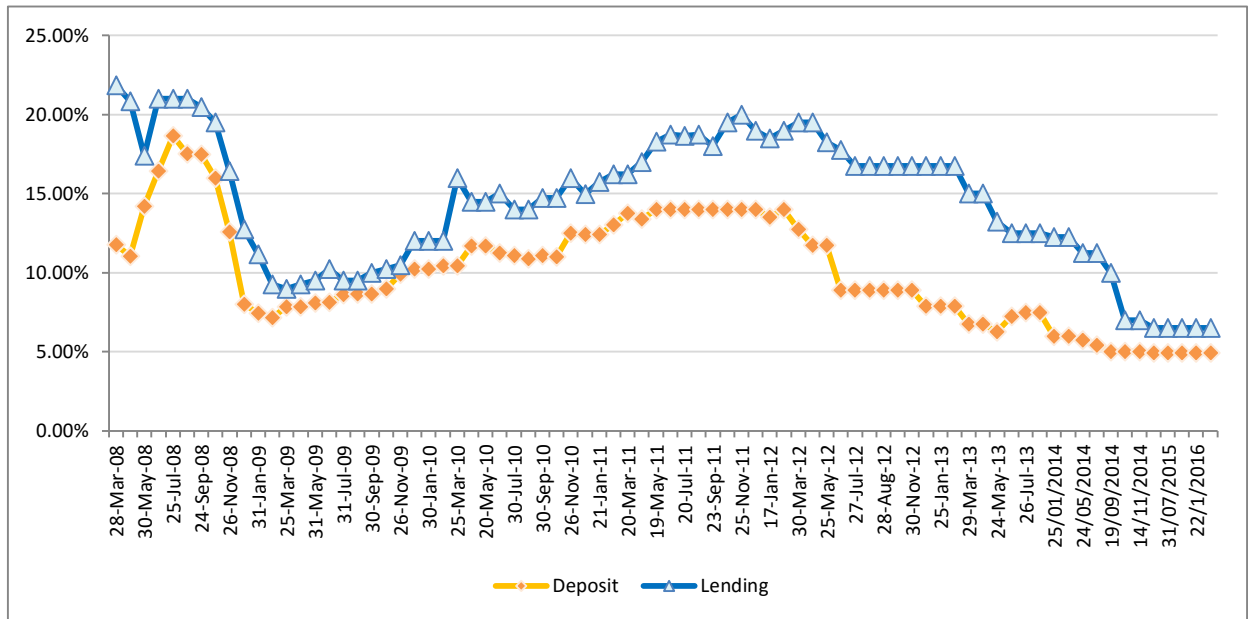


Fig. 1 Average deposit and lending rate of commercial banks for the periods 2008 – 22/01/2016.

Source: The State Bank of Vietnam

Figure 1 shows the fluctuation of deposit and lending rates of commercial banks from 2008 to 2016. Although the State Bank of Vietnam (SBV) has set the ceiling deposit interest rate of 14% at the end of 2010, but in most financial institutions in 2011 had the deposit rates were higher than the ceiling rate. The competition in interest rates and the policies to attract capital between banks were quite fierce. Due to the increase of real deposit rates and the bad debt ratio tended to rise so the commercial banks pushed the lending rates to be higher. Therefore, the lending rate also rose. The difference between the deposit rate and the lending rate were at 4-5% compared to the normal levels of about 3%. This led to most of commercial banks were profitable in 2011 than 2010 despite of the lower credit growth in 2011. However, if the banks had fully provision, banks' profitability could be reduced significantly. Most banks had non-performing loan ratio increased, but the rate of provision for bad debts had the tendency of decreasing. The balance of credit risk provisions at the end of 2011 were 62.81%. In the first half of 2008, interest rate racing phenomenon in banks has created new uncertainties in the currency markets, making it difficult for policy management activities and threatening macroeconomic stability, safety of the banking system, especially the smaller banks. In the first half of 2008 to 2011, the interest rate racing phenomenon in banks made financial markets become unstable, the monetary policies' management were difficult. These issues have threatened the macroeconomic stability, the safety of banking system, especially the small banks.

As shown in the figure above, from 2012 the market discipline has been set up and financial market became more stable compared to the previous years. Because The State Bank has set up operational objectives for the banking sector in the following years and also issued specific regulations/ rules in order to ensure the inflation and capital threshold,

the ceiling deposit rate and lending rate as well as loan classification and provisions can be controlled. The deposit rates and lending rates continued to decline and remained stable over the periods of 2013 and 2014. The table below shows the documents issued by the State Bank related to deposit rates, loans classification and provisions.

Table 1 The documents issued by the State Bank related to deposit rates, loans classification and provisions.

No.	Deposit rates	Loans classification and provisions
1	Circular No. 06/2014/TT-NHNN – 17/03/2014: Providing for the maximum interest rate applicable to USD deposits of organizations, individuals at credit institutions	Decision No. 493/2005/QĐ-NHNN – 22/04/2005: Regulations on classification of debts, and establishment and use of reserves to deal with credit risks in banking operations by credit institutions
2	Circular No. 07/2014/TT-NHNN - 17/03/2014: Providing for the maximum interest rate applicable to VND deposits of organizations, individuals at credit institutions	Decision No. 18/2007/QĐ-NHNN – 25/04/2007: On amendment of and addition to a number of articles of the regulations on classification of debts, and establishment and use of reserves to deal with credit risks in banking operations by credit institutions, issued with decision 493/2005/ QĐ-NHNN of the state bank
3	Decision No. 498/QĐ-NHNN - 17/03/2014: On the maximum interest rate applicable to VND deposits of entities, individuals at credit institutions, foreign bank branches	Circular 02/2013/TT-NHNN – 21/01/2013: Providing on classification of assets, levels and method of setting up of risk provisions, and use of provisions against credit risks in the banking activity of credit institutions, foreign banks’ branches
4	Decision No. 2173/QĐ-NHNN – 28/10/2014: On the maximum interest rate applicable to VND deposits of entities, Individuals at credit institutions, foreign bank branches under the Circular No. 07/2014/TT-NHNN dated 17 March 2014	Circular 09/2014/TT-NHNN – 18/03/2014: On amendment of and addition to a number of articles of Circular 02/2013/TT-NHNN – 21/01/2013
5	Decision No. 2589/QĐ-NHNN - 17/12/2015: On the maximum interest rate applicable to USD deposits of entities, individuals at credit institutions, foreign bank branches under the Circular No. 06/2014/TT-NHNN dated 17 March 2014	Circular 14/2014/TT-NHNN – 20/05/2014: amending and supplementing a number of articles of the Regulation on loan classification, provisioning and use of reserves to handle credit risk in banking operations of credit institutions issued under Decision No. 493/2005/QĐ-NHNN dated 22/04/2005 of the State Bank

Recommendations of policies to enhance market discipline in the business of commercial banks

The article provides some policy suggestions to improve the compliance of discipline in the banking business in Vietnam:

Firstly, monetary policy should be focused on the main objective is to stabilize the general price level. This is also the basic goal that IMF launched on the report about the lessons from the global financial crisis, "the central bank must maintain the stability of the trust for stabilization of prices that they have been before the crisis and this confidence must be protected. The control and analysis of developments and risks of the financial system are able to integrate in real form implementation of monetary policy". Besides the construction of the price policy, State Bank needs to have flexible application of different interest rates' levels in order to better respond to shocks in the economy.

Secondly, strengthen the leading role of central banks in the regulatory role of the economy. This is to increase the management and supervision of State Bank for the national economic and finance system. The central bank has done in terms of the function of management in the field of monetary, credit and banking; just perform the function of "Bank of banks". Therefore, the administration of the central banks will contribute to stabilizing the macro-economic policies and improving the resilience of banking system.

Thirdly, companies in the financial sector need to raise the importance of corporate governance in this area, because these companies play a central role of the savings transshipment and an allocation of capitals in the economy and creation of market discipline. Therefore, State Bank need to support the liquidity of commercial banks with the long-term, large volume than previously, supported by the refinancing, foreign currency swaps and directing commercial banks to play a role dominant in the supply of capital and gradually adjust interest rates in line with economic developments. State Bank also needs to closely coordinate between the interest rate control with the other tools of monetary policy, management of gold and foreign currency markets. In regards to handling bad debts, the government must increase the effectively operation of the Vietnam Asset Management Company (VAMC). In order for it to perform well, VAMC should be given the sufficient conditions and powers, such as specific budget package and time frame to action with bad debts or to recover purchased debts.

Lastly, but certainly not least, for market discipline working, all market participants, such as depositors or lenders, must have access to the right information for their decisions based on financial statements, financial ratios and other related information. This means that both the regulators and the financial institutions must ensure transparency of information systems.

Conclusion

Improving market discipline of banks is a big challenge for many countries in the world. Therefore, finding and implementing solutions to enhance the efficiency of business operations of the bank is the most concern of the government and the operators of monetary policy in both the world and Vietnam. The purposes of the article are to

systematize the basic rationale of market discipline, undisciplined situation of banks in the period of financial crisis in the US and its affect to Vietnam. At the same time, the article presents the government and central banks' regulations to restore the order and discipline of the financial market after the crisis. Finally, the article suggests a number of solutions to enhance market discipline for Vietnamese banking sector.

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