ENSURING EFFICIENCY AND GOOD CORPORATE GOVERNANCE FOR STATE ECONOMIC GROUPS IN VIETNAM

By

Hoang Hong Ly

THESIS

Submitted to

KDI School of Public Policy and Management in
partial fulfillment of the requirements for the degree
of

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ABSTRACT

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Growing along side with state-owned enterprise development, Vietnamese state economic groups (SEGs) have been established by restructuring state general corporations. The government aims to form strong SEGs to become leading players of the whole national economy, which have capability to compete in the global market. However, Vietnamese SEGs expose weaknesses both in massive unrelated diversification and unsound corporate governance currently. What is the right direction to address SEGs' shortcomings and strengthen them to become national champions is a great concern among policy makers and observers. By reviewing theory of corporate governance and diversification motivations, examining the causes of SEGs' current shortcomings, and studying experiences of South Korea and China, this thesis suggests recommendations to ensure efficiency and good corporate governance for SEGs in Vietnam.

Keywords: state economic groups, diversification, corporate governance, Vietnam, Korea, China.

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Table of Contents

LIST OF TABLES

LIST OF FIGURES

LIST OF BOXES

Introduction

Vietnam has already joined several regional and international economic organizations, of which the WTO is the most important in accelerating global economic integration. Once Vietnam integrates deeply into the world economy, Vietnamese enterprises will have to struggle not only in the global market but also at home.

On November 12, 2005, the Vietnamese government approved the establishment of the first state economic group - the Vietnam Coal and Minerals Group (VOVNews, 2006). Since then eleven others have made their debut. Vietnam aims to establish powerful state economic groups (SEGs) that play a key role in the national economy, thereby allowing the government to regulate market flexibility and creating a lever for the whole economy amidst global competition (VOVNews, 2006). However, the establishment of economic groups is new and therefore management of these groups becomes a challenge for the government. This requires policy-makers to grasp all issues of economic groups to secure their foothold in the competitive global market and enhance development of national economy.

Among the current issues surrounding Vietnamese SEGs, diversification is a controversial concern. Besides their main business fields, these economic groups are investing in other fields, especially in unrelated business areas (VietNamNetBridge, 2008). Some observers claim that they must focus on the main business field, while others suggest that they should diversify to enhance their sustainability.

Therefore, the questions that this study seeks to answer are should SEGs pursue diversification, into what business areas they might enter, and how much they should diversify. In this connection, the advantages and risks of unrelated diversification will be investigated. Another question is how to ensure efficient corporate governance of SEGs to improve their performance. In order to answer this, problems in SEGs' corporate governance will be examined.

A good way to realize the objective of establishing powerful economic groups in Vietnam is by reviewing experiences of other countries. China is well-known with its state business groups. Besides, Korea is also famous with its public corporations and family-controlled *Chaebols* which were heavily benefited by the government as its development partners. Therefore, Korea and China are selected countries which can provide many useful lessons in governance and management of business groups.

This study's purpose is to conduct a comprehensive analysis on the current situation of Vietnamese SEGs and make recommendations based on experiences from China and Korea. In more detail, the study will look at the current trends towards diversification and the corporate governance practices of the groups. From the uncovered problems, this study will suggest recommendations to ensure efficiency and good corporate governance for SEGs. In addition, lessons from China and Korea will be extensively utilized, while taking into account the differences between Vietnamese, Korean and Chinese groups in terms of their ownership structure and growth path.

Since the establishment of SEGs is a recent phenomenon, the number of researches on their operation and corporate governance, especially research conducted in English, has not been plentiful. This study will thus be a worthy source to add more information to the literature to support both Vietnamese and international information seekers. The study also provides a reference for the Vietnamese government, decision makers, SEGs, and other concerned parties to have a better understanding of the related situations.

This study is limited to business diversification and corporate governance issues of SEGs, which is the field of interest of the researcher, to make suggestions. However, the real operational business does not consist of only the diversification strategy and therefore broader consideration in the linkage with other issues might be needed to make the best decision for those groups.

The objective of this study is to answer two main concerns: (1) should SEGs diversify and if yes, into what business areas they might enter, and how much should they enter; and (2) how to ensure efficient corporate governance in SEGs. In order to do so, some respects should be clarified: How is the current situation? What are the problems in their diversification and corporate governance? What are the relevant solutions? The structure of this study is organized to deal with those respects in chapter 2, 3, and 4.

In the next sections, the study will provide some general information, as well as a summary of prior related research and describe the methods by which the study is conducted. Chapter 1, then, will show the overview of Vietnamese SEGs. Current situations in diversification and governance of the groups will be discussed in chapter 2. Chapter 3 will focus on existing issues in their diversification and corporate governance. Following this, based on the found issues, chapter 4 will make suggestions to ensure efficiency and good corporate governance for SEGs while taking in to account Korea's and China's experiences. Finally, the study will be closed by the conclusion chapter with the summary of all study.

Literature review

There are various definitions of business groups or economic groups. A business (economic) group is "a group of companies that does business in different markets under a common administrative or financial control" (Leff, 1978), "a cluster of legally distinct firms with a managerial relationship" (Jamesrmaclean, 2005) or "a set of firms, which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action" (Khanna & Rivkin, 2001).

In Korea, according to the Monopoly Regulation and Fair Trade Act of Korea Fair Trade Commission (1990):

> The term "Business Group" pertains to a group of companies whose businesses are substantially controlled by the same person according to the following pursuant to the standards prescribed by the Presidential Decree:
>
> A. The "same person" is a company or a group composed of such person and one or more companies he/she controls.
>
> B. The "same person" is not a company or a group composed of two or more companies he/she controls.

In China, "according to the National Statistics Bureau of China (NSBC), a business group consists of legally independent entities that are partly or wholly owned by a parent firm and registered as affiliated firms of that parent firm" (Ma & Lu, 2005).

In Vietnam, the Law on Enterprise (2005) mentions the concept of business group model as a group of companies which has "the long term relationship in terms of economic interests, technology, market and other business services. Group of companies comprises the following forms: a)Parent company and subsidiaries; b)Economic corporation; c)Other forms". The Decree

139/2007/NĐ-CP[1] detailed some provisions of the Law on Enterprise 2005 and regulated in the article 26:

> An economic group consists of companies with the independent legal person status, which are combined or associated through investment, capital contribution, merger, acquisition, re-organization or other forms of association; bound together on a long-term basis in terms of economic interests, technology, market and other business services, thus formulating a business complex with enterprises organized at two or more levels, operating in the form of parent company-subsidiary company.

Business groups are ubiquitous not only in emerging countries but also in developed ones. BGs are formed mostly by equity ties both of vertical (pyramid control) or horizontal types (cross-shareholding). Business groups operate in various industries from banking and finance to manufacturing and energy. Studying on business groups is important in all countries, especially in developing ones because “there is hardly any economic investigation that can (or should) be carried out without reference to business groups and their impact” (Khanna & Yafeh, 2005).

Many companies start their business with a single product or a single business area to keep resources concentrated on developing the main line. When growing larger and stronger, they might find additional opportunities to add revenue, products, markets and entering in new business areas both related and unrelated to the main beginning line. That is an example of diversification strategy. Diversification “refers to the expansion of an existing firm into another product line or market” (OECD, 1993) or is understood as “a risk-reduction strategy that involves adding product, services, location, customers and markets to companies' portfolio” (Entrepreneur, 2009). Almost all business groups have diversification strategy and since they diversify, they can be called diversified business groups which “typically consist of legally

[1] Decree 139/2007/NĐ-CP dated 05/9/2007, on guiding the implementation of a number of articles of the Enterprise Law

independent firms, operating in multiple markets, which are bound together by persistent formal and informal ties" (Khanna & Yafeh, 2005).

There are two types of diversification, related and unrelated (OECD, 1993). "Related diversification occurs when the firm expands into similar product lines" while "unrelated diversification takes place when the products are very different from each other" (OECD, 1993).

In Vietnam, although SEGs have been newly established from 2005, they have already started to diversify. This has occurred not only in related areas but also in unrelated ones with a lot of investment capital (Cong Thang, 2009). The recent operation of SEGs triggers many controversies among observers. SEGs' current operation is characterized by an excessive investment, jumping into risky and sensitive areas, and lack of concentration on their forte business (Cong Thang, 2009). However, those arguments have stopped at the level of debate on meetings, conferences, or interviews, and have just been published in some articles and a few reports. There are rarely published researches specifying deeply on diversification of SEGs.

Besides investigating diversification issues of Vietnamese SEGs, there is another aspect that should be considered, namely corporate governance. European Central Bank defined corporate governance as "Procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making" (2004). Corporate governance can be seen as the basis for efficiency of a company's activities. It has a significant influence on the operation and performance of companies in which diversification is a part. "Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital" (IFC, 2009).

There are a lot of studies on diversification and corporate governance of business groups worldwide. In Korea, the number of studies on corporate governance and diversification of their business groups - *Chaebols* which are famous for large diversification is plentiful. Bae, Kwon, and Lee (2008) examined the valuation effect of corporate diversification of Korean business groups before and after the 1997 Korean financial crisis; Choi and Cowing (2002) studied the relationships involving corporate diversification, concentration and economic performance for the 25 largest Korean Chaebols over the period 1985–1995. Corporate governance of *Chaebols* is also received numerous attention of scholars, from Chaebols' structure and feature of corporate governance (Isao, 2004), control structure and shareholdingship (Hwang and Seo, 2000) to executive compensation and performance (Kato, Kim & Lee, 2007).

Chinese business groups have been also studied in many aspects of corporate governance and diversification such as the influence of affiliation and market institutions on business groups' performance (Carney, Shapiro & Tang, 2008), the relationship between ownership structure and firm performance and the influence of corporate status on that relation (Yue, Lan & Jiang, 2008), examination of Chinese business groups' performance of 470 publicly listed firms from 1999 to 2004 (Carney, Shapiro & Tang, 2008), investigating the establishment and growth process, diversification strategy, organizational structure of Chinese business groups (Ma & Lu, 2005).

In Vietnam, corporate governance of SEGs and their diversification has not been paid enough attention. Few studies related to this area have been published. Researchers only can get vague information on SEGs in minority of online newspapers or reports. Therefore, this study aims to contribute to the treasury of general knowledge, and assist researchers in finding information of economic groups in Vietnam especially in terms of their diversification and corporate governance.

Methodology

This chapter demonstrates methods utilized to answer the research questions. It presents the type of research and research design as well as clarifies the chosen sample of economic groups in Vietnam. Collecting and analyzing data and information are presented, followed by the discussion of validity and reliability of research.

Type of research

The research is mainly qualitative, aiming to explore the current situation and issues, then suggesting recommendations for improvement. Additionally, the research also utilizes some quantitative data to provide solid numbers relating to the operation of economic groups.

Research design

This study is designed in the form of both descriptive and exploratory research. This research design allows the researcher to explore the practices of SEGs' diversification and corporate governance, and what SEGs should do. The study thus generates basic knowledge, clarifies relevant issues, and examines associate responsibilities and relationships among stakeholders.

Research methods

The utilized research methods include a thorough literature search, policy analysis and comparative analysis. By the literature search method, the researcher looked at related studies, reports, published statistics, articles, and journals to understand the actual situation of SEGs as well as the experience of economic groups in Korea and China. Furthermore, policy and comparative analysis is also applied by investigating governmental documents and policies on economic groups of Vietnam, Korea, and China, then comparing the circumstance of each country to synthesize solutions for the diversification and corporate governance of SEGs.

Focus sample

There are both private and state economic groups in Vietnam. However, the thesis focuses on state owned economic groups. Until now, Vietnam has established twelve state economic groups, eleven of which are fully state-owned and one is partly owned by the state, and the researcher has chosen all of them to conduct the thesis.

Data collection and analysis

This study gathered information and data by finding the official documents of the governments and analyzing relevant studies, reports, books, articles, and other materials from lectures and conferences. Current policy information and operational data are sourced from laws, governmental decrees and regulations, publications of Ministry of Planning and Investment, Central Institute for Economic Management (CIEM), Academy of Finance, National Center for Socio-Economic Information and Forecast (NCEIF), and State Capital Investment Corporation (SCIC), etc. Information is also collected from Internet websites (e.g. Vietnamnetbridge, VOVNew) to find out the objective ideals of specialists and citizens apart from the government's view. Materials from Korea and China such as State-owned Asset Supervision (SASAC), Administration Commission of China, The Federation of Korean Industries (FKI), Korea Economic Research Institute (KERI), etc are used to review experiences of those countries. Furthermore, the study also uses information from reputable international journals (e.g. International Journal of Entrepreneurship and Innovation Management, Journal of Corporate Finance, SERIQuaterly…) to investigate academic literature.

From the selected literature, the thesis examined purpose of establishment, functions, designated missions, current diversification and corporate governance to analyze current situation of SEGs. Also, numerable information of experience from Chinese and Korean business groups is collected to get appropriate solutions for Vietnam.

Validity and reliability

This research uses official government documents to express situation in Vietnam. The thesis also explores studies done by think-tank organizations in Vietnam, China, and Korea such as NCEIF, CIEM, FKI, KERI, SASAC and academic institutions such as the Vietnam Academy of Finance and KDI School to evaluate the current situation of and get lessons for SEGs. This improves the credibility for the sources of research and provides the benchmark for observation and analysis.

Based on the mentioned sample, methods, and process of collecting and analyzing information, this thesis will fulfill the purpose of conducting a comprehensive analysis on SEGs and making recommendations based on experiences of Korea and China to ensure efficient diversification and good corporate governance for Vietnamese SEGs.

Chapter 1: Overview of state economic groups in Vietnam

1.1. Establishment of Vietnamese state economic groups (SEGs)

The SEGs' formation has gone alongside with the formation and development of state owned enterprises (SOEs) in Vietnam. Before 1990, state cooperatives and SOEs occupied the life-line and controlled all operation of the Vietnam's economy. However, operating in the planned economic mechanism, these state enterprises became governmental administrative organizations. The government began to reorganize SOEs with some pilot projects in 1990-1991.

Through the SOE reform process, Prime Minister promulgated Decisions 91/TTg [2] in 1994 to establish state general corporations from reorganizing existed SOEs, namely general corporations 91[3]. Those state general corporations were formed from selected large scale SOEs which "have important role in the national economy, are able to ensure necessary requirement for domestic market, and have prospect to develop and penetrate foreign markets" (Decision 91, 1994). They operated in certain strategically important sectors such as electricity, gasoline, coal and mineral, post and telecommunication, textile, shipbuilding, steel, air line, cement, chemical, paper, tobacco, food. In 2004, there were eighteen general corporations 91 with 487 members (Academy of Finance, 2009). These general corporations hold and control many key areas of the economy. Therefore, they play an important role in the country's economic growth and were identified as an important tool to monitor the whole economy and society.

[2] Decision 91/TTg dated 7 March 1994 on pilot establishment of economic groups. However, because economic groups were a new model in Vietnam at that time so those established enterprises under Decision 91 were not yet called economic groups, but general corporations 91. Until 2005, those general corporations 91 started to be reorganized to become economic groups.
[3] GCs 91 were established by Prime Minister's office. GCs 91 need at least 7 company members. Moreover, GCs 91 need to have book equity of at least VND 1 trillion and 7 to 9 members in the board.

Although the idea of establishing economic groups had been conceived in the Decision 91, only at the 3rd plenum of Communist Party Central Committee in August 2001, economic group establishment was discussed in detail. The resolution of the plenum emphasized on restructuring SOEs and forming economic groups (Vietnam embassy, 2001). To deploy the resolution, the government has been establishing SEGs by reforming general corporations 91. The first SEG - the Vietnam Coal and Minerals Group made its debut in Hanoi on November 12, 2005.

Until January 2010, there are 12 economic groups established by the Prime Minister namely; VNPT, Vinacomin, Petro VN, EVN, Vinashin, Vinatex, VRG, BaoViet, Viettel, Vinachem, HUD Holdings, and Songda. Table 1 shows the list of SEGs in Vietnam. The SEGs are organized according to the "parent and subsidiary" model, where the parent companies are fully state-owned. Only Baoviet group has a special mother company which is established as a joint-stock company in which the state holds a majority of shares. Those SEGs are under the supervision of Prime Minister except for Baoviet group which is under Ministry of Finance and Viettel group which is under Ministry of Defence.[4]

Table 1: State economic groups in Vietnam

Group Name	Mother Company (or Holding Company)	Ownership Structure of Mother Company	Supervising Government Agency	Establishment date
Electricity of Vietnam Group (EVN)	Electricity of Vietnam www.evn.com.vn	100% state capital	Prime Minister's Office	17 Dec, 2006
Vietnam National Oil and Gas Group (Petro VN)	Petro Vietnam www.pvn.vn	100% state capital	Prime Minister's Office	29 Aug 2006
Vietnam Coal and Mineral Industries Group (Vinacomin)	Vietnam National Coal and Mineral Industries www.vinacomin.vn	100% state capital	Prime Minister's Office	12 Nov 2005
Vietnam Post and Telecommunications	Vietnam Post and Telecommunication Corp.	100% state capital	Prime Minister's Office	26 March 2006

[4] It is because Viettel group is restructured from the army telecommunication corporation – Viettel Corporation which is under Ministry of Defence.

Group (VNPT)	www.vnpt.com.vn			
Vietnam Shipbuilding Industrial Group (Vinashin)	Vietnam Shipbuilding Industry Corp. www.vinashinship.com.vn	100% state capital	Prime Minister's Office	23 May 2009
Vietnam Textile and Garment Group (Vinatex)	Vietnam National Textile and Garment Corp. (Vinatex) www.vinatex.com.vn	100% state capital	Prime Minister's Office	6 Dec 2005
Vietnam Rubber Group (VRG)	Vietnam Rubber Corp. www.vnrubbergroup.eu	100% state capital	Prime Minister's Office	30 Oct 2006
Bao Viet Group	Bao Viet Holdings www.baoviet.com.vn	77.54% (government), 10% (foreign), domestic (3.56%), employees (0.81%), insurance agencies (0.12%), others (7.97%)	Ministry of Finance	15 Oct 2007
Viettel group	Viettel http://www.viettel.com.vn/	100% state capital	Ministry of Defence	12 Jan 2010
Vietnam National Chemical group (Vinachem)	Vietnam chemical Corp. http://www.vinachem.com.vn/	100% state capital	Prime Minister's Office	23 Dec 2009
Housing and Urban Development (HUD Group)	HUD Corp. http://www.hud.com.vn/	100% state capital	Prime Minister's Office	12 Jan 2010
Songda Group	Songda Corp. http://www.songda.com.vn	100% state capital	Prime Minister's Office	12 Jan 2010

Source: Vietnamese government portal and websites of economic groups

The government is still reforming SOEs according to the parent-subsidiary model and plans to establish more SEGs. According to CIEM (2009), some corporations in shipping (Vinalines), railways, tobacco (Vinataba), and cement areas have been assigned to be restructured into economic groups. Some other large-scale enterprises in banking sector such as Bank for Foreign Trade (Vietcombank), Bank for Investment and Development (BIDV), Bank for Industry and Trade (VietinBank), and Mekong Housing Bank (MHB), are expected to be reorganized and shifted to economic groups through a process of full equitization which is similar to the case of Baoviet Insurance Group.

The SEG formation in the economic development process of Vietnam shows their unique characteristic. The establishment of all existing economic groups has resulted from administrative management decisions of the government basing on the SOE reform, not from the initiatives and capabilities of companies by themselves. It also means that Vietnamese SEGs are different from business groups in other countries. They are not set up by the process of agglomeration, capital concentration, or merger and acquisition.

1.2. Purpose of the establishment and functions of Vietnamese SEGs

The establishment of SEGs is one of the most important government policies in Vietnam. The purpose of establishing SEGs is to promote capital agglomeration and economies of scale, push up SOE reform, improve the efficiency of large scale SOEs in strategically important sectors, strengthen their ability to penetrate the global market, and enhance efficiency of the whole economy.

The first government document on establishment of economic groups, the Decision 91 in 1994, stated the purpose of forming SEGs is "to promote agglomeration and concentration, enhance competitive capability, gradually abolish administrative management, strengthen state management over all enterprises, and improve the economy's efficiency". The decree 101/2009/ND-CP on piloting the establishment, organization, operation and management of SEGs in 2009, then, reinforce the purpose of SEG establishment: to form economic groups "in key sectors or industries which need to be developed, improve groups' competitive capability and ability to penetrate global market".

With the goal of forming industrial leaders for the whole economy, SEGs have following functions (Decree 101/2009/ND-CP):

- To ensure the great economic balances of the economy, apply high technologies, and create development motivations for other fields and the whole economy.
- To promote linkage within the value chain and develop other economic sectors.
- To strengthen effective management and supervision of state capital and assets invested in groups' members.

1.3. Current business environment of SEGs with global competition

After the “Doi Moi” policy in 1986, Vietnam has observed the dramatic change in both the economy and society. Now, Vietnam is in the progress of global economic integration. “Vietnam signed an economic and trade cooperation agreement with the EU in 1992, joined ASEAN in 1995, AFTA in 1996 and APEC in 1998. Vietnam also signed the Bilateral Trade Agreement with the United States in 2000” (MOFA, 2007). The biggest economic event for Vietnamese was on 11 January 2007 when Vietnam joined the WTO and took the organization’s membership to 150 (WTO, 2007).

According to Minister of Trade - Truong Dinh Tuyen, “by 2015, most commodities imported to Vietnam will have duties ranging from 0 to 5%” (VOVNews, 2006). Once Vietnam integrates deeply into the world, all economic entities, particularly the SEGs, which serve as the leading force of Vietnam’s economy, will have to struggle not only in the global market but also at home.

In order to secure firms’ foothold, SEGs should increase their competitive capacity. “The fact is that while Vietnamese trademarks have not established a firm foothold overseas, the prestigious trademarks of big international groups are dominating the country” (VOVNews, 2006). As a result, domestic SEGs are very vulnerable compared to other global economic groups. Therefore, SEGs should make every effort for their survival and growth in the intensified competition of the integration process. “They should also consider the interests of millions of Vietnamese people who desire to generate and enjoy the fruits of socio-economic development” (Chi Lan, 2006, cited in VOVNews). By doing so, the dream of Vietnam to establish powerful economic groups can be achieved.

<u>Chapter 2:</u> Current diversification and governance of state economic groups in Vietnam.

2.1. Diversification pattern of State economic groups (SEGs)

As of January 2010, Vietnam has twelve SEGs which are assigned to corresponding main businesses including post-telecommunication-information technology (VNPT and Viettel [5]), ship building and repairing (Vinashin), electricity production-distribution-trading (EVN), gasoline exploration-exploitation-processing-distribution (PetroVN), coal and mineral exploration-exploitation-processing-distribution (Vinacomin), textile and garment (Vinatex), rubber growing-exploitation-processing (VRG), insurance business (Baoviet), construction and construction material manufacturing (Songda), basic-phamarceutical-consumption chemical manufacturing (Vinachem), and house and real estate (HUD).

Besides the main business, most SEGs diversify to other unrelated business fields such as securities, insurance, banking, real estate, telecommunication, cement, transportation, tourism, and labor export. In this expansion pattern, diversification is pursued in two ways. The first one is that the mother company makes a direct investment or capital contribution to establish new companies in new business fields. The second one is when the subsidiaries invest or contribute capital to other companies in unrelated business (MPI Vietnamese delegation, 2009).

It seems that all SEGs aggressively jump into other business fields, especially "fashionable areas" such as banking, securities, and real estate. This was illustrated in VietNamNetBridge, 2008: "The Prime Minister on October 30, 2006 signed the decision

[5] Viettel group only operates in telecommunication and information technology fields.

approving the project on establishing the Vietnam Rubber Group (VRG). Just one month later, November 14, 2006, VRG decided to set up the VRG's Securities Company, of which VRG's Finance Company contributed 51% of the chartered capital (VND20.4bil)". However, "the appearance of a securities company under a rubber group did not surprise anyone, as the market at that time also saw the establishment of the securities company under PetroVietnam…, ship building group… The EVN group is also one of the groups which has been pioneering in making investments in banking and securities" (VietNamNetBridge, 2008). In addition, the real estate field is not under-explored. Real estate developers and citizens as a whole have been familiar with such names as Vinatex Land (24 Dec 2007), Vinacomin Land (13 Nov 2007), or Petro Land (29 Oct 2007) which were formed correspondingly by Vinatex, Vinacomin, and Petro VN. More than that, there are also a number of finance companies under SEGs. Some of them were SOEs established by the government then being reorganized to be subsidiaries of SEGs and some of them have been newly formed by SEGs. Such names as Petro VN Finance, EVN Finance, VN Shipbuilding Finance, Rubber Finance, Mineral & Coal Finance, Post & telecommunication Finance are well-known in the finance sector. Through the time, the number of SEGs' subsidiaries in such finance, securities, banking areas has become abundant. Appendix 1 lists some SEG's unrelated subsidiaries which operate in finance, banking, and real estate areas.

2.2. Corporate governance of Vietnamese SEGs

Vietnamese SEGs' formation is based on the restructuring of state general corporations "91" and the development of a group of state-owned companies toward the "mother-subsidiary" model in which one hundred percent of the mother company's charter capital or the majority of its shares is owned by the government. Until the end of 2009, the government issued Decree

153/2004/ND-CP[6], Decree 111/2007/ND-CP[7], and Decree 101/2009/ND-CP[8] to regulate the restructuring, establishment, organization and management of SEGs.

2.2.1. Organizational and ownership structure of SEGs

The Vietnamese government orients the establishment of SEGs basing on the restructuring of general corporations 91 toward "holding company structure" which is called "mother-subsidiary model" in Vietnam. Usually, circular shareholding (cross shareholding) structure and holding company structure are the two forms of business groups' organizational and ownership structure. Compared to the circular shareholding structure, the later can bring some benefits for business groups to enhance their management function:

- Holding company structure increases transparency for the whole group's organizational and ownership structure. Thus, it can increase the speed of the group's management decision making, make the holding company easier to oversee the entire group, allow advantages in financial planning, and help governmental agencies and investors easier to supervise and access groups' information.
- Holding company structure provides a more appropriate distribution of responsibilities across management levels between the holding company and subsidiaries. It centralizes specific management functions within the holding company (developing the group's strategies, allocating capital among groups' subsidiaries, coordinating subsidiaries…), which enables the group to accommodate subsidiaries more efficiently under one roof. At

[6] Decree 153/2004/ND-CP dated 9th August 2004 on organization, management of State General Corporations and transformation of SGCs and independent state companies according to the model of "parent and subsidiary company".
[7] Decree 111/2007/ND-CP dated 26th June 2007 on the organization and management of state corporations and the transformation of state corporations, independent state companies and parent companies being state companies into ones operating after the parent-subsidiary company model under the Enterprise Law.
[8] Decree 101/2009/ND-CP dated 5th November 2009 on piloting the establishment, organization, operation and management of state economic groups.

the same time, holding company structure still ensures operation flexibility for each subsidiary as it allows decentralized management in which "each subsidiary retains its own management team, and … become responsible to the parent company on a profit and loss basis" (referenceforbusiness, 2010).

According to the Article 4 of Decree 101/2009/ND-CP, the organizational and ownership structure of SEGs is constructed under "mother-subsidiary" model which comprises:

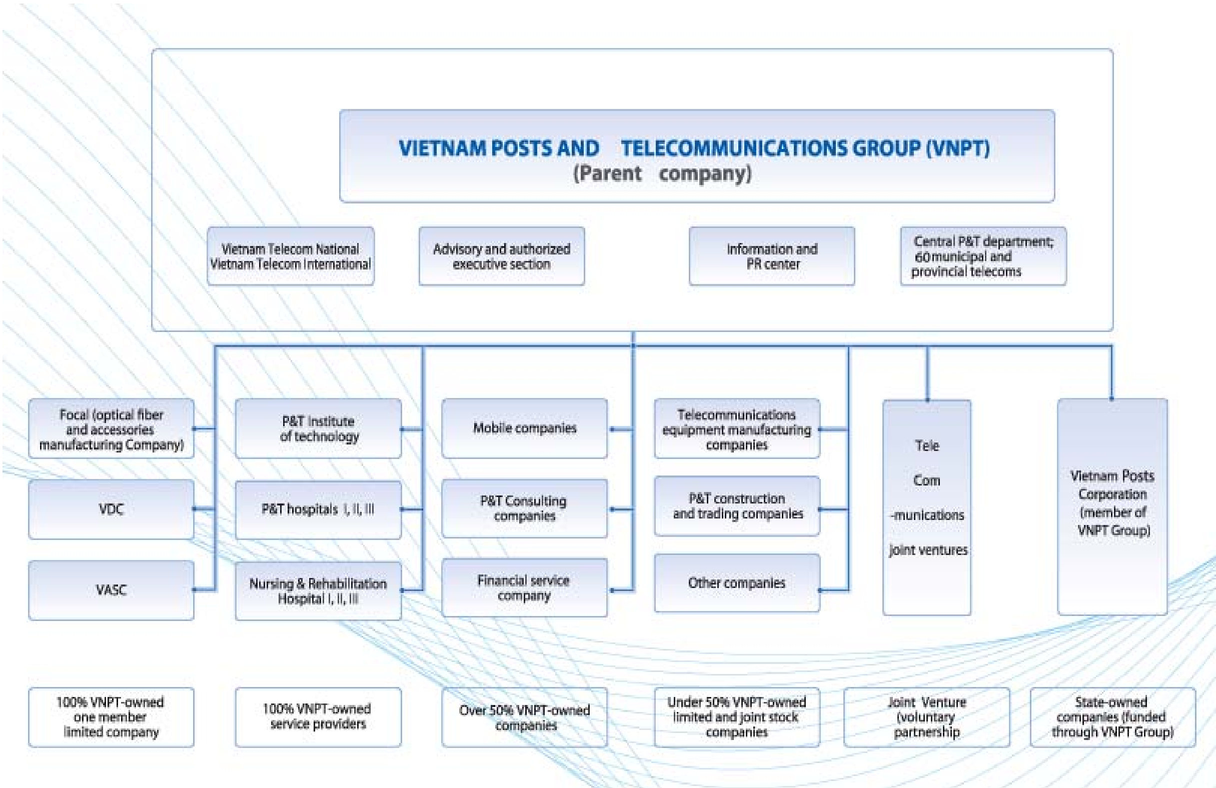
a) Parent companies (referred to as grade-I enterprises) which are enterprises whose charter capital is wholly owned or controlling right is held by the State under the Prime Minister's decision;
b) Affiliate companies of grade-I enterprises (referred to as grade-II enterprises) which are enterprises whose controlling right is held by grade-I enterprises and organized as joint-stock companies, one-member or two-plus-member limited liability companies, corporations after the parent-affiliate company model, joint-venture companies, or overseas subsidiaries;
c) Affiliate companies of grade-II enterprises and lower-grade enterprises.
d) Associated enterprises of the group, including enterprises in which capital contribution portions of parent companies and affiliate companies are below the controlling level; enterprises without contributed capital of parent companies and affiliate companies which voluntarily join the association, whether under association contracts or not.

Based on the regulation, Vietnamese SEGs' structure consists of mother company (grade I), subsidiaries (grade II, III…) whose majority or minority of capital is held by the mother company or lower grade subsidiaries, and associated companies which voluntarily join the group without capital contribution of mother company and subsidiaries.

Managerial organization structure of the mother company is regulated in the Article 20 of Decree 101/2009/ND-CP: "A parent company has its Board of Directors, director general, Control Board and assistant apparatus".

The chart below is an example of the organizational and ownership structure of VNPT. Standing in the highest position is the mother (parent) company which is owned 100% by the government. Subsidiaries are in various forms such as state-owned, joint-stock, joint venture, and limited liability companies which are owned 100%, more than 50%, or less than 50% by VNPT.

Figure 1: The organizational and ownership structure of VNPT



Source: VNPT website 2009, http://www.vnpt.com.vn/en-US/About-VNPT/Organization-Structure/vnpt.html

In the past, the relation between the government, general corporations (GCs), and subsidiaries was heavily based on administrative, subsidized, and "asking-giving" mechanisms. The government allotted capital to GCs, then GCs allotted to subsidiaries with little concern on effectiveness. In addition, the GCs were overwhelmed by the job of managing, monitoring, and supervising all subsidiaries, which led to inefficient operation.

However, with the new structure of "mother-subsidiary" model, the government invests in the mother company and the mother company invests in subsidiaries and other enterprises

(NCSEIF, 2007). Subsidiaries have the right to invest in other member companies except the holding company (Decree 101/2009/ND-CP). The mother company also shifts its monitoring mechanism on subsidiaries from administrative monitoring to monitoring of business operation through its investment. Such kinds of transaction as selling, buying, lending, borrowing, and renting between the mother company and subsidiaries must be based on contracts.

2.2.2. Corporate Governance of SEGs

Government's supervision on SEGs

According to the Decree 132/2005/ND-CP [9] on performing rights and duties of state owner in SOEs, the Decree 86/2006/ND-CP [10] for amendment, and the Decree 101/2009/ND-CP, the Prime Minister is responsible for ten SEGs including EVN, PetroVN, Vinacomin, VNPT, Vinashin, Vinatex, VRG, Vinachem, HUD, and Songda; the Ministry of Finance is responsible for Baoviet Group, and the Ministry of Defense is responsible for Viettel group.

The Decree 132, Decree 86 and especially the Decree 101/2009/ND-CP clarify management and supervision of SEGs. Assignment of tasks and decentralization of powers to exercise the state owner's rights towards parent companies of SEGs is regulated in the Article 40 of Decree 101:

1. *The Prime Minister (PM) shall:*
- Decide on establishment of parent companies; decide on reorganization, dissolution or ownership transformation of parent companies at the request of line ministries and based on opinions of the Ministry of Finance (MOF) and the Ministry of Planning and Investment (MPI);

[9] Decree 132/2005/ND-CP dated 20th October 2005 on exercise of rights and performance of obligations of the state-owner to State Companies.
[10] Decree 86/2006/ND-CP dated 21st August 2006 on Amending and supplementing a number of articles of the Government's Decree no. 132/2005/ND-CP of October 20, 2005, on exercise of rights and performance of obligations of the state owner to state companies

- Approve objectives, strategies, long-term plans and business lines of parent companies at the request of their BODs and based on opinions of line ministries, the MOF and the MPI;
- Approve charters of parent companies and amendments and supplements thereto at the request of their BODs and based on opinions of line ministries, MOF and MPI;
- Decide on capital investment for the formation of charter capital of parent companies and adjustment of charter capital in the course of their operation at the request of their BODs and based on opinions of line ministries, the MOF and the MPI;
- Decide on investment projects of parent companies and outward investment projects which fall under the Prime Minister's deciding competence;
- Decide on appointment, re-appointment, dismissal, removal from office, commendation and disciplining of chairpersons and members of BODs of parent companies at the request of line ministries and according to verification by the Ministry of Home Affairs;
- Permit the BODs to decide on appointment, re-appointment or dismissal of CEO or enter into labor contracts with, commend or discipline CEO at the request of the BODs and upon verification by line ministries

2. *Line ministries shall:*

- Propose to the PM for decision the establishment, reorganization, dissolution or ownership transformation of parent companies; the appointment, re-appointment, dismissal, removal from office, commendation and disciplining of chairpersons of the BODs of parent companies;
- Give their opinions on charters of parent companies or amendments and supplements thereto; appointment, re-appointment, dismissal, commendation or disciplining of. and entry into labor contracts with CEO, before the PM approves them: or on objectives, strategies, long-term plans, business lines, charter capital and adjusted charter capital of parent companies before the PM decides on them;
- Direct the implementation and realization of objectives, strategies and long-term plans of parent companies and the inspection thereof;
- Take responsibility for the observance of processes, procedures, standards, qualities and capacity of members of the BODs and CEO of parent companies before proposing them to the PM for appointment.

3. *The Ministry of Finance shall:*

- Give its opinions, before the PM considers and decides, on the establishment, reorganization, dissolution and ownership transformation of parent companies: approval of charters of parent companies and amendments and supplements thereto; capital investment for the formation of charter capital and adjustment of charter capital in the course of operation of parent companies;
- Fully invest in charter capital of parent companies under the PM's decisions;
- Approve financial management regulations of parent companies at the request of the BODs of parent companies, unless otherwise prescribed by the Government.

5. *The Ministry of Planning and Investment shall:* give its opinions before the PM considers and decides, on the establishment, reorganization, dissolution and ownership transformation of parent companies; objectives, strategies, long-term plans and business lines of parent companies; approval of the charter capital of parent companies; approval of amendments and supplements to the charter capital of parent

companies; capital investment for the formation of charter capital and adjustment of charter capital in the course of operation of parent companies.

6. The Ministry of Home Affairs shall:

- Assess the observance of processes, procedures, standards and conditions for appointment, re-appointment, dismissal, commendation and disciplining of chairpersons and members of BODs as proposed by line ministries to the PM.
- Guide the order and procedures for appointment, re-appointment, dismissal, removal from office, commendation and disciplining of chairpersons and members of BODs, CEO, deputy directors general or deputy directors, chief accountants and other key managerial posts of parent companies.

7. The BODs of parent companies may be authorized by the PM to exercise the rights and perform the obligations of the state owner towards parent companies and state-invested capital in state economic groups…

The Article 42 of Decree 101 regulates on assignment of tasks to perform supervision on SEGs:

a/ *The Ministry of Finance* shall supervise and assess financial operations, business results and effectiveness of the parent company and the entire group; supervision of issuance of stocks, increase in the charter capital of the parent company and member enterprises: expenses for salary payment; supervision of borrowing of loans for investment in financial, banking, real estate and securities areas; supervise the movement of capital, investment and resources within the group and from the group to the outside or vice versa: and monitor consolidated financial statements of the groups;
b/ *The Ministry of Labor War Invalids and Social Affairs* shall supervise SEGs in implementing regulations on the average salary increase rate which is lower than the labor productivity increase rate;
c/ *Line ministries* shall supervise investment portfolios, main and related business lines: assess the structure of main and related business lines; oversee leading management personnel of parent companies; assess the capability to satisfy demands for leading management personnel for main and related business lines;
d/ *The Ministry of Planning and Investment* shall monitor and supervise the implementation of schemes on establishment of SEGs; supervise parent companies in establishing new enterprises, contributing capital to other enterprises in risky sectors, industries, geographical areas and projects; supervise and assess the performance of the state owner's function towards parent companies in SEGs; assess results of implementation of these schemes; analyze advantages and risks of development of SEGs: supervise and assess the implementation of development strategies of SEGs;
e/ Other supervision jobs not specified at Points a. b, c and d of this Clause shall be performed by the Government or the Prime Minister or agencies and organizations authorized by the Government or the Prime Minister.

Board of Directors (BODs) in the mother company

According to the Article 21 of Decree 101/2009/ND-CP, the BODs is "a body directly representing the state owner in a parent company, exercising the rights and performing the obligations of the owner towards enterprises whose charter capital is wholly invested by the parent company and to the parent company's capital contributions to other enterprises". The BODs is composed of between 5 and 9 members appointed, reappointed, dismissed or replaced, commended, rewarded or disciplined by the Prime Minister at the request of line ministers. The term of office of a member of BODs is 5 years. Members of BODs may be reappointed. The Prime Minister shall decide on the membership and number of full-time or part-time members of the BODs of each SEG.

According to Dr. Tran Tien Cuong – CIEM (2009) there are two types of members of BODs: people from the group and governmental officers. In PetroVN, there are two representatives from Ministry of Finance (Mr.Tran Xuan Ha – Vice minister) and Ministry of Industry and Trade (Mr. Bui Xuan Khu – Vice minister) being members of BODs (PetroVN website, 2010). In other groups, BODs' members are all people from the groups.

Although the Decree 101/2009/ND-CP regulates "the chairman of the BODs may not concurrently work as director general of the parent company", Mr. Pham Thanh Binh in Vinashin holds two positions of BODs' chairman and CEO at the same time (Vinashin website, 2010). Dr.Cuong-CIEM explains that in most of SEGs, there exists the distinction between the chairman of BODs and the general director (CEO), except for the Vinashin with the pilot model of which the chairman of BODs also hold the position of CEO (2009).

Responsibilities of BODs are regulated in the Article 22 of Decree 101/2009/ND-CP:

- To elaborate and submit to the Prime Minister for approval and organize the impleme ntation of, the parent company's strategies and long-term plans; to decide on the paren t company's annual plans after obtaining the line ministry's comments; to decide on st rategies, long-term plans and business lines of affiliate companies whose charter capit al is wholly owned by the parent company.

- To decide on investment projects included in the SEG's development planning and long-term plans already approved by the PM; to authorize the parent company's director general or representatives of the parent company's capital portions in other enterprises to decide on investment in projects included in plans it has approved.
- To decide on projects on investment in. contribution of capital to. or purchase of shares from other companies, and on sale, under law. of the parent company's assets which are valued up to 50% of the remaining total asset value stated in the parent company's latest financial statement.
- To decide on borrowing, lending, hire or lease contracts and other economic contracts of a value exceeding the parent company's charter capital under law.
- To decide on appointment, re-appointment, dismissal, commendation, disciplining of or entry into or termination of labor contracts with, the director general after obtaining the Prime Minister's approval…
- To decide on appointment, re-appointment, dismissal, commendation, disciplining of members of Members' Councils or presidents or controllers of one-member Ltd. companies whose charter capital is wholly held by the parent company; to approve proposals of Members' Councils or presidents of one-member Ltd. companies on appointment, re-appointment, dismissal, commendation, disciplining of these companies' directors general or directors.
- To adopt plans on use of after-tax profits or offsetting of losses in the course of business operation proposed by the director general in compliance with the parent company's financial management regulation.
- To inspect and supervise the director general, deputy directors general, directors of attached units
- To inspect and supervise the Members' Council or presidents and controllers of one-member Ltd. companies whose charter capital is wholly held by the parent company, representatives of the parent company's capital contributions in other enterprises
- To exercise the rights and perform the obligations of the owner or owner of shares in affiliate companies.
- To adopt the following for the CEO’s decision: Guarantee for each loan of an affiliate company which is bigger than the charter capital of this company; Contribution of capital for establishing new joint-stock companies or Ltd. companies with two or more members; Hire or lease contracts, borrowing or provision of loans bigger than the charter capital of affiliate companies wholly held by the parent company…

Control Board (CB) of a mother company

SEGs (and some certain corporations) must have a Control Board (also known as the Inspection Committee) that supervises the CEO and assistant apparatus.[11] The Article 26 of Decree 101/2009/ND-CP regulates Control Board (CB) of the mother company:

> 1. The CB shall be set up by the BODs and composed of between 3 and 5 members, with its head being a member of the BODs and assigned by the latter. Other members of the CB shall be selected, appointed, re-appointed or dismissed by the BODs.[12] The chairman of the BODs or the CEO may not concurrently act as head of the CB.
> 2. The term of office of a member of the CB is 5 years. Members of the CB may be re-appointed and are entitled to salaries, bonuses or allowances decided by the BODs
> 3. The CB shall operate under a regulation approved by the BODs, and has the following tasks, powers and responsibilities:
> a) To inspect and supervise the lawfulness and truthfulness of the management and administration of business operations, recording of accounting books and financial statements, and observance of the parent company's charter, the BODs' resolutions and decisions, and decisions of the chairman of the BODs concerning the parent company and affiliate companies; to take responsibility before the BODs for the exercise of its vested rights and assigned tasks;
> b) To perform tasks assigned by the BODs, report on inspection and supervision results to the BODs on a monthly, quarterly and annual basis and on a case-by-case basis; to promptly detect and report to the BODs on abnormal activities against corporate governance regulations or elements of illegal acts committed within the parent company and affiliate companies whose charter capital in wholly invested by the parent company;
> c) To refrain from disclosing inspection and supervision results before obtaining the permission of the BODs; to take responsibility before the BODs and law for its acts of tolerating or covering up violations.
> 4. A member of the CB must fully satisfy the following criteria and conditions:
> a) Permanently residing in Vietnam:
> b) Being physically fit, honest and upright, and having good ethical quality and a good sense of law observance;
> c) Possessing a university or higher degree and being an expert in the accounting, audit, economics or finance domain or having professional expertise relevant to the parent company's business lines; being knowledgeable about law; having a service seniority of at least 5 years in the said domain; having no previous conviction or criminal charge for economic crimes;
> d) Being not a spouse, child, parent or blood sibling of a member of the BODs, the CEO, the chief account or cashier of the parent company;
> e) Working on a full-time basis and not concurrently holding a leading post in the state apparatus.

[11] The Enterprises Law of 2005 requires that a Control Board must be established when a shareholding company has more than 11 individual shareholders or one (or more) organization shareholder(s) holding more than 50 % of the equity capital.

[12] For the members of the Control Board, the Law of Enterprise 2005 regulates that "more than half of the CB must reside in VN, and at least one member is an accountant or auditor" and "members of the CB may not hold the managerial positions in the company; shall not necessarily be shareholders or employees of the company".

CEO (General Director) of the mother company

The Article 27 of Decree 101/2009/ND-CP regulates about CEO of a parent company:

1. The CEO is the at-law representative of the parent company, unless otherwise decided by the Prime Minister at the request of the BODs; administers the parent company's day-to-day operation according to its objectives and plans and the BODs' resolutions and decisions; and take responsibility before the BODs and law for the exercise of his/her vested powers and performance of his/her assigned tasks.
2. The CEO is appointed, reappointed, dismissed, commended or disciplined by the BODs which also may sign or terminate a labor contract with him/her after obtaining the Prime Minister's written approval. The parent company's charter must specify criteria and conditions for the CEO.
3. The CEO is appointed or enters into a labor contract for a term of office of 5 years. The BODs shall decide on re-appointment of or renewal of the labor contract with the CEO after obtaining the Prime Minister's approval.
4. The BODs shall decide on dismissal of or early termination of the labor contract with the CEO after obtaining the Prime Minister's approval in the following cases:

a) He/she lets the parent company suffer from losses for two consecutive years or fail to achieve the set target ratio of profit to the owner capital for two consecutive years or in an intermingled loss and profit-making state without any remedy, except for cases in which a loss or lower ratio of profit to state-invested capital has been approved by a competent authority; loss has been anticipated due to investment in production expansion or technology renewal under resolutions or decisions of the BODs; a loss or lower ratio of profit to state-invested capital is caused by objective circumstances which have been explained to and approved by a competent authority;…

b) The parent company falls into bankruptcy but fails to file bankruptcy requests under the law on business bankruptcy;

c) He/she fails to fulfill obligations or targets assigned by the BODs; repeatedly and systematically violate resolutions and decisions of the BODs and operation regulation of the parent company;

d) He/she dishonestly exercises his/her powers or abuses his/her position and powers to earn profits for him/herself or for another person; has made untruthful reports on the parent company's financial status;…

<u>Chapter 3</u>: Issues in diversification and corporate governance of Vietnamese state economic groups

In chapter 2, the study provided information on current diversification and corporate governance of SEGs. This chapter is to find out existing problems in their massive unrelated diversification. Additionally, this chapter also shows common corporate governance challenges of SOEs as well as holding company (mother-subsidiary) structure before examining shortcomings of SEGs' corporate governance. Basing on the perception of problems, the study will make suggestions to improve diversification pattern and corporate governance of SEGs in the next chapter.

3.1. Issues in current diversification and performance of Vietnamese SEGs

3.1.1. Neglect of the main business

According to the survey of 200 biggest enterprises in Vietnam by United Nation Development program (UNDP), "many enterprises including economic groups are speculating securities and real estate whilst neglecting the core business"(My Dung, 2008). As leading players in respective industries, SEGs should invest their resources to enhance technology and productivity. However, they often jump into other unrelated fields while they neglect upgrading their main business. "Economic groups now tend to run after short term profits…the groups have not been going in the right directions, while neglecting the investments to upgrade technologies and competitiveness" (Le Dang Doanh, cited in VietNamNetBridge (2), 2008).

SEGs were formed to become the backbone of economy, thus they are funded by the government and have to concentrate on core areas in which they have advantage. However, many SEGs have not accomplished their main function. The Vietnam Academy of Finance (2009) shows that PetroVN has operated for many years but most of their products are crude oil exports to foreign countries while Vietnam has to import 100 percent of the gasoline used for manufacturing. For Vinatex, they have to import most of their manufacturing material. Moreover, not only are their products marked with the names of foreign brands but 80 percent of their products' value is also from foreign countries. EVN has a responsibility to develop the national electrical system but they have not focused on their main area. Instead, they have diversified investments to many other areas such as finance, post-office, and real estate while a lack of electricity for society's manufacture and household use occurs every year without remedy. One such instance was in 2008 when the government designated to EVN the responsibility of developing many important power projects in the period of 2008-2010 (Son La, Huoi Quang, Ban Chat, Uong Bi II…) (EVN, 2008). EVN had to "conduct negotiations with commercial banks to sign credit contracts on funding" and these projects needed such a huge amount of investment capital that they made "the capital pressure on these commercial banks" (VNbusinessnews, 2008). However, while those power projects had not got enough required capital, EVN did not optimally utilize its own funds and still tried to invest in other unrelated areas. For example, EVN needed VND 3,360 billion for Uong Bi II project which was started on 23 May 2008 and still in a fund raising process until finishing (EVN, 2008). Nevertheless, EVN with An Binh Bank and REE Corporation established EVN Finance Joint Stock Company on 8 July 2008 with the charter capital of VND 2,500 billion in which EVN contributed 40 percent (VinaCorp, 2009). The diversification to unrelated areas of EVN was so aggressive that the Deputy Prime Minister Hoang Trung Hai had to ask "EVN to stop injecting money in non-electricity projects to focus on power plant projects" (VNbusinessnews, 2008).

3.1.2. Scattering of resources and weak competitiveness

In theory, business diversification that brings maximum profit with minimum cost to the owners should be seen as a good thing and should be encouraged. However, Vietnamese SEGs should not diversify their business spontaneously without considering their capability. Nguyen Dinh Cung (CIEM), said that: “Every business should have a forte business field, where it can gather its strength before thinking of expanding its business into other fields.” (cited in VietNamNetBridge (1), 2008). Vu Viet Ngoan (National Assembly’s Economics Committee) also has a similar view point: “there are problems with massive investments by SEGs. The groups should concentrate their labor force and financial strength on their main business operations to promote their competitive edges. However, they are running after short-term profit, jumping into non-forte business fields, which is leading to strength dilution”(cited in VietNamNetBridge (3), 2008).

Practice shows that SEGs have not built up their own strong area to compete with other players in the market. At the same time, the resources of government and groups are limited. Thus, they should not scatter the limited wealth in many areas, as they weaken their competiveness by doing so. However, the following situation often happens in reality: in 2008, the Vietnamese government had to borrow from the global finance market to support Vinashin in order to develop shipbuilding. However, Vinashin used its funds to invest in securities, banking, insurance, and real estate with VND 3,323 billion (equal to 1.1 times of its equity) (Academy of Finance, 2009). The opinion of Doctor Pham Tri Hung, Vietnam Marketing and Management Institute, expresses: “There are some warnings about recent diversification of SEGs when they try to invest in finance, bank, real estate… It is not necessary for economic groups to develop multiple businesses. They need to specialize in the key industry because their resource is limited"(2009).

3.1.3. Taking high risk and low efficiency

Vu Viet Ngoan (2008) warned that SEGs with their current diversification are exposing themselves to high risks and low efficiency:

> "They are exposing themselves to very high risks as they are injecting money in unfamiliar fields. They wrongly think that securities and banking can bring fast and quick profit. … In general, economic groups now have two problems. First, as they are investing in too many fields, they cannot get high efficiency on their investments. Secondly, they are making mistakes…as they are investing in unfamiliar fields, with which they are facing high risks" (cited in VietNamNetBridge (3), 2008).

Vinashin is a typical example for such inefficient investment of SEGs. In 2007 when the establishment of subsidiaries exploded among SEGs, Vinashin surpassed other groups with 147 subsidiaries and affiliates. According to a statistic of Ministry of Finance in 2007, on average, one subsidiary of Vinashin was formed on every 1.69 days. However, two years later, many of those subsidiaries and affiliates were facing loss, debt burden, and bankruptcy (Ngoc Lan, 2010).

The actual operational results of SEGs in 2008 show their current high risk expressed by high debt to equity ratio and low liquidity. Academy of Finance (2009) pointed out that SEGs' debt to equity ratio and the ratio of overdue loans are high and have already gone beyond a safe range. The actual liquidity of some companies is low compared to their book value. Many companies had a debt to equity ratio larger than 3 times, and some even had a ratio larger than 20 times, such as 21.8 times for Vinashin.

Also presented in the performance report of Vietnamese SOEs (31/12/2008), SEGs' performances were not good; all the groups did not accomplish their plan in terms of both sales and profit. [13]

Figure 2: Performance results of SEGs in 2008

Thousand billions of VND

SEGs	Sales	Achievement rate compared to plan	Earnings before tax	Achievement rate compared to plan
PetroVN	144.260	77.0%	25.200	47.8%
EVN	27.777		0.470	58.0%
VNPT	23.706	44.6%	6.225	49.8%
Vinacomin	15.405	59.0%	1.550	51.0%
Vinashin	15.405	79.0%	0.375	57.2%
Vinatex	10.744	50.0%	0.187	29.0%
VRG	5.153	42.9%	1.844	63.5%

Source: the Department of Enterprise Reform and Development, Cited in Vietnamese Finance 2008 (2009), Academy of Finance – Finance Science Institute, Hanoi: Finance Publishing House.

According to the report of the State Bank of Vietnam (31/12/2008), the total debt of the above seven SEGs in credit institutions was VND 128,786 billion, increased 20,54% compared to 2007. The total overdue loan was VND 4,168 billion (equal to 3.24% of their total credit balance in those credit institutions), 15% of which was unrecoverable bad debt (Le Nhung, 2009).

Most of SEGs' investment in securities, banking, insurance, and investment fund got loss. At the end of 2008, the amount of investment capital in securities of EVN was VND 214 billion; the amount of investment capital in investment fund of Petro VN was VND 368.9 billion, of VRG was VND 271 billion, of Vinashin was VND 144 billion and all of those investments did not get any profit (Le Nhung, 2010).

[13] It is not easy to get financial data of SEGs as they are not public companies and their actual financial data is confidential. Usually for SOEs and SEGs in Vietnam, their operation is assessed at the end of a year basing on their plans established in the beginning of the year to submit to their supervision body.

It is normal for any new business project to not bring in profit during the beginning period. Therefore, SEGs might argue that their investments in securities, banking, insurance, and investment fund are not all wrong. However, the noted point is that SEGs are still weak in their main business lines where they have many advantages compared to other market players. While having not fulfilled their main business obligation, being in short of financial and managerial resource, being stuck in bad performance and high debt ratio, SEGs still largely extend investment in other unrelated risky areas. Thus, such unrelated investments increase the bad business situation of SEGs and are partly responsible for the poor performance.

3.1.4. Conflict of interests between SEGs and banks

The major concern is if groups can obtain control right in banks or other deposit-taking institutions (which are joint stock companies in current SEGs' situation), they can influence these banks to give preferential credit for their own diversification and expansion projects. It is more possible for the groups to do so if the government's supervision is not strong and efficient. Actually, the State Bank of Vietnam "has not efficiently controlled banks so that many banks hold so few fixed-income assets and a lot of risky ones, strongly depending on stock and real estate markets, leading the whole banking system to face risks (Thu Loan, 2008).

In the bank-included model of groups, if government does not have a strong system of prudential regulation and supervision, the banks under the influence of the group may provide preferential credit for the group's subsidiaries while refusing to extend loans to outside companies which may have more profitable and efficient projects. This situation can be seen as inefficient allocation of capital and causes a conflict of interest between the group and their banks. Moreover, it also results in discrimination between the groups' subsidiaries and outside companies in accessing credit. Additionally, it might make the banking sector more unstable when banks in the system become more vulnerable.

The situation is more likely to occur under the current poor competition of Vietnam's banking market and the availability of government's support for banks. "If a bank becomes financially distressed, the central bank is likely to provide liquidity support to that bank or initiate its merger with another bank (or do both), to ensure that the problem bank does not cause a systemic crisis" (ADB, 2009). Because there is lack of threat on bankruptcy, economic groups and their banks can lend to groups' projects without thorough consideration of efficiency and profit target for banks. More than that, the potential support of government for banks can encourage banks to take more risk which can lead to a bank crisis - a systematic risk (Leaven and Levine, 2009) because shareholders might share the upside gain, but might not worry about sharing the downside loss (Nam, Kim & Cuong, 2010).

The separation of commercial and financial interests ensures investment projects to be subjected to double scrutiny: by the business entity which wants to undertake the project and by the financial entity which decides to provide loans for it. "Lack of separation implies that those who consider a project worth undertaking will be supporting it from both the borrowing end and the lending end. Under these circumstances, a dubious investment decision can be pursued for very long, with additional funding being provided to cover losses even if the chances to ever recover the investment are thin" (World Bank, 2009). If SEGs would control over banks or deposit-taking institutions, they would reduce the need to develop bankable projects and "allow poor investment decisions to be pursued way beyond what is reasonable" (World Bank, 2009). In practice, "the combination of commercial and financial interests under the same roof…has been repeatedly associated with economic crises in middle-income countries. Chile in 1982-83 and several East Asian countries in 1997 illustrate the risks involved" (World Bank, 2009).

3.1.5. Weak management in new unrelated business fields

Among the diversification model of SEGs, such fields as finance, banking, securities, and real estate have not only distracted their resources, affected their main businesses, and caused more risk in their operation, but also induce a weak management in the new business areas.

Extensive diversification into unrelated fields often parallels with a significant increase in the number of affiliated companies which are far different from the existing ones in terms of operation and management methods. It is said by MPI Vietnamese Delegation (2009) that the rapid increase in the number of affiliate companies can make SEGs difficult to manage diverse investment in their groups. The massive investment in unrelated areas easily leads to the failure of properly managing subsidiaries and thus can cause risk for the internal finance of the group. Difficulty in managing and in making investment decision is easy to understand because the mother companies don't have enough specialized and qualified staff in such risky fields as bank, finance, securities and real estate.

3.2. Common corporate governance problems of SOEs and holding company structure

3.2.1. Common corporate governance problems of SOEs

There are some common corporate governance problems found in SOEs. Those usual problems include passive ownership by the state due to state's multiple roles which leads to a conflict of objectives (Nam, 2009; Asish, 2009; Simon, 2006); a complex chain of agents (non-identifiable principals) or many governmental bodies influence SOEs known as plethora of control (OECD, 2005; World Bank 2006; Nam, 2009; Simon, 2006; Asish 2009); government's protection from the threats of takeover and bankruptcy which reduces incentive of boards and managers (World Bank, 2006; Nam, 2009; Baygan, 2005); boards with little authority, bypassed by shareholders and managers, or nominated by politically-based appointees (Simon, 2006); undue political influence on CEOs (CEOs trying to benefit the politicians who support them rather than maximizing the profits of SOEs (Nam, 2009); insufficient tools to incentivize and discipline management (compensation, termination, takeover, bankruptcy) (Simon, 2006).

Correspondingly, key elements to promote good corporate governance in SOEs are improving the ownership function of the state, making the objectives of SOEs clear, improving the transparency of SOEs' performance, and empowering SOE boards and incentivizing/disciplining managers (Nam, 2009; Simon, 2006).

3.2.2. Common corporate governance problems of holding company structure

A holding (mother-subsidiary) company structure is a pyramid ownership structure which increases the disparity between control rights and cash flow rights. Some controlling shareholders can grasp control right worth vastly more than their contributed wealth by holding controlling interests in companies which hold controlling interests in other companies (Morck, Strangeland and Yeung, 1998; Hwang, 2001). Such disparity brings about expropriation of minority shareholders by controlling shareholders (through arranging internal transactions that benefit the subsidiaries with high ownership stakes at the expense of those with low ownership stakes), lower firm value, and poor operating performance (Nam, Kim and Cuong, 2010; Hwang, 2001). Moreover, pyramid control structure may exacerbate agency problem, give incentive to the controlling shareholders to expand "his" business group to build a corporate empire (Hwang, 2001; Morck, Strangeland and Yeung, 1998), and facilitate the concentration of economic power (Morck and Yeung, 2004).

If a holding company structure exerts centralized form (as Korean *Cheabols* with centralized multidivisional form) in which the mother company centralizes operating as well as strategic and financial decisions, it will not foster accountability of affiliates as the boundary of accountability becomes ambiguous between affiliates and the mother company (Hwang, 2001). The mother company might deeply intervene into management of subsidiaries, which reduces the autonomy and incentive of subsidiaries.

3.3. Issues in current corporate governance of Vietnamese state economic groups

SEGs are the main hope of the whole country's economy. They should have high operating quality due to support policies from the government. However, their operation reveals many weaknesses, raising the question of why and where those shortcomings can arise. The causes of their outstanding issues come from both the weak monitoring of the government on SEGs and the poor internal corporate governance of SEGs.

3.3.1. Shortcomings in the government's supervision on SEGs

Conflicting objectives

As other SOEs, Vietnamese SEGs also face a common problem of conflicting objectives owing to multiple roles of the government both as the owner and the policy regulator. Currently, SEGs are under the control of Prime Minister and many other ministries. Those individuals and agencies assume both ownership and regulatory functions on SEGs and those functions usually conflict each other. Thus, the government has to choose the most important target and scarify the others in each particular period. For example, the government has monitored SEGs to implement some missions of curbing inflation, stabilizing the macro-economy, providing products or services with subsidized-price, which makes SEGs suffer huge loss (Vietnam Academy of Finance, 2009). Such conflict of objectives does not give incentives to SEGs and makes the performance assessment of SEGs become more difficult.

A complex chain of agents

As another common problem of SOEs, there are many government agencies taking part in supervising and managing SEGs. The function of and cooperation between the owners, namely the state and other responsible ministries or government organizations, is often complicated and unclear. The part 2.2.2 a) of this study showed the current complicated assignment of tasks and powers to exercise the state owner's rights on SEG's mother company and assignment of tasks to perform supervision on SEGs. There are Prime Minister, line ministries, Ministry of Finance, Ministry of Planning and Investment, Ministry of Home Affairs, The Ministry of Labor War Invalids and Social Affairs and others probable organizations directly involved in supervision of SEGs. Multiple agencies and individuals involved in the groups' performance at the same time leads to overlapped monitoring and supervision over SEGs. Consequently, this brings about awkwardness, delay, and even conflict in applying regulations, asking approval, and therefore reduces the performance quality of SEGs.

Vacuum of legal regulation and policies

For the task of regulating the establishment, organization and operation of the economic groups, the current legal framework is insufficient (Cuong, 2009). Moreover, because some economic groups are monopolies, "a well functioning regulatory system must also be established to set the level of their service charges and prevent unfair trading practices" (Nam, Kim, and Cuong, 2010). Additionally, another set of regulations is needed to improve ownership structure and transparency of holding company structure. Furthermore, many subsidiaries of mother companies are equitized and if there is not appropriate monitoring mechanism, minority shareholders of those subsidiaries might concern about facing the risk of expropriation by controlling shareholders. Thus, regulations to protect minority shareholders should be also established to attract outside investors. Besides, SEGs may confront other common corporate governance problems of holding structure as well and thus need a strong regulation in those aspects.

3.3.2. Shortcomings related to BODs and CEO of mother companies

Firstly, there exists inadequate management capacity in SEGs. Recently, the management ability of BODs and CEO is deficient in terms of both quality and quantity (NCEIF, 2007). Even though the study has not found out influence of politics on nominating BODs or CEO, it should be noted that the current process of appointment, dismissal, evaluation, and compensation of the groups' managers is dominated by bureaucrats. "Once it is in conflict with the interests of bureaucrats, there is the risk that this process can be compromised" (Nam, Kim, and Cuong, 2010).

Secondly, there is a bureaucrat participation in BODs. Sometimes bureaucrats are directly involved in the management of SEGs. That is the case of Petro Vietnam when the Vice Minister of Finance and Vice Minister of Industry and Trade take the part of Board members. According to Nam, Kim and Cuong (2010), such micro-management by bureaucrats is harmful for SEGs on a number of ways:

> Firstly, governmental agencies may have policy objectives that may not be compatible with profit maximization. When the two contradict, bureaucrats will pursue the objective

> of governmental agency at the expense of SEGs' interest. Secondly, bureaucrats normally do not have the knowledge or the experience to make decisions on business matters so that decisions may be unnecessarily delayed. Thirdly, governmental agencies may favor managers that are obedient to them. These managers, however, are not necessarily the most competent ones. Fourthly, bureaucrats may pursue their own personal interests by misusing their power over economic groups.

Thirdly, there is no attempt to introduce "non-executive members that are independent from line ministries and at the same time representing the public interest" into BODs of SEGs. In addition, "no rules exists disqualifying board members that directly or indirectly have business relationship with the company they serve" (Nam, Kim, and Cuong 2010).

Fourthly, relating to compensation of SEGs' managers. Vietnam has introduced a payment mechanism based on performance and target-achievement for SOE managers. However, the current compensation structure may "distort the incentives of managers. For instance, performance-based pay is structured so that it increases with the amount of self-mobilized capital.[14] Since self-mobilized capital includes debt capital, it may give managers the wrong incentive to build up excessive leverage" (Nam, Kim, and Cuong 2010). Also, payment is not based on long-term performance, but solely based on prior year's performance. This may induce managers to make myopic business decisions (Nam, Kim, and Cuong 2010).

3.3.3. Shortcomings in subsidiaries and the mother–subsidiary relation of SEGs

SEGs have shifted to the mother-subsidiary model which allows the separation in performance and responsibility of the mother company and subsidiaries and gives more autonomy to these affiliated companies. However, this model is still new for SEGs since they used to run in an

[14] Accoring to Cuong (2009) and Nam, Kim, Cuong (2010), in case of performance-based pay, the management can collectively receive up to 5 percent of after-tax profit times (self-mobilized capital / total capital). This pay is subject to a yearly upper ceiling of VND 200 million (for companies without the BODs) or VND 500 million (for companies with the BODs). In case of target-completion pay, the management can collectively receive up to 2.5 percent of after-tax profit times (self-mobilized capital / total capital). This pay is subject to a yearly upper ceiling of VND 100 million (for companies without the BODs) or VND 250 million (for companies with the BODs).

administrative "superior–subordinate" pattern for long time. SEGs have not adapted to the new model and their current internal governance exposes some weaknesses that should be changed to obtain better performance.

Regarding directors and managers of subsidiaries

Similar to the shortcoming of BODs and CEO in mother companies, the inadequacy in both quality and quantity of directors and managers, lack of independent directors, disincentive payment structure also exists in subsidiaries so that the management force has not afforded to the groups' development (NCEIF, 2007; MPI VN delegation, 2009).

Organizational mechanism

Regarding mother companies, the monitoring method that they apply on subsidiaries still inclines to dictate rather than management toward economic benefit. The mother companies still keep their old "superior-subordinate" perception with inadequate compliance of subsidiaries' regulations of investigation and observation. Some senior officers' activities incline to order or mandate and lack instruction or support for the subsidiaries as shareholders" (MPI Vietnamese delegation, 2009).

With regard to subsidiaries, some of them are inactive in their decisions and operation. It is a common occurrence in most SOEs as they passively operate under subsidized and administrative mechanism for a long time. Their change to the holding company model has been only in name and not in operation (VOVNews, 2008). In some cases, subsidiaries were afraid to make decisions for even investment projects on which they have authority (MPI Vietnamese delegation, 2009). Because of the inactivation of subsidiaries, overload and inefficiency is obvious for the mother companies to deal with all aspects of management.

In contrast, some subsidiaries are so aggressive that they exceed their authority. They don't fully obey the regulations about reporting and asking approval from the mother company before making important decisions such as nominating senior personnel and organization structure (MPI Vietnamese Delegation, 2009). The numerous instances of subsidiaries exceeding their authority diminish the competence of mother company to manage those affiliated ones.

The finding of the above weaknesses in both diversification pattern and corporate governance aims to seek appropriate solutions. SEGs only can have the correct direction when understanding exactly what has gone wrong. In the next chapter, the study will suggest recommendations basing on those shortcomings in order to strengthen SEGs to become leading players driving the whole economy.

Chapter 4: Suggestions to ensure efficiency and good corporate governance for Vietnamese state economic groups.

Based on the existing shortcomings and the reasons for causing those problems, this chapter suggests solutions to ensure efficiency and good corporate governance for SEGs. In addition, experiences from Korea and China in terms of the government's supervision on their business groups as well as their business groups' practice on diversification will be discussed to derive lessons for Vietnam. However, before obtaining lessons to improve SEGs, it is important to address the question of whether Korea's and China's experiences are relevant for SEGs. In order to answer this concern, the similarities among Vietnamese, Korean, and Chinese business groups are mentioned in the aspects of establishment, ownership structure, and development direction.

4.1. Establishment and development of business groups in Vietnam, China, and Korea

Vietnam's SEGs hold key positions in the national economy, operate in strategically important areas, and play a crucial role in stabilizing macro-economy and supplying substantial products. They receive support from the government and implement government strategies. The establishment of SEGs has based on the reform of SOEs. Large-scale state corporations were restructured according to the "mother-subsidiary" model to become SEGs. All of the groups have mother companies fully owned or mainly owned (Bao Viet) by the state. Vietnam is planning to establish new SEGs based on the same principles as existing ones.

China's and Vietnam's economies have a lot of similar characteristics which are prevalent in transition process, moving from centrally-planned to market-based economies with the vital position of SOEs. Vietnam has undertaken corporate reform through SOE equitization from 1995. In this process, SEGs have been formed since 2005 with the expectation to become industrial leaders of the whole economy. Similarly, China's economic reform was taken in 1980s and 1990s by SOE privatization. Chinese government made intensive endeavors to convert large SOEs into holding companies to cultivate business conglomerates for the national economy.

The reform of SOEs in China was taken along two lines. The first one is to expand enterprise autonomy and increase profit incentives by undergoing "the profit retention and profit contract systems (1979 to the early 1980s), the tax-for-profit system (1983 to 1985), and the contracted management system since 1986" (Lee & Mark, 1991; Yu, Ees & Lensink, 2008). The second one is to promote the restructuring and association of SOEs from 1978. In 1980, the State Council started to encourage "the formation of all kinds of economic alliance to break the old system of market partition and local government blockage" (Yu et al, 2008). "After observing the advantages of horizontal economic alliance, in 1986, the State Council issued "Regulations regarding a few problems related to the further promotion of horizontal economic alliance" in which the word "business group" first appeared in the state council's official documents" ((Yu et al, 2008). "In 1991, the government issued "Information about selecting a patch of largest business groups as experimental units" and formed 57 business groups as the experimental ones for special promotion. The experimental business groups are required to form based on a core firm, and to develop shareholding relationship between firms" (Yu et al, 2008).

After 1993, small and medium sized SOEs were allowed to be privatized according to the strategy of "holding on to the large and letting go of the small" to restructure and improve the performance of the SOEs. In 1997, the State Council promulgated "opinions on deepening the experimentation of the largest business groups" to require the experimental business groups to build up parent-filial system based on shareholding relationship (Yu et al, 2008). From 1997 to 2001, the government further promoted the development of largest business groups in order that they can play the pillar role in national economy and can compete with foreign firms (Yu et al, 2008). In 2003, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was established. “The SASAC took the role of claiming property rights on behalf of the state… and has the power to appoint and remove the directors and managers and send supervision board to the large state-owned enterprises/business groups. Local state-owned enterprises/business groups are under management of local SASAC correspondingly” (Yu et al, 2008).

Currently, China has two types of business groups consisting of state-owned and non-state-owned. If the parent corporation is a SOE, the business group is classified as state-owned and the remaining groups are classified into the second type (Ma & Lu, 2005). Those groups hold the key function in the China’s economy. The sales revenue of business groups account for more than 50 percent (nearly 80 percent in 2004) of China’s GDP from 2000 to 2004, of which the state-owned business groups contribute the majority (Yu, Ees & Lensink, 2008). The state-owned business groups also hold the dominant position in terms of total asset, sales revenue, and employment (more than 80% in 2004) (Yu, Ees & Lensink, 2008).

South Korea has become famous for a rapid economic growth with the “Miracle of Han River”. One important reason has been the high degree of state intervention in the market economy, marked by the existence of both public and quasi-public enterprises (Kim, Kim, and William, 1994). During 1960s-1970s, Korean private entrepreneurs lacked the wherewithal to develop critical industries that were necessary to the nation's economic growth (Mongabay, 2010). Hence, in order to develop strategic industries to foster national growth, the government supported some private firms through providing them generous policy loans and other incentives (Nam, Kim & Cuong, 2010; Mongabay, 2010; Jwa, 2009). Gradually, “the strong private firms in the 60s had rapidly grown…and eventually becoming the today's large conglomerates" – *Chaebols* (Jwa, 2009). "The Korean government offered these groups low-cost loans and other incentives to create corporations that could compete globally" (Keys & Campbell, 2002).

For Korean SOEs, the "government started to differentiate SOEs that can be run on a commercial basis from those that cannot" in the mid-1980s (Nam, Kim & Cuong, 2010). The government allowed greater autonomy for the former, and introduced the Government-Owned Enterprise (GOE) Act of 1983 as well as established a supervisory board to oversee all the latter. By mid-1990s, the number of large-scale commercial SOEs grew significantly and the government decided to privatize those SOEs. Then, the Act on the Managerial Structure Improvement and Privatization of SOEs (1997) was promulgated to improve SOEs' governance before their eventual privatization (Nam, Kim & Cuong, 2010).

Korean national economy has grown along with the development of both SOEs and *Chaebols* who have been close to, and acted as implicit development partners of, the government (quasi-internal organizations - QIOs) (Nam (2), 2009). They received government's support, carried out the state's strategies and had many achievements in the nation's important industries.

Regarding the control system of business groups in China and Korea, the pyramid structure of Chinese business groups guarantees centralized control and giving the state more control rights than cash flow rights (Wantanabe, 2002). "According to the NBSC's statistics in 2004, 92.1% of parent firms of all Chinese business groups have the decision-making power"(Yu, Ees & Lensink, 2008). In contrast, Korean *Chaebols* are controlled by founder families and these founder families usually hold relatively insignificant ownership shares of their affiliated companies (Chung 2004; Yu, Ees & Lensink, 2008).

In terms of internal ownership structure, Chinese business groups' structure is characterized by a simple hierarchy with a parent company at the top and the affiliates at the next tier while Korean *Chaebols's* structure is more complicated, with owner family at the top, several core companies at the next tier playing the role of holding companies, and other affiliates at the bottom (Lee & Woo, 2001; Yu, Ees & Lensink, 2008).

"In terms of the weight of the business groups in national economy, the share of the top 20 business groups in China is not comparable to that of Korean Chaebols" (Yu, Ees & Lensink, 2008). "The ratio of the aggregate sales revenue of the top 20 groups to the Chinese GDP in 2004 is about 28.59% (NBSC 2004), whereas the similar ratio in Korea is 70.8% in 1987" (Yu, Ees & Lensink, 2008).

In China, while state-owned business groups are more focused on their core business, non-state-owned business groups have a dissimilar diversification strategy. However, these private groups "entered only a few industries such as real estate, information and communication, and biotechnology, provided that the projects were attractive enough to get the bank loans" (Ma & Lu, 2005). Also in Korea, private groups *Chaebols* show an extensive diversification pattern while state corporations have a less diversifying model.

Both state and private business groups and corporations in China and Korea have had a significant contribution to the development of national economies. Moreover, business groups and corporations of the two countries have many compatible characteristics to Vietnamese SEGs and "group formation in Vietnam is in infancy, and the inspiration seems to come from South Korea and China" (Abegaz, 2005). Thus, they are good models to give experiential lessons to improving Vietnamese SEGs.

4.2. Suggested solutions to ensure the efficiency of SEGs' diversification.

Chapter 3 examined weaknesses in SEGs caused by their current unrelated diversification. Those shortcomings consist of neglect of the main business, scattering of the resources and weak competitiveness, taking high risk and low efficiency, conflict of interests between banks and groups, and weak management in new unrelated fields. In order to suggest solutions to improve SEGs' diversification, it is essential to explore reasons for their current massive unrelated diversification.

4.2.1. Reasons for diversification of Vietnamese SEGs

Diversification can be discussed in two types which are related and unrelated. Related diversification occurs when the firm expands into similar product lines and unrelated diversification takes place when the products are very different from each other (OECD, 1993). A firm can choose related diversification strategy when it wants to spread risks within related business activities; catching opportunities existing in a value chain; sharing common technologies, skilled labor, distribution channels or operating methods; achieving economies of scope by reducing costs when operating some businesses under one firm; achieving synergy when the combined effect is larger than the sum of parts; protecting from monopoly in intermediate product markets and attempting to deter new entry or expecting tax saving and circumvention of price controls, etc. However, when a cyclical downturn of the industry occurs, it is easier for a firm only diversifying to related businesses to fall in trouble than a firm diversifying to unrelated areas.

On the other hand, unrelated diversification can bring some advantages such as spreading risks into different businesses to avoid "putting all eggs in one basket" that is stabilizing earnings when the hard time of one industry is offset by the good time of the others; obtaining better internal financial resource allocation due to a better access of detailed and accurate information than external capital market; less need for coordination among subsidiaries (compared to related diversification) which helps to reduce intervention in the management of subsidiaries by the mother company and increase accountability of subsidiaries for their performance. However, unrelated diversification puts a burden on management which leads to the final argument that "consolidated performance of unrelated businesses tends to be no better than sum of individual businesses of their own or may be worse; unless managers are very talented and focused, unrelated diversification cannot be used to increase shareholder wealth compared to related diversification" (Arthur, 2009).

There are some studies on reasons for diversification of a group, particularly business groups in emerging economies as discussions by Leff (1987), Goto (1982), Granovetter (1994) Ghemawat and Khanna (1998), Maitreesh and Raja (2000), Anurag and M. Akbar (2007). Those explanations relate to forming an internal market for a better resource allocation when external markets and institutions are not well developed (Leff, 1976; Ramirez, 1995; Williamson, 1979; Khanna and Palepu, 2000); utilizing economies of scope (Rumelt, 1974) or economies of scale (Chandler, 1990), maximizing profit and spreading risks, etc. According to Nam (2001), reasons for diversification of business groups might fall into six main categories as shown in the Box 1.

Box 1: Major motivations for diversification

Generation and exertion of market power. With "deep pocket" (anticipated help from other members), subsidiaries of a business group may more easily adopt predatory pricing for the purpose of driving competitor out of the market. They may also show some non-competitive behavior collectively, as they frequently confront each other in wide range of markets. For instance, they may "mutually forbear" vigorous competition among themselves for fear of retaliatory actions by other groups, while trying to foreclose markets for non-diversified firms.

Pursuance of managers' and owners' interests (agency view). In large-scale firms with dispersed ownership, managers tend to pursue their own interests by diversified corporate expansion. This strategy increases not only managerial perquisites and pleasure of empire-building but also their job security, since it would require more managerial resources and might lower the business risk as well. In contrast, in business groups with concentrated ownership or pyramidal ownership structure, diversification might serve the interests of controlling owners at the expense of those of minority (outside) shareholders.

Creation of group-wide internal markets. In the early stage of development, factor markets, particularly the financial market, suffer from serious imperfections. In this situation, business groups would better be able to finance their new and existing business by mobilizing in-group financial resources, since information asymmetry is less of a problem within a group. Facing underdeveloped labor market, they would also attempt to develop necessary human resources themselves and allocate them in a most efficient way within the groups. Here, business groups are viewed as an organizational response to the inefficient external factor markets, which are at least partially substituted with their own internal markets.

Utilization of common resources and economies of scope. Another advantage related to the internal uses of resources is economies of scope: gains from sharing valuable assets, both tangible and intangible, within a diversified firm or group. These gains arise because, in spite of their value within a group, they either have little value or are rarely traded in the outside markets. Most important asset in this respect may be entrepreneurship, distinctively lacking in the early phase of industrialization. If entrepreneurship is indeed the key to business success, it is nature for diverse business undertakings to come under the management of a proven entrepreneurial talent.

Reduction of business risk and portfolio optimization. Business diversification means reduced risk. In the absence of a well-developed capital market and limited financial resource, portfolio diversification is inadequate for the personal wealth of controlling families, and they might want their business to diversify instead. Diversification also helps tide over temporary business difficulties. It enables them to aggressively enter into risky business with a long gestation period.

Capturing profit opportunities induced by government incentives or regulations. In many countries, business group grew rapidly in connection with government-initiated drive for industrialization that provided a wide-range of incentives including preferential credit, tax exemptions, and exclusive licenses. Eligible for these government-administered incentives were mainly large business. They kept adding new business in an effort to secure the subsidiaries as much as possible often with the belief that the government would have no other choice than bailing them out in the event of financial distress.

Source: Nam Sang-Woo (2001), "Business Groups Looted by Controlling Families, and the Asian Crisis", ADB Institute Research Paper 27, Tokyo: Asian Development Bank Institute.

For Vietnamese SEGs, they are diversifying extensively into unrelated areas, especially finance, banking, real estate and securities, while neglecting their core businesses which are designated by the government and are key industries of the national economy. The question is why they all jump into unrelated business fields? What is the reason behind such massive activities?

Among some major motivations for diversification, the current massive unrelated diversification cannot be explained by the argument of market power because SEGs mostly have monopoly in their main business and their unrelated subsidiaries seem too weak for them to strengthen their market power at least in the short run. Pursuance of managers' interests by diversifying into business fields that managers have knowledge and experience to secure their job, increase potential of negotiating higher compensation and latitude in decision making (Shleifer and Vishny, 1989) has no relevance either in the case of SEGs in Vietnam. It is because most of unrelated fields are newly emerged areas and far differ from the core business where managers usually work at. As for the operation of internal markets, internal capital and labor markets are two most important internal ones. However, it is difficult to utilize internal human resource among unrelated areas. Thus, it does not make much sense for SEGs to build up internal labor market. Additionally, continuously adding subsidiaries and affiliates to spread a net in as many fields as possible to get the government's bailout in case they face bankruptcy is not necessary for Vietnamese SEGs. It is because they are operating in strategically important industries of the national economy and are selected by the government to get support. Hence, even they do not have any spreading net, they will get support and rescue from the government in case they are in financial distress.

Besides the above reasons, some CEOs of SEGs, as Dao Van Hung - Chair man of EVN, pretext that they need to diversify to such high profit fields as bank, securities, or real estate to obtain earnings to lift up the core business which is responsible for public interest (Phuong Loan, 2008). However, trying massive unrelated diversification to boost the core business is also not reasonable since SEGs have enjoyed many incentives in their core fields (land, credit, resources…) for long time but they could not lift up the main fields. Now they suddenly claim that pursuing unrelated businesses is to push up the core one is not sensible.

In contrast, the aggressive diversification into unrelated businesses of SEGs can be explained in some ways. *Firstly*, there might be a lack of competition in both their main businesses and unrelated fields. In the core businesses, SEGs virtually monopolize so that they do not need to put much effort to care for their competitive capability and improve their products and services. Thus, SEGs do not focus on the core businesses and use resources to invest in other fields. At the same time, the competition in current market of unrelated fields might be weak, too. This condition opens chance for many firms to entry and to operate easily, even those not specializing in such areas.

Secondly, extensively diversifying especially into finance, banking, securities, and insurance might express SEGs' need to build up an internal capital market. External capital market in Vietnam has not yet developed so that firms might get difficulty in accessing capital from external market. Even though SEGs are funded by the government, state budget allocation among many different uses might be imperfect so SEGs might feel that they need internal capital market for their own use.

Thirdly, SEGs might expect to take advantage of investment opportunities, achieve more profit, enlarge their industrial scale, and disperse business risk from their current diversification pattern. The period of 2007-2008 was a good time for securities, insurance, banking, and finance when these industries grew rapidly and achieved highest profit among industries of Vietnam's economy. However, SEGs' performance shows that they are neglecting the main business, scattering resources, taking high risk and low efficiency, and weak management ability. Even though the poor performance may be due to the costs of starting new businesses, it may very well be attributable to the lack of a clear long-term development strategy as well as a strong management capability and skill. This view is consistent with the weak management ability of BODs and CEO of mother companies as well as directors and managers of subsidiaries which was examined in part 3.3.2 and 3.3.3 of this thesis.

4.2.2. Suggestions to ensure the efficiency of SEGs' diversification.

Based on problems of SEGs' current unrelated diversification and the reasons explored, the questions arise to answer is "*Should SEGs diversify?*" And if yes *"What area should they enter in their diversification pattern?"* and *"How much should they diversify?"*

As mentioned above, diversification is a good way to grasp the benefit of economies of scale and scope, reduce business risk, obtain more profit, etc. More specifically for Vietnam, the study of Abegaz (2005) on the innovative organizational model for large state enterprise reform found that the suitably–adapted diversified business group is a promising model for large-scale SOEs at the intermediate stage of corporate reform. The group-wise diversification model can help enterprise overcome market failures, high risk, high agency cost, "significant barriers to cost-efficient acquisition and diffusion of technology information across firm boundaries" (Abegaz, 2005), scarce management skills, and inadequate publicly-provided infrastructure.

However, it is noted that "poorly structured or regulated groups may bring potentially large welfare losses including … unjustifiable access to state financial capital, stifling competition from small firms and foreign investors, and frustrating effective monitoring" (Abegaz, 2005). Therefore, the main point is to make sure the efficient organizational groups to explore the "gold opportunity" in the under-developed market of Vietnam. If Vietnam government and its economic groups can do so, they can "stand a good chance of moving to the frontline of the "flying geese" of East Asian development" (Abegaz, 2005).

Additionally, the practice of Korean *Chaebols* which are characterized worldwide with their diversification illustrates their achievement in diversification strategy as they are growing to become global business groups. The below table shows the diversification of *Chaebols*:

Figure 3: Diversification of Korean Chaebols

Average number of businesses	**1993**	**1997**	**2000**	**2004**	**2008**
Big 30 business groups	18.3	19.8	15.3	14.1	17.5
Big 5 business groups	31.2	30	25.4	21.8	27.2

Source: Hwang (2009), "Korean business groups and diversification", Proceeding from A study visit on Economic groups of Vietnam, KOICA-KDI School of Public Policy and Management.

After the Asian crisis 1997, *Chaebols* reduced their diversification compared to before but the level of diversification was still high. After the global crisis 2008, Korea with the domination of *Chaebols* in the economy is one of a few countries in the world escaping from the crisis earliest. Hwang (Korea Economic Research Institute - Federation of Korea Industries) also suggests: diversification is a good path for economic groups as "eight arms can be better than one arm in developing countries where institutional capital is in short supply", with the added condition of having good corporate governance (2009).

The conclusion is that Vietnam's SEGs should diversify their business areas with an efficiently structured and governed group in mind.

This, however, does not mean that SEGs should diversify into any business areas spontaneously as they want. Because in the current extensively unrelated diversification, SEGs are facing many drawbacks, thus the questions are "*what area should SEGs join in?*"and "*how much should they diversify?*"

The answer is that SEGs should make a clear preferential order in their investment strategy in which they have to make the highest priority to concentrate on their main business; then, if their resources are available for diversification, they should prefer to invest in related businesses before thinking of unrelated ones; and, their investment in banks or credit-taking institutions and some such high risky areas as private equity or venture capital should be restricted. There are some reasons for SEGs to do so:

Firstly, the purpose of the government is to establish SEGs operating in strategically important industries to become strong players in the global competitive market. Thus, it is not advisable for them to diversify while neglecting the core business which is designated by the government.

Secondly, it is essential for every SEG to build its own strength in the core business, especially in the context that Vietnam must fully comply with WTO's commitments soon. The government will not be allowed to support SEGs and have to ensure a level playing field for all enterprises. SEGs will not be able to compete with other global business groups if they spread limited resources in many areas and do not ensure competitive strength in the core line in which they have advantages. Thus, the core business must be the highest priority of SEGs; then, if they are competent for diversification, they should prefer to invest in related businesses to strengthen their core line and benefit from economies of scope, opportunities in a value chain, and sharing common resources; after that, if their resources are still available for promising unrelated diversification, SEGs may enter in that area but with a thorough consideration on investment efficiency, profitability, and influence on the main business to avoid any negative effects. Moreover, it is noteworthy that the benefit of unrelated diversification compared to related diversification is questionable (Arthur, 2009) and some empirical studies showed that unrelated diversification reduces the shareholder's value (Ferris, Kim & Kitsabunnarat, 2003; Nam, Kim & Cuong, 2010).

Thirdly, as explained above, SEGs are expected to form an internal capital market. However, it should be noted that internal capital market can more efficiently allocate resources when a firm adopts a focused strategy involving closely related business because the holding company is more capable to rank investment opportunities across the affiliates only in that case (Stein, 2000; Paola, 2001; Khanna and Tice, 2001).

Fourthly, when groups control banks or credit-taking institutions, it is easy to bring about the conflict of interests between groups and banks. Moreover, investing in high risky areas such as private equity or venture capital may put a huge influence on the main business.

The experience from Korea shows that after the Asian financial crisis in 1997, the surviving *Chaebols* restructured their operation and have mostly tended to diversify into related business (Hwang, 2009). The trend concentrating on related business as an adjustment after the crisis can be a lesson for Vietnamese SEGs. More than that, experience of Korean state corporations such as KEPCO, POSCO, KOGAS shows that they utilize their resource to focus on core businesses and their diversification is mostly in related projects as well as research and development (KEPCO, 2003; POSCO, 2006; KOGAS, 2010)

In China, the research of Ma and Lu (2005) on Chinese business groups "might surprise some readers, namely that Chinese business groups are less diversified than their counterparts in many other countries". The state-owned groups' diversification strategies "are more focused on their core businesses" and "this is partly due to pressures from the state that requires them to become the leading players or even national champions in their own industries" (Ma and Lu, 2005).

With regard to owning banks by groups, which can lead to the risk of conflicting interest between the groups and banks, it is noteworthy that "the risk exists regardless of whether the commercial interests are owned by the private or the public sector" (World Bank, 2009). In China, the commercial banks are not allowed to become shareholder of firms according to the Commercial Bank Law of China (Yu et al, 2008). According to Nam, Kim and Cuong (2010), the separation of commerce and banking has been a core principle of the U.S. and Korean governments for many decades. "Ownership of commercial banks should be restricted so that economic groups, whether they are state-owned or private, do not have control over them" (Nam Kim and Cuong, 2010).

Box 2: Separation of commerce and banking in Korea

In Korea, the principle of separating commerce (industrial capital) and banking (commercial banks) has been the maintained since 1982. In 1982, the government wanted to privatize commercial banks that has been in the hands of state for the past 20 years, but was also concerned with the problem of economic power being concentration in few *chaebol* families. This lead the government to impose an ownership limit of 8%. That is, no shareholder, together with its specially related parties, can own more than 8% of commercial bank shares. In 1994, this ownership limit was relaxed and raised up to 12% for firms mainly engaged in financial business, but lowered down to 4% for others. Immediately after the economic crisis, in 1998, the ownership limit was set again to be 4% regardless of the business the shareholder is in. In 2002, the ownership limit was relaxed to 10%, but there was a 4% cap on voting rights. In 2009, the cap on voting rights has been relaxed to 9%.

Source: Nam, Kim, and Cuong (2010), "On the governance of state-owned economic groups in Vietnam". Proceedings from "Senior Policy Dialogues and Dissemination Seminar", Vietnam MPI

On the side of the state, the Vietnamese government should give clear regulations and instructions on the principal business areas of SEGs as well as those fields that SEGs are allowed to invest in and how much they should invest. In case of making investment out of the permission, SEGs have to obtain approval from the government. This practice can give SEGs an apparent pathway and constitute the basis to perform the monitoring and supervision functions of the government on SEGs. The lessons from China confirm that "the Chinese government strictly controls the principal business domains of groups…, especially those domains that are influential to the economic security; the government also approves their intended outer investment" (CIEM, 2009).

In fact, the Vietnamese government promulgated some regulations on related issues, which is considered as a right action. The government issued Decree 9/2009/ND-CP[15] and Decree 101/2009/ND-CP to restrict unrelated diversification of SEGs and SOEs. The Article 16 of Decree 101/2009/ND-CP gives provisions on investment limitations and business lines of state economic groups:

> Parent companies and member enterprises of groups may register business lines under law but shall concentrate their investment on and conduct business operations within main business lines and related business lines…

[15] Decree No. 09/2009/ND-CP dated February 5, 2009 on the Regulation on financial management of state companies and management of state capital invested in other enterprises

> A parent company which, directly or through its affiliate companies, conducts business operations in business lines unrelated to main business lines must satisfy the following conditions:
> a/ It has fulfilled the task of conducting the main business lines assigned by the owner; conducting unrelated business lines will cause no impact on the performance of the main business lines as well as on their expansion and development
> b/ It uses business operations and results in unrelated business lines to support and develop the main business lines;
> c/ It performs the reporting obligation and submits to supervision by the state owner representative of investment, investment efficiency and impacts of business operations in unrelated business lines.

Article 12 of Decree 9/2009/ND-CP regulates:

> SOEs are not allowed to contribute capital or buy shares from venture capital funds, equity investment funds, and securities companies…. SOEs have to use at least 70% of their total capital to make investments into activities belonging to their principal business domain. In particular for the sectors of banking, insurance and securities, SOEs are permitted to make their investment in the form of a capital contribution only to one enterprise per sector; the level of investment cannot exceed 20% of the receiving organization's legal capital, and total contribution of parent company and of all subsidiaries cannot exceed 30% of the recipient organization's legal capital. In an exceptional case of needing to surpass this level, the groups should submit its request to the Prime Minister for examination and approval.

It is, however, not easy to strictly ensure the conformation of SEGs. Among the causes explored for SEGs' massive unrelated diversification, one main cause is lacking competition in both the core businesses and unrelated fields. Thus, it is better for the government to address the issue from the root of problem rather than simply restricting SEGs. The problem can be improved significantly if the government pushes further competition in both the core businesses and the unrelated fields. If the government now does not want to release the key areas which is strategically important industries to private and foreign sectors, it can increase competition by allowing more state enterprises to operate in those areas. By that way, SEGs cannot continue enjoining monopoly, but focus more on improving their quality and productivity, and develop their core business.

Moreover, the other reason for current SEGs' diversification is forming an internal market because the state budget allocation might be inefficient and the external market is underdeveloped. Thus, the government also should develop a well-functioning capital market. Not only does it aim for a better credit allocation among the subsidiaries of SEGs but also for the benefit of the groups and their subsidiaries when they are equitized.

4.3. Suggested solutions to ensure good corporate governance of SEGs.

The shortcomings of SEGs' corporate governance express themselves in both external government's supervision and internal governance of the groups. The external factors attribute to conflict of objectives, a complex chain of agents, bureaucrat participation, and vacuum of legal regulations and policies. The internal factor relates to empowering BODs and CEO and the weak organizational mechanism.

4.3.1. Suggested solutions for shortcomings in government's supervision

As for main challenges of managing and supervising SOEs, the key challenges needed to overcome the existing external shortcomings of SEGs are properly exercising the state ownership function and improving the transparency of SEGs' objective and performance.

It is stated clearly in the guidelines on corporate governance of SOEs by OECD (3) that "the state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness" (2005). Correspondingly, the government should establish a clear ownership policy; let the exercise of ownership rights be clearly identified within the state administration; let the boards carry out their responsibilities without undue representation of government officers; and allow SOEs full operational autonomy to realize the defined objectives (OECD (3), 2005; Nam, 2009). In the case of Vietnamese SEGs, this study suggests the government to improve the transparency of SEGs' objective and performance; establish a specialized organization for supervising and exercising ownership rights toward SEGs; and improving governance structure and transparency of holding company structure.

a) Improving the transparency of SEGs' objective and performance

Firstly, the government should re-clarify objective for SEGs basing on commercial and non-commercial basis as the Korean government classified its SOEs in mid-1980s (Nam, Kim, and Cuong, 2010). In the current situation, some SEGs can entirely operate under profit-maximization basis such as VNPT, Viettel, Vinatext, VRG, etc. If some SEGs have to carry out non-commercial activities, they should record those activities in separate financial accounts so "the performance of managers can be evaluated solely based on their commercial activities" (Nam, Kim, Cuong, 2010). In addition, the loss due to non-commercial activities should be compensated by state budget, so the possibility that economic groups loose incentive to improve their products' quality due to setting subsidized (low) prices for certain social parts can be avoided. Also, the government should give greater autonomy to SEGs to run on a commercial basis to meet their objective.

Secondly, based on the defined objective of SEGs, the government as the owner should clarify SEGs' targets by specific achievements or specific performance indicators in each period. Thus, SEGs can have a benchmark for their performance and the government supervision on SEGs' can be more efficient and transparent.

Thirdly, along the SEGs' practical performance, the government should cooperate and maintain continuous dialogue with "the state supreme audit institutions" (Nam, 2009), "external auditors and specific state control organs" (OECD, 2005). Thus, the government can regularly oversee and update SEGs' performance, and give timely oriented direction when necessary.

b) Exercising the ownership function

Models to exercise ownership function

According to Vagliasindi (2008) and OECD (2) (2005), there are three models for a state to exercise the ownership function on SOEs: centralized, decentralized and duel models. *The decentralized model* is the most traditional one where SOEs are under the responsibility of relevant sector ministries. The main advantage of this model is a greater availability of sector expertise but it faces main drawbacks or dangers which are the difficulty in clear separation of ownership function from the regulatory role (industrial policy regulating) and the risk of government's interference on SOE's daily operation (Vagliasindi, 2008; Nam, 2009; OECD (2), 2005). *The dual model* used to be the most common and is still adopted in many OECD countries where the responsibility is shared between the sector ministry and a "central" entity. An important potential advantage of this model is the possibility of alleviating the conflict of ownership and regulatory functions by dividing the two roles to different ministries. Another advantage is that it can facilitate both technical and fiscal oversight. However, the main disadvantage is the potential for blurring responsibilities of involved ministries and the possibility that SOE management perceives itself to be "the servant of two masters", with detrimental results for morale and performance (Vagliasindi, 2008). *The centralized model* has become more popular and often resulted from the recent implementation of privatization programs, in which the ownership responsibility is concentrated under one main agency. The main advantages of this model are the clear line of accountability from the SOE to the government, the ability of the government to exert close fiscal supervision and to form a coherent SOE policy, and allowing the best use of limited human resources available to undertake the specialized job of exercising the government's ownership function. The main disadvantage is the likelihood that the depth of available expertise in the one main agency will be shallower than in sectoral ministries (Vagliasindi, 2008; Nam, 2009).

Apart from the three above models, there are other specific structures involved in exercising the ownership function of SOEs. They are *holding companies* and *Ad hoc specialized consulting services* (Vagliasindi, 2008; OECD (2), 2005). The later is in the form of specialized consulting companies, more flexible and independent from overall government policy. They give advices to the ownership entity within the government like SICOT in Italia, CCMAU in New Zealand, and GBPFAU in Australia (OECD (2), 2005). The *holding company* as IRI in Italia, OIAG in Australia, APV Rt. in Hungary is the model to which the ownership of SOEs has been transferred. These holdings are in turn owned by the state and under the responsibility of one ministry (Vagliasindi, 2008; OECD (2), 2005). This model aimed at decreasing political interference in the management of SOEs, giving more flexibility to their management, and introducing tougher budget constraints. This model has been prevalent in former transition economies because "it is also a vehicle to carry out privatization" (OECD (2), 2005). It, however, has shown limitations. It has not proven to be efficient either in terms of corporate restructuring or in financial management (Vagliasindi, 2008). Perhaps, it is now retained only in Australia but is closer to a centralized model. "The main advantage is the ability to facilitate a nationwide program for the privatization and restructuring of state-owned industry. Its major disadvantage is that it does not by itself resolve the basic issues of poor corporate governance of SOEs. Instead, it simply relocates the problem to the level of the holding company. The question then becomes how efficient and accountable the holding company is, and whether a centralized, decentralized, or dual system should be adopted to improve its performance" (Vagliasindi, 2008).

Exercising ownership function in Vietnam

Although there has not been a clear unified model for the state to exercise the ownership function toward SEGs, the current model of ownership exercising can be classified as decentralized model. Some SEGs are operating under the control of Prime Minister, Baoviet is under Ministry of Finance, Viettel is under Ministry of Defense while there are many other ministries also taking part in exercising the ownership function and supervising SEGs. Added to this, there is "no differentiation between the state ownership function and the governmental administration function of ministries" (Cuong, 2009). As main drawbacks of decentralized model examined above, the government faces the difficulty in clear separation of ownership function from the regulatory role. Therefore, the right and benefit of the state owner in SEGs have not been explored properly (MPI Vietnamese delegation, 2009).

Among the above mentioned models, this study suggests Vietnamese government to exercise the *centralized one* to better realize the state ownership right and separate ownership function from regulatory role on SEGs. This can be done by concentrating the ownership responsibility in one main governmental agency which acts as a state investor or shareholder in SEGs while other different ministries or agencies only exercise the governmental administration and regulatory role on SEGs. According to Vagliasindi (2008), "the OECD's recommended model is for a centralized ownership function. The OECD goes even further in recommending the centralized ownership to be exercised by an independent agency, even though this model is relatively untested in practice both in developed and developing countries". Furthermore, the worldwide trend of reform is also away from the decentralized model and more towards the centralized model (OECD (2), 2005).

The *centralized model* is the study's suggestion for Vietnamese government in the long run. In the short-term, when human resource and other conditions have not been favorable for the government to exercise the centralized model immediately, the study suggests organizing SEGs under the State Capital Investment Corporation (SCIC).

SCIC in Vietnam

The government established a special financial institution namely the State Capital Investment Corporation (SCIC) under Decision No. 151/2005/QD-TTg[16] of the Prime Minister. SCIC is a for-profit organization in the form of a state corporation which "is mandated to exercise ownership rights in SOEs on behalf of the state" (World Bank, 2009). The establishment of SCIC by the government aims to continue SOE restructuring process and improve state investment mechanism toward market principle (Cuong, 2009). Added to this, the creation of the SCIC helps to "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" (VCCI, 2007). According to the Decision 151 and SCIC portal (2010), some missions of SCIC include exercising state shareholder rights in state invested enterprises; managing state invested capital and generating added value and maximizing capital efficiency; and investing state capital in key industries with a view to preserving and maximizing the value of state capital. However, SCIC currently does not assume any responsibility on SEGs (SCIC, 2009; Cuong, 2009). The study recommends expanding the role of SCIC so it can hold the

[16] Decision No. 151/2005/QD-TTg dated 20th June 2005 on Establishment of SCIC.

ownership responsibility not only in SOEs but also over SEGs as SASAC in China, Temasek in Singapore, and Khazanah in Malaysia. When SCIC assume the role of state owner on SOEs and SEGs, this practice becomes similar to the *holding companies* model.

Once SEGs are put under the control of SCIC, the role that currently carried out by Prime Minister and other ministries should be played by the BODs of SCIC. Thus, instead of controlling both SEGs and SCIC, Prime Minster will oversee SCIC only and in turn, SCIC will be responsible for SEGs. Currently, the BODs of SCIC includes "one leader of Ministry of Finance, leaders from other related Ministries who have deep knowledge in financial and capital investment as well as enterprise management" (Cuong, 2009). To minimize the conflict of interest in SCIC, the board should "not be represented by Ministries other than the Ministry of Finance, which is believed to be responsible for the management of state capital" (Nam, Kim and Cuong, 2010). Moreover, the study recommends hiring outside board members who represent public interest in SCIC. In the case of Korean GOE Management Evaluation Committee, the committee had "a number of civilians appointed by the President. The civilian committee members were non-resident members with sufficient knowledge and experience in the area of SOE management" (Nam, Kim and Cuong, 2010).

However, it is noteworthy that the *holdings* model is a good model in privatization process but still contains more weaknesses than the centralized one and it does not thoroughly address the shortcoming of separating ownership and regulatory roles as expressed in other countries' experience. Thus, in the long run, the government should make a further move from the holdings model to the centralized one. That is because "the holding structures remain an exception…where they are not supposed to be permanent structures, but should disappear with the completion of privatization and restructuring of industry" (OECD (2), 2005).

The shortcomings of *holding company model* are also expressed in SCIC as it is facing difficulties such as the fact that the number of enterprises from many different industries managed by SCIC goes beyond SCIC's capacity (Cuong, 2009; VCCI, 2007); conflict of objectives when SCIC are controlling both bank and non-bank companies; potential conflict of priority when SCIC has both commercial and unprofitable social investment objectives; unclear corporate governance in which many government agencies are involed in SCIC; and not yet separating the onwership and regulatory roles of the government on SCIC (VCCI, 2007; Cuong, 2009). Although this study does not go deeply in SCIC, some basic recommendations for SCIC are suggested as following.

The government should consider establishing additional SCICs (Nam, Kim, Cuong, 2010) and SCIC should attract and retain more talent by implementing modern and commercial human resource policies, including competitive compensation and benefit packages (VCCI, 2007). Also, the government should separate banks from investment portfolio of SCIC as the Chinese SASAC does not combine commercial and financial interests under the same roof (World Bank, 2009). In case SCIC is mandated to manage both, "there is a need to establish an effective "Chinese wall" between the units managing these assets to ensure that conflicts of interest do not arise" (VCCI, 2007).

As common shortcoming of *holdings* structure in exercising ownership function of the state, fundamental conflict between the ownership function and the administrative management function of government remains unresolved in SCIC. It is the reason for causing above mentioned potential conflict of priority and unclear corporate governance in which there is other ministries and provincial authorities, beside Prime Minister and Ministry of Finance, taking part in managing SCIC (VCCI, 2007). Thus, in the long run, this study recommends the Vietnamese government should move to the *centralized model.*

China's experience

Before 2003, Chinese SOEs were under the control of many ministries and governmental agencies. The State Council of China approved the founding of the State Asset Supervision and Administration Commission (SASAC) in May 2003. "SASAC is the organization authorized by the State Council to perform the responsibilities as the investor of the state-owned asset on behalf of the central government" and it separates "the government social and public management functions from the role as the investor of the state-owned assets in terms of institutional framework" (SASAC, 2003). Thus, after 2003, SASAC has been responsible for restructuring, reorganization, assessment and personnel in SOEs while other departments of government have been responsible for macro-control, administration, industrial policy and state auditing (Xiaoliang, 2006). The aspect in which SASAC performs the responsibility of investor of SOEs includes management of responsible persons, management of major matters, and management of state-owned assets (Xiaoliang, 2006). The Chinese SASAC is not only responsible for SOEs but also state business groups "which were seen as those with the highest potential to benefit from economies of scale and become global players over a short period of time" (World Bank, 2009). In practice, China already "experienced a period of experimenting with various organizations that were already established…; and finally, came to the creation of SASAC to assume the role of state owner in managing and supervising business groups and large-scale corporations to which previously experimented organizations proved inappropriate" (CIEM, 2009).

c) Improving governance structure and transparency of ownership structure

Vietnamese SEGs' ownership structure is pyramid. It is well documented that the pyramid structure can cause the disparity between control right and cash flow right, bringing about expropriation of minority shareholders, agency problems, incentives to build corporate empire, concentration of economic power, and lower firm value.

To limit such negative effects, the government should consider the regulation of holding company structure in Korea which aimed to improve corporate ownership and governance structure of large business conglomerates. Some main regulations include:

> (i) the 100% upper limit on debt-to-equity ratio, (ii) the 50% minimum share ownership requirement in subsidiaries (30% in case of public subsidiaries), (iii) the ban to have grandson companies in unrelated businesses, (iv) the ban to own shares in financial institutions (in case of non-financial holding companies), and (v) the ban on subsidiaries holding shares in other subsidiaries (OECD, 2002; KFTC, 2003; Nam, Kim, and Cuong, 2010)

Moreover, the Korean government also provided benchmarks for exemplary companies in governance system, granted incentives to business groups with low control-ownership disparity (Koh, 2009), and had policies to encourage companies to have advanced (transparent) holding company structure (KFTC, 2003).

Besides, the government should strengthen the transparency of ownership structure by requiring SEGs to disclose their ownership structure to the public. In Korea, "share ownership relationships between affiliates, and those between controlling families and affiliates will be publicized every year... The gap between ownership and control of each company and business conglomerate will be measured and disclosed each year as well" (KFTC, 2003). The Korean government also bolstered the disclosure obligations of both unlisted and unregistered companies. Stock transaction histories between specially related persons and affiliates, and loans from financial affiliates are to be disclosed as well (KFTC, 2003). Additionally, the Korean government opened a website to publicly disclose each *Cheabols'* intra-group ownership structure from 2007 (Nam, Kim, Cuong, 2010).

Currently in Vietnam, "there is no external review mechanism for related-party transactions approved by the Board" while "the board is mainly composed of executives" so that "board approval of related-party transactions is not likely to be an effective control device" (Nam, Kim, Cuong, 2010). "Also, the law does not give shareholders the right to challenge the board or to require a court to declare an unfair related-party transaction to be invalid. Moreover, the law does not impose responsibilities on the board and its members for unfair related-party transactions" (Nam, Kim, Cuong, 2010). Therefore, the Vietnamese government should improve the current laws to address those shortcomings. Additionally, other considerations might be the formation of an inspection committee, "exclusively composed of non-executive independent members" to approve related-party transaction (Nam, Kim, Cuong, 2010). SEGs now have Control Board (CB) responsible for supervising CEO and assistant apparatus. SEGs can consider forming a CB consisting of all non-executive independent members, and authorize this CB to approve related-party transactions. Another way can be introducing at least 50% independent directors in the Board. Korean experience shows that the role of 50% outside director ratio was helpful in reducing related-party transactions (Black, Kim, Jang, and Park, 2008).

4.3.2. Suggestions to empower BODs and CEO of groups' mother companies

Empowering Boards is one of the key challenges in corporate governance of SOEs. According to OECD (3) (2005), "the boards of SOEs should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions”. In order to empower BODs, the owner should professionalize the Board, avoid encroaching Board’s role, construct a board with a reasonable size and good composition, and improve board’s evaluation and responsibility (OECD (3), 2005; Nam, 2009).

To professionalize the Board, the state should minimize political influence in the board member nomination process (Nam, 2009). In Vietnam, there is an inadequacy in both quality and quantity of board members but this thesis did not found out influence of politics on nominating BODs. Therefore, the government should improve the nomination process letting SCIC (if SEGs under SCIC) be responsible for getting better candidates. Added to this, the study suggests that the government should incorporate independent specialist’s consultancy in the process of nomination and compensation of BODs. The government also should not let state representatives join BODs as in the case for Petro Vietnam. Added to this, the government should not encroach on the BODs’ role and should give the BODs necessary authority to carry out its function.

Besides, the boards “should be composed so that they can exercise objective and independent judgement” (OECD (3), 2005). Thus, the government (SCIC) should recruit a sufficient number of competent *independent (non-executive) directors* (from private sector) to empower the independent judgment of BODs. The government also should clarify rules to discard disqualified board members as well. According to Nam, Kim and Cuong (2010), the number of independent directors represented in BODs should be at least 50% and candidates for independent director positions should not have any tie with management or SCIC that can jeopardize their independence. Moreover, the chair of BODs and CEO (whose positions are combined in the case of Vinashin) should be separated to empower board’s independence from management (OECD, 2005; Nam, 2009).

Appointment or dismissal of CEOs by BODs should be made in consultation with the ownership entity (Nam, 2009). In more detail, CEO candidates should be nominated by the Board and appointed by the government (SCIC) (Nam, Kim, Cuong, 2010). Even though no political influence has been found on nominating CEOs, there is a qualitative inadequacy of CEOs. Thus, the government also should incorporate independent specialist's consultancy in the process of nominating CEOs to get better candidates. Once being appointed, the CEOs should enter a *performance contract* with SEGs that clarifies performance targets, performance evaluation criteria and methods, detailed compensation structure, and conditions to be rewarded or dismissed. Then, this contract also should be disclosed to the public.

However, sometimes practices of SOEs in the world show that performance contracts were not effective because SOE managers have more information advantage to negotiate soft targets; governments usually prefer contracts with inadequate incentives and shorter duration; government still constrain managerial autonomy; and the contract is not credible without a third party (Nam, 2009). Correspondingly, Vietnam should avoid those empirically reported problems. The performance contract between the government and CEO should have the attendance of the third party. The government should also invite independent specialists to measure required objectives and evaluate CEO's performance. In addition, both the government and CEO should follow strictly the contract as long as it is signed.

Regarding compensation of CEO, the government (SCIC) should develop clear performance indicators for assessing managerial performance of CEO and evaluation score should be linked to specific reward, bonus, and punishment. Also, performance evaluation report should be disclosed to the public. That was Korean experience with Government Invested

Enterprise (GIE) Management Evaluation Council regulated in GIE Administration Basic Act of 1983 (Nam, 2009).

Currently, the tenure of Board members, Control Board members and CEO is 5 years and can be renewed. The Vietnamese government should shorten their term to at most 3 years. "Shortening the tenure alleviates the problem of staggered board and enhances the effectiveness of cumulative voting which is mandated under the Enterprise Law of 2005" (Nam, Kim and Cuong, 2010).

4.3.3. Suggestions for subsidiaries and the mother-subsidiary relation of SEGs

In order to get success in forming leading economic groups for the whole economy, enhancing internal governance also plays an important role. Based on the current internal governance problems of SEGs the study suggests the following solutions.

a) Strengthening directors and managers in subsidiaries

Capable directors and managers of subsidiaries are also insufficient in both quality and quantity. Suggestions for this part are similar to above suggestions for BODs and CEO in mother companies. Mother companies should ensure a better and adequate nomination of directors and managers in their subsidiaries. Mother companies also should get independent specialist's consultancy in the process of nomination, compensation and evaluation of directors and managers in their subsidiaries. Performance contracts, independent directors in subsidiaries, performance linked to reward and punishment also should be applied for subsidiaries. SEGs also should pay attention on professionalizing directors and managers in subsidiaries by offering them instructing courses and other studying opportunities.

b) Improving organizational mechanism of the groups

The mother company should refrain from intervening in the management of its subsidiaries. Instead, the managerial guide and monitor of the mother company have to be based on the ownership relation. Subsidiaries should have their own autonomy in operation and making decisions and at the same time, they have to take their own responsibility on their activities. The mother company can manage the operation of subsidiaries by exercising its shareholder rights.

Besides, SEGs should put in place clear rules for efficient allocation of management functions between the mother company and subsidiaries. For example, the mother company can be responsible for group's strategic direction, coordination and resource allocation among subsidiaries, while subsidiaries are responsible for business operation subject to the direction of the mother company. The mother company and subsidiaries also should negotiate and co-construct consistent regulations on function, responsibility, relation among companies within the group. Those internal regulations can provide the basis for whole group to operate more efficiently.

Moreover, if it is necessary, the mother company might form a specialized division concentrating on regularly supervising subsidiaries' operations to make quick necessary adjustments. Korean *Chaebols* typically have excellent head-quarters with specialized supervising divisions which can quickly identify needed changes and make timely adjustment on subsidiaries (Hwang, 2009).

Also importantly, as mentioned in the part 4.3.1.c) of this thesis, in order to minimize potential problem related to unlawful related party transaction which can be easily resulted from pyramid structure of groups, the mother company should have a subcommittee that assumes the mandate of approving or disproving transactions with other member firms within the group. This subcommittee is recommended to be exclusively composed of non-executive independent members (Nam, Kim, and Cuong, 2010).

Conclusion

Vietnam established SEGs with the aim for them to become leaders of the whole economy which can compete in the global market. SEGs have been created as a result of SOE reform, as they have been established on the basis of the restructuring of state general corporations. As of January 2010, Vietnam has twelve pilot SEGs. Most of them have the mother companies fully state owned and one has the joint stock mother company which is majority-owned by the government.

Although SEGs have been newly established, they have already made massive diversification into unrelated fields, especially finance, banking, securities, and insurance. This extensive diversification accompanied by many problems has become the controversial concern of many observers and raises doubt on SEGs' corporate governance. This study aims to investigate outstanding issues in both SEGs' diversification and corporate governance to suggest relevant recommendations.

SEGs' current diversification and performance expose such problems as the neglect of their main business, scattering resources and competitiveness, taking high risk and low efficiency, *having the potential* conflict of interest between groups and banks, and weak management in new unrelated business fields.

In their corporate governance, SEGs demonstrate both external and internal weaknesses. The first weakness relates to the government's supervision which shows a conflict of objectives, a complex chain of agents, and a vacuum of legal regulations and policies. The second one involves various weaknesses for BODs and CEO of mother companies such as insufficient management ability, bureaucrat participation in BODs, no attempt to introduce independent directors, and shortcomings in compensation of managers. The third one is the shortcomings of groups' subsidiaries and mother-subsidiary relation which relate to directors and managers of subsidiaries and the internal organizational mechanism.

Based on the identified shortcomings and the investigation of the causes for problems as well as common guidelines of corporate governance, this thesis suggests solutions to ensure efficiency and good corporate governance for SEGs while considering experiences of Korea and China.

Diversification can be a promising model to form strong state groups in such less developed countries as Vietnam, but the groups and the government have to ensure an efficiently structured and regulated group model which goes along with good corporate governance. However, SEGs should put the highest priority on improving their core strength; then, if they can afford to diversify, they should prefer to invest in related areas before thinking of unrelated ones; and, SEGs' investment in banks/credit-taking institutions and some extreme risky areas (venture capital…) should be restricted.

In the area of government supervision on SEGs, the thesis suggests improving the transparency of SEGs' objective and performance; ultimately adopting the *centralized model* of state ownership function while, in the short run, organizing SEGs under SCIC; and, improving governance structure and transparency of ownership structure of SEGs.

Suggestions to empower BODs and CEO of groups' mother companies include professionalizing the Board, introducing independent directors, improving the process of appointment, dismissal and evaluation of board members and CEO, using performance contract, and developing appropriate compensation schemes for CEO.

As for subsidiaries and the mother-subsidiary relation of SEGs, the groups should strengthen the roles of directors and managers of subsidiaries and improve internal organization mechanism of the groups.

Appendix 1: List of some unrelated subsidiaries of Vietnamese SEGs (2010)

Group	Unrelated subsidiaries	Subsidiaries' shares owned by groups	Established/ invested date	Business areas of subsidiaries
Petro VN	Petro VN finance joint stock Corp. (PVFC) www.pvfc.com.vn	78% owned by PetroVN	2008	Finance and banking
	Petro VN Financial Investment and Consultancy Co. (PVFC Invest) www.pvfcinvest.vn	35.5% owned by PVFC	2007	Financial investment and consultancy
	PVFC Real Estate JSC (PVFC Land) http://www.pvfc.com.vn		2007	Real estate trading
	PVFC Fund Management JSC (PVFC Capital) http://www.pvfccapital.com.vn	24% by PetroVN, 27% by PVFC	2007	Fund management
	Phu Dat Investment and Construction JSC http://phudatjsc.com.vn	93.4% owned by PVFC, 6.5% by PVFC Land, 0.1% by PVFC Invest	2008	Real estate
	PetroVN Finance Communication JSC. (PVFC Media) http://www.pvfc.com.vn	PVFC is 1 of 5 founders	2007	Media
	PetroVN Insurance Corp. (PVI) www.pvi.com.vn		2007	Insurance
	PetroVN Drilling Investment Corp. (PVD Invest) www.pvdi.com.vn	51% owned by PetroVN Drilling Co.	2007	Financial investment and consultancy
	PetroVN trade union finance investment Corp. (PVFI) www.pvfi.com.vn	75% owned by PVN and its employees, 10% owned by PSI	2008	Financial investment and consultancy
	Petro VN Securities JSC (PVFC Securities) www.psi.com.vn	More than 50% owned by PVFC	2006	Securities
	Ocean bank http://oceanbank.vn	20% by Petro VN	2009	Banking
	An Binh Joint Stock Bank (ABBank) http://www.abbank.vn	27% owned by PVFC	2005	Banking
	Global Petro JS Bank (GP Bank) http://www.gpbank.com.vn	20% owned by PetroVN	2005	Banking
	PetroVN Power Land JSC (PV Power Land) www.pvpowerland.vn	28% owned by PV power, 10% by PVFC	2007	Real estate
EVN	Ha Thanh Security JSC (HASC) www.hasc.com.vn/		2006	Securities
	An Binh securities JSC (ABS) http://www.abs.vn	Majority of shares owned by EVN and ABB	2006	Securities
	Power Real Estate JSCs. (EVN Land) includes: EVN Land Saigonhttp://www.evnlandsaigon.vn EVN Land Central http://www.evnlandcentral.com.vn/	Majority of shares owned by EVN	2007	Real estate
	An Binh Joint Stock Bank (ABBank) http://www.abbank.vn	25.37% owned by EVN	2005	Banking
	EVN Finance JSC (EVN Finance) http://www.evnfc.vn/	40% by EVN 8,4% by ABBank	2008	Finance and banking

Vinashin	VN shipbuilding finance Co. (VFC) www.vinashin-finance.com.vn	100% owned by Vinashin	1998	Finance and banking
	Vinashin Finance Leasing Co. Ltd. (VFL)	100% owned by Vinashin	2008	Finance and finance leasing
	CIMB-Vinashin Ltd. Co (CIMB-Vinashin securities)	Owned by VFC and CIMB	2008	Securities
	Vinashin-finance securities Co. www.vinashin-finance.com.vn	100% owned by VFC	2008	Securities
	Vinashin Thanh Dat real estate JSC-Vinashin Land			Real estate
VRG	Rubber finance Co. (RFC) http://rfc.com.vn	100% owned by VRG	1998	Finance and banking
	Ruber Securities joint stock Co. (RUSE) www.rubse.com.vn	40% owned by VRG and 11% owned by RFC	2006	Securities
	Saigon Hanoi Bank (SHB) http://www.shb.com.vn	15% owned by VRG	2006	Banking
	Saigon-Hanoi Fund management JSC (SHF) www.shf.com.vn	Majority of shares owned by VRG, SHB, and Vinacomin	2008	Investment Fund
Viettel	Vinaconex-Viettel finance JSC (VVF)	32% onwed by Vietel	2008	Finance and banking
	Military joint Stock Bank (MB) http://www.militarybank.com.vn/	15% owned by Viettel	2008	Banking
Vinacomin	Mineral & Coal finance Co. Ltd. www.cmf.vn	100% owned by Vinacomin	2007	Finance and banking
	SHB-Vinacomin Insurance Joint- Stock Company www.svic.vn	19.8% owned by Vinacomin	2008	Insurance
	Saigon Hanoi Joint Stock Bank (SHB) http://www.shb.com.vn	15% owned by Vinacomin	2006	Banking
	Saigon-Hanoi Fund management JSC (SHF) www.shf.com.vn	Majority of shares owned by Vinacomin, SHB, and VRG	2008	Investment Fund
VNPT	Post & telecommunication finance Co. (PTF) www.ptfinance.com.vn	100% owned by the state	1998	Finance and banking
	Vietnam Postal Savings Services Company (VPSC) www.vpsc.com.vn	100% owned by VNPT Holdings	1999	Banking
	Posts &Tel. Joint - Stock Insurance Company (PTI) www.pti.com.vn		1998	Insurance
	Vietnam Maritime JS Bank (Maritime Bank) www.msb.com.vn/	21.33% by VNPT	2005	Banking
Vinatext	Textile Finace Co. (TFC) www.vinatex.com.vn	100% owned by Vinatext		Finance and banking
	Vinatext Land www.vinatexland.net/		2007	Real estate
	Empower Securities JSC (EPS) http://www.eps.com.vn	22% owned by Vinatext	2007	Securieties
Vinachem	VN chemical Finance JSC (VCFC) www.vcfc.com.vn	37% owned by Vinachem, 10% by Bao Minh	2008	Finance and banking
	Vietstar joint stock bank	5% owned by Vinachem	2008	Banking

	Bao Minh Insurance JSC (Bao Minh) http://www.baominh.com.vn		2004	Insurance
Songda	Songda Finance JSC. (SDFC) www.sdfc.com.vn	Majority owned by Songda Holdings	2008	Finance and banking
	PVFC Fund Management Joint stock Company (PVFC Capital) http://www.pvfccapital.com.vn	20 % by SUDICO – subsidiary of Songda	2007	Fund management
	Petro VN Power Land JSC (PVPower Land) http://www.pvpowerland.vn/	10% owned by Songda	2007	Real estate

Source: websites of SEGs, above mentioned companies, http://www.nganhangtaichinh.com/, and http://www.company.vn/

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