

# Viet Nam

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## **Summary**

*Microfinance in Viet Nam is dominated by subsidized programs, either those channelled through government-owned banks, or those implemented via mass organizations. These subsidized programs hamper the viability of genuine microfinance institutions (MFIs) and reflect a social welfare, rather than a financial sector, approach to microfinance. Only a small number of programs, primarily those implemented by international NGOs and donor agencies, apply best practice and emphasize sustainability. Some new institutions, formed in the 1990s after the collapse of the credit cooperatives, also show potential.*

*While it is important that the State Bank of Viet Nam review interest rate restrictions to enable microfinance programs to charge market-related rates, this is dependent on broader processes of financial sector reform and is bound up with the problems of introducing market principles into the economy. Importantly, the introduction of positive real deposit rates would encourage savings mobilization.*

*Providing effective regulation and supervision of deposit-taking institutions is an urgent priority. There is also a role for the central bank to promote microfinance by supporting research, collaborating in the development of performance and reporting standards, and supporting institutional strengthening of MFIs.*

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## Viet Nam **Currency Equivalent**

Currency Unit – Dong (D)  
 US\$1 = D13,995 (at mid-1999)

### Abbreviations

ADB	Asian Development Bank
CARE	Cooperative for Assistance and Relief Everywhere, Inc.
CGAP	Consultative Group to Assist the Poorest
CIDA	Canadian International Development Agency
FA	Farmers' Association
GDP	gross domestic product
GRET	Groupe de Recherche et d'Echanges Technologiques
HEPR	Hunger Eradication and Poverty Reduction
MFI	microfinance institution
NGO	nongovernment organization
PCF	People's Credit Fund
RSHB	rural shareholding bank
SBV	State Bank of Viet Nam
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
VBARD	Viet Nam Bank for Agriculture and Rural Development
VBP	Viet Nam Bank for the Poor
VFU	Viet Nam Farmers' Union
VWU	Viet Nam Women's Union
VYU	Viet Nam Youth Union

### Note

In this report, "\$" refers to US dollars.

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*While trying to create a modern financial system in a transitional economy it would be easy to overlook microfinance*

*Some economic reform has been achieved but there are major challenges — Viet Nam remains one of the poorest countries in the world*

## 1 Introduction and Background

Because a country's financial policies and regulation of microfinance influence to a large degree the growth and development of microfinance, it will be extremely important for that country to have policies and regulation that promote, rather than suppress, the growth and development of microfinance institutions (MFIs) and programs. In transitional economies, the broader issues of creating a modern financial system are likely to preoccupy policymakers, including the process of establishing a central bank which operates according to internationally accepted norms and principles and with an appropriate degree of independence. In a transitional economy undergoing financial sector reforms it would not be surprising if microfinance, as a separate category requiring attention, were to be overlooked.

This paper analyzes the role of the State Bank of Viet Nam (SBV), the country's central bank, in the growth and development of microfinance and in the broader context of reform. It discusses how central bank policies and regulation can impede or promote the development of microfinance in Viet Nam.

### 1.1 Recent Economic Performance and the Poverty Situation

Viet Nam has made remarkable progress in moving from a centrally planned economic system toward a "functioning market economy," although much remains to be done before it could properly merit that description. Its Doi Moi economic renovation program launched in 1986 commenced the transition to a market economy. In 1995, the World Bank reported that Viet Nam "carried out ambitious economic reforms, including decollectivizing agriculture, liberalizing prices and promoting the domestic and foreign private sectors" (World Bank 1995, i). As a result of economic reforms, Viet Nam has enjoyed a high economic growth rate, with average annual growth of gross domestic product (GDP) estimated at 8.6 percent in 1990–1997 (UNDP 1999). In 1998 the GDP growth rate was 4 percent (ADB 1999). Inflation decreased from a high 70 percent in 1990 to 6 percent in 1997, but increased to about 9.2 percent in 1998.<sup>1</sup>

Despite major progress in economic reforms, Viet Nam faces current challenges that need to be addressed urgently. It has suffered a decline of competitiveness within the region, the banking system is weak, and state enterprises still absorb a very high proportion of domestic savings. Foreign direct investments have slowed down. Viet Nam has provided widespread access to basic social services, but this system has shown signs of deterioration, and the quality of social services has declined.<sup>2</sup> Box 1 contains a summary description of reform measures, the outcomes, and some emerging challenges to the Vietnamese economy.

1 Dao et al. (1999, 34) observed that "the worsening of the economy is a reflection of the reduction of foreign capital flow and domestic investment in 1998. Total investment is expected to fall by \$2 billion."

2 Memorandum of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Country Assistance Strategy of the World Bank Group for the Socialist Republic of Viet Nam, August 1998 (World Bank 1998).

### **Box 1: Reform Process at a Glance: Past Progress and Some Emerging Concerns**

#### **Major reforms undertaken**

Viet Nam undertook a series of major reforms beginning in the late 1980s:

- decollectivization of agriculture and new land laws with security of land tenure
- price reforms, including removal of virtually all administered prices, movement towards interest rate liberalization, and exchange rate unification
- liberalization of foreign trade and investment
- progress towards establishing a legal framework to encourage growth led by the private sector
- initial opening up of the financial sector to domestic and foreign private banks.

#### **Outcomes**

These reforms halted the economic decline of the 1980s, and made Viet Nam one of the fastest growing economies in the world. Highlights of successes during the 1990s include:

- per capita income growth in excess of 5 percent per year
- inflation decreased from near-hyperinflationary levels to single digit
- a threefold increase in investment in real terms
- dramatic growth in foreign investment
- a fivefold increase in domestic savings
- a doubling in agricultural production
- a major export boom with exports growing at 25 percent per year
- widespread, visible improvements in the lives of Viet Nam's population.

#### **Emerging concerns**

More recently, however, Viet Nam has faced the twin challenges of the East Asian crisis and a loss in the momentum of growth as the impact of the first generation of reforms fades. As a result, some troubling signs have emerged, including:

- macroeconomic stability is under threat
- momentum of growth is slowing
- quality of growth may be deteriorating
- social and environmental sustainability of the growth path has been eroding.

Source: World Bank (1998)

Thus, notwithstanding its impressive economic growth calculated by the United Nations Development Programme (UNDP), Viet Nam, with an estimated population of 76.7 million, remains one of the poorest countries in the world. With a Human Development Index score of 0.664, Viet Nam ranks 110th out of 174 countries (UNDP 1999). Average annual per capita income is estimated at about \$300. Eighty percent of the population lives in rural areas and has an estimated annual per capita income of \$60–100. According to the Vietnamese Living Standards Survey, the overall incidence of poverty is extremely high, and about 51 percent of the population lives below the international standard poverty line (Dao 1999). While the Doi Moi reform policy has brought unprecedented economic growth, the gains have not been equitably shared.<sup>3</sup> The current concerns are how to maintain the growth trajectory and how to distribute the fruits of economic growth more equitably.

The serious poverty situation motivated the Vietnamese government to launch a poverty alleviation strategy, Hunger Eradication and Poverty Reduction (HEPR), in 1997. Each government department and institution has to have a focus on poverty and social issues as part of its normal operations, and the Government has created a number of national programs to alleviate poverty across the country.<sup>4</sup>

***The government  
launched an anti-  
poverty strategy in  
1997***

3 Dao (1999). The 1998 inflation rate was taken from State Bank of Viet Nam (1998).

4 Pairaudeau (1999) describes the operation of these in Duyen Hai District in Tra Vinh Province.

## 2 Development of Microfinance

### 2.1 Microfinance and Poverty Alleviation

*Microfinance is an element in the government's anti-poverty strategy and has been supported by donor institutions*

The acute poverty situation in Viet Nam has focused the attention of the Government on the financial services needs of the poor as a potentially powerful instrument in poverty alleviation. Thus, the Government has used state-owned banks to provide subsidized loans to poor households, and has regulated interest rates through the central bank, the State Bank of Viet Nam (SBV) to achieve poverty alleviation objectives. The international donor community, as represented in Viet Nam, has also expressed the belief that microfinance is an important tool for poverty alleviation. Typical is the view that "access to small loans provides the working poor with the means to make use of opportunities to improve their incomes, while access to savings facilities allows poor families to build up household equity and a valuable cushion against seasonal production shortages and unforeseen crises."<sup>5</sup> International NGOs and the donor community have been instrumental in the introduction of many innovative savings and credit schemes.

### 2.2 Scope and Outreach of Regulated Financial Institutions

The microfinance sector is served by regulated financial institutions, unregulated semi-formal institutions, and informal lenders. Aside from the central bank, SBV, the formal financial sector is composed of the following institutions:

- (i) five state-owned commercial banks: namely, the Viet Nam Bank for Foreign Trade, Viet Nam Bank of Investment and Development, Viet Nam Industrial and Commercial Bank, Viet Nam Bank for Agriculture and Rural Development (VBARD), and Viet Nam Bank for the Poor (VBP);
- (ii) 977 people's credit funds;
- (iii) 69 credit cooperatives;
- (iv) 50 shareholding banks, of which 31 are urban based and 19 are rural;
- (v) four finance companies;
- (vi) 68 foreign banks, of which 29 have opened branches in Viet Nam;
- (vii) four joint-venture banks.

*The potential market for rural microfinance consists of some 12 million low income and very low income households*

The Vietnamese microfinance market is estimated to be about 65 percent of the rural population or 12 million rural households. Of these, 10 percent are considered very low income households, and 55 percent (6.6 million) are low income households. Table 1 shows the outreach of various regulated MFIs.

### 2.3 Diversity of Models

As anywhere else in the developing world, Viet Nam has a wide diversity of microfinance models and structures. These range from the large microcredit programs funded and operated by government entities, such as VBARD and VBP, to the savings and credit projects run by international nongovernment organizations (NGOs) and local mass organizations.

5 Roy Morey, United Nations Resident Coordinator and UNDP Resident Representative, Hanoi, Viet Nam, in his foreword to the CGAP–UNDP (1996) report on microfinance in Viet Nam prepared by Alan Johnson.

**Table 1: Outreach of Regulated Microfinance Institutions in 1998**

<b>Financial institution</b>	<b>Total HH Customers (million)</b>	<b>Percent of Total Rural HHs</b>	<b>Average Loan Size (US\$)</b>	<b>No. of LIH Customers</b>	<b>Percent of total FI customers</b>	<b>Percent of LIH</b>
VBARD	4.0	33.0	290	1.8	45	27
VBP	1.3	11.0	110	0.6	46	9
PCFs	0.6	5.0	300	0.3	50	4
RSHBs	0.01	0.08	—	—	—	—
<b>Total</b>	<b>5.91</b>	<b>49.08</b>	<b>—</b>	<b>2.7</b>	<b>—</b>	<b>40</b>

HH = households, LIH = low income households, FI = financial institution. See also Abbreviations. — = data not available or not calculated.

Source: Estimates by Dao et al. (1999).

Of the banks, only government-owned banks, that is, VBARD and VBP, are providers of microfinance services. VBARD uses its extensive branch network, that reaches down to the commune level, to provide poor households with subsidized loans, as well as offering deposit services. On the other hand VBP, without a network of its own, uses the branches of VBARD at the commune level to lend to targeted poor households.

Some international NGOs, external donors, mass organizations, and other semi-formal institutions also play a critical role in microfinance. They provide funding, technical expertise on microfinance, and management support to various savings and credit projects. Local mass organizations have also tried to implement their own savings and credit schemes in addition to providing support to VBARD and VBP in screening these banks' target clientele.<sup>6</sup>

In this section we discuss the major institutions concerned with microfinance and the innovations they have introduced. Institutions discussed include the two government banks, VBARD and VBP, and the people's credit funds. The latter are a relatively new institutional form built with foreign assistance on the foundations of an earlier national credit cooperative system. In addition, we consider the rural shareholding banks (RSHBs), another innovation arising from the defunct credit cooperative movement. We also consider a variety of semi-formal schemes which are designed to implement the financial aspects of mass government poverty programs. Some attention is given to the microfinance programs of mass organizations (conducted as part of one or another of the government's poverty programs) as well as to the innovations of international NGOs and donors. Finally, there is some discussion of informal finance, which continues to flourish in Viet Nam.

### **Viet Nam Bank for Agriculture and Rural Development**

VBARD and VBP are the major providers of subsidized microcredit to poor Vietnamese households. Established in 1988, VBARD was formerly the agriculture credit department of SBV. As of 1997, it had 600 branches and 1,500 smaller outlets, with 21,000 staff, of whom more than 7,000 are credit officers. VBARD is present in 25 of Viet Nam's 63 provinces. Its presence at the commune level is low, but is quite high at the district level. Thus, it has to innovate in order to reach the communes. People's credit funds (PCFs), which operate in most of the 63 provinces, are the only financial institutions able to match and, in fact, exceed the network of VBARD.

<sup>6</sup> As Dao (1999) points out, not all international NGOs adopt best practice; some continue to subsidize interest rates and tolerate loan defaults.

***Government banks, mass organizations, and the international community are active in microfinance, using diverse models and structures***

***VBARD is far from having national outreach but it is making innovations to increase access***

VBARD has introduced mobile banking units and a system of joint liability groups that are used for loans without collateral. VBARD tries to reach target individuals through the joint liability groups that act as intermediary organizations and have helped increase VBARD's outreach. Another approach is to lend to individuals who are members of "guarantee groups" organized by mass organizations. Under this scheme, the groups make a common guarantee to repay the loan. The mass organization that has organized the guarantee group sponsors it and provides secondary guarantees to VBARD for loan repayment. VBARD works closely with mass organizations, for example, the Vietnamese Women's Union (VWU) and the Farmers' Association (FA), to reach poor farmers through the formation of joint liability groups.

Because of these innovations, the proportion of rural households able to access VBARD loans jumped from 9 percent in 1994 to 40 percent in 1997. This represents "a shift away from financing state-owned enterprises toward financing private households and businesses" (World Bank 1996). VBARD's main objective is to reach as many private households and businesses as possible with subsidized credit. However, it is doubtful whether VBARD will be able to sustain the transfer of subsidized credit in view of the Government's budgetary constraints. Its role in transferring subsidized credit also conflicts with its function of providing commercial credit to non-poor entities.

***Many areas where the poor are concentrated remain out of VBARD's reach***

Despite its attempts to reach poor households, VBARD's outreach to poor communes in isolated and mountainous areas, where the concentration of poverty is highest, has been limited. Among the difficulties are the distances that need to be covered and the deplorable road conditions.

### **Viet Nam Bank for the Poor**

VBP was established in August 1995 in order to serve poor households that cannot be reached by VBARD. Its major task is to provide subsidized credit to poor households as a mechanism to alleviate poverty, and over 50 percent of its loan portfolio constitutes preferential credit to the poor. As of the end of 1997, VBP had provided subsidized credit to 1.6 million poor households, which represent 30 percent of poor households. VBP uses VBARD's extensive network of branches and small outlets; it has no separate staff members. It is not involved in any savings activity, but is largely dependent on the Government for its loan funds. It also draws funding from state-owned banks.

***Unlike VBARD, VBP has a specific poverty mandate***

VBP uses joint liability groups to provide credit to poor households. It works with mass organizations such as VWU and FA to organize savings and credit groups in poor communes, and transfers loans directly to the poor through these groups.

The most important issue facing VBP is its lack of long-term viability and sustainability. Several factors are responsible for this: (i) the subsidized interest rate it charges is not adequate to cover actual operational costs, (ii) its dependence on the Government for funding and on VBARD for staff and offices, and (iii) the weakness of the joint liability group system of credit management, as indicated by the low loan recovery rates (see Dao 1998). Another issue is the current VBP policy of lending only to farm-based households, which effectively shuts out non-farm entrepreneurs and other types of country-based, but non-farm, borrowers.

***VBP's operational policies undermine its sustainability***

### **People's Credit Funds**

PCFs are commune-level savings and credit cooperatives modeled on the Caisse Populaire Credit Union System in Quebec, Canada. The establishment of PCFs started in July 1993 as a pilot project under the supervision of SBV. In 1994, Développement International Desjardins provided the program funding from the Canadian International Development Agency (CIDA). Prior to the creation of PCFs, thousands of

credit cooperatives (about 7,100 in 1985) had been established in communes throughout the country. However, these credit cooperatives collapsed. An estimated D100 billion in deposits “were not reimbursed” to their owners and 6,000 credit cooperatives went bankrupt in 1989–1990.<sup>7</sup>

PCFs operate under the cooperative law, where loans are made only to cooperative members. A qualification share of D50,000 is required of each member. Although PCFs accept deposits from members and nonmembers alike, they give loans only to members. The average loan size is usually less than D1 million. They do not require collateral for small loans; in contrast, they require borrowers of large loans to provide collateral that can consist of land-use-right licenses or other assets. The maturity period for loans is less than 12 months. PCFs charge interest rates of around 1.5 percent per month, while the monthly savings rate is 0.9 percent. These rates, which are determined by SBV, are generally higher than those of VBARD and VBP.

Dao and Hotte (1998) estimated that, as of the end of April 1997, around 1 million households have had access to credit provided by PCFs, and that approximately 800,000 households have a borrowing relationship with PCFs at any given time. Information provided by SBP on the PCFs’ operations shows that, as of April 1997, three years after their establishment, PCFs were able to mobilize D764,707 million.<sup>8</sup> PCFs have a deposit insurance program with the Viet Nam Insurance Company, under which PCFs’ bankruptcy or insolvency makes the insurance company liable to reimburse members their deposits.

Dao and Hotte (1998) attribute the PCFs’ relative success in funds mobilization to the following factors:

- (i) PCFs are accessible to clients, making it convenient for members to deposit and withdraw money;
- (ii) deposit rate is higher than those offered by other credit institutions;<sup>9</sup>
- (iii) deposit mobilization methods vary and are adjusted to the people’s needs; and
- (iv) deposit insurance is available for deposits with terms exceeding three months.

The main criticisms of PCFs are that (i) they are inaccessible to the poor who apparently cannot afford to pay the required qualification share, and (ii) they are relatively inexperienced in microcredit provision and in dealing with poor women and joint liability groups (Dao and Hotte 1998). However, PCFs could become effective MFIs

***PCFs are membership-based organizations, and mobilize savings successfully***

### **PCFs and Savings Mobilization**

PCFs are relatively successful in mobilizing savings, in the context of Viet Nam, because:

- PCFs offer accessibility and convenience to clients for deposits and withdrawals
- deposit rate is higher than those offered by other credit institutions
- deposit mobilization methods are tailored to people’s needs
- deposit insurance is available for deposits with terms exceeding three months.

7 Dao and Hotte (1998). Exchange rate was D11,000 = US\$1.

8 Deposits are mostly short-term — that is, less than a year.

9 SBV allows PCFs to lend at rates higher than those charged by other credit institutions in the same areas and to pay depositors a higher funds mobilization rate. The difference in funds mobilization rate ranges from 0.5 to 0.7 percent per month.

if given technical assistance by external donors, if supported by SBV and the Government, and if the response of communes to their establishment is enthusiastic.

***RSHBs lend successfully to women and have potential to reach poor households***

### **Rural Shareholding Banks**

RSHBs arose from the reorganization or mergers of rural credit cooperatives. They have limited exposure to poor households, although their experience with lending to women's groups organized by VWU is very satisfactory. The loan repayment rate from these groups averages 98.3 percent. RSHBs have the potential to reach poor households because of their geographical proximity to those households. This proximity gives them access to critical information, enables them to have simple lending procedures, and keeps transaction costs low (Dao 1998). RSHBs also target clients other than poor farmers. However, weak deposit mobilization and lack of access to commercial borrowing limits their available funds, which in turn limits their growth and development as MFIs.

### **Potential Microfinance Strengths**

The rural shareholding banks and people's credit funds — formal financial institutions supervised by SBV — have the potential for growth and a wide delivery mechanism for microfinance programs. Their main advantages are:

- the legal status they enjoy
- a wider delivery network
- support from local authorities
- flexible savings schemes.

### **Semi-formal Financial Schemes**

The semi-formal financial schemes are composed of national programs (for example, HEPR), savings and credit schemes implemented by mass/social organizations like VWU, and rural microfinance schemes established by international NGOs. The Government recognizes semi-formal MFIs, but these are not regulated or supervised by SBV.

### **National Programs for Poverty Alleviation**

National programs are funded by the state budget and are directed towards poverty alleviation. Four major national programs provide microcredit to poor households (see Box 2 for a short description of those programs). Government ministries are in charge of implementing the microcredit programs which typically consist of providing subsidized and collateral-free loans to borrowers who are asked to meet certain public objectives, for example, planting trees or job creation in rural areas.

The national programs have the best of intentions. However, the highly subsidized nature of these programs casts doubt on their sustainability. The lack of any interest in savings mobilization gives the wrong signal to clients and reinforces the continuing demand for subsidized loans.

### **Microfinance Programs of Mass Organizations**

Mass organizations are quasi-governmental bodies that are represented at four administrative levels — national, provincial, district, and commune — which allows them to be present from the senior levels of government down to the grassroots level. Mass organizations, such as FA, Veterans' Association, Viet Nam Farmers' Union (VFU), Viet Nam Youth Union (VYU), Peasants' Union, and VWU, assist the

***Lending under the HEPR program is a social welfare, rather than a financial sector, activity***

## **Box 2: National Programs Providing Microcredit to Poor Households**

### **National Program for Hunger Eradication and Poverty Reduction (1998–2000)**

To reduce poverty through nine projects, funded at \$714 million:

- rural infrastructure and reconstruction
- production and job creation assistance
- credit to the poor
- assistance to education
- assistance for public health care
- agriculture extension services
- strengthening the capacity of project staff and commune cadres
- assistance to ethnic minority people
- resettlement and settlement in newly established economic areas.

VBP implements the Credit to the Poor program. Each poor household will get a collateral-free and subsidized loan of D2–2.5 million payable in 36 months.

### **Program for Greening Barren Hills (1993–1998)**

For reforestation and local infrastructure, funded at \$210 million. Some \$30 million was for providing interest-free loans for the planting of orchards and trees. To cover local service costs, an interest rate of 0.1–0.2 percent per month may be charged. The Ministry of Planning and Investment supervised this program. In mid-1998, this program was replaced by the Program of Greening 5 Million Hectares of Forest.

### **National Program of Greening 5 Million Hectares of Forest**

For extending interest-free credit to rural households who will plant perennials. The Ministry of Agriculture and Rural Development is in charge of providing this subsidized credit program.

### **Program for Job Creation**

For extending \$76 million of credit with a maximum term of six months at a subsidized interest rate of 0.6 percent per month. State treasury offices located in district centers give loans to borrowers, mostly small micro-enterprises in rural areas. The Ministry of Labour, Invalids and Social Affairs supervises the program.

Source: Dao (1999)

Government in disbursing loans under specific government programs (Dao 1998). The last group, VWU, has a mass membership of almost 11 million women, with an estimated 80,000 women's savings and credit groups. Major programs involving the mass organizations are listed in Box 2.

The extensive local networks of mass organizations which go down to the grassroots level enable them to act as “brokers” between VBARD/VBP and borrowers. They also assist the People's Committee in forming joint liability groups that act as guarantors for loans at the commune level. In return for this service, the mass organizations receive a commission from VBARD/VBP. This is consistent with the current credit policy of VBARD/VBP, which is to provide loans directly to farm households and not through mass organizations.

Mass organizations, primarily VWU, VFU, and VYU, have also established savings and credit groups that enabled them to reach as many as 1.6 million borrower households with total credit disbursed of about \$220.1 million by 1998. VWU sourced its credit funds from VBARD and VBP (68 percent), grants (24 percent), and savings mobilized (8 percent). VFU received credit funds from VBARD and VBP (89 percent) and savings mobilized from members (11 percent). On the other hand, VYU received all its credit funds from VBARD and VBP (Nguyen and Nachuk 1998, cited in Dao (1999)). The huge dependence on the Government for loan funds is a glaring weakness of mass organizations' savings and credit schemes. Another problem is the lack of skills and staff for greater outreach.

**Mass organizations have outreach; VWU has 11 million members and 80,000 savings and credit groups**

**Although heavily dependent on government for loan funds, mass organizations have shown the potential for microfinance**

Mass organizations are not financial intermediaries although they can certainly reach a large number of poor clients. However, they have shown tremendous capacity for organization and community training. In this regard, as mass-based institutions, they can help the development of microfinance in the country by their social intermediation role. The important result is that those savings and credit groups have shown that the poor are good clients who value both savings and credit services provided by various semi-formal credit providers, as shown by high loan repayment rates and a strong motivation to save. Vietnamese experience with savings and credit schemes indicates that the poor are good credit risks; they can and do save; and they are not as much concerned with the cost of credit as with timely access to credit (CGAP–UNDP 1996).

### **Microfinance Programs Supported by International NGOs and External Donors**

Viet Nam has seen an influx of international NGOs and bilateral donors that have brought technical assistance on best practice and loan funds for on-lending to poor borrowers. Some of the major international NGOs are the following: Groupe de Recherche et d'Echanges Technologiques (GRET), ActionAid, Développement International Desjardins, CARE, Save the Children Fund (UK), and OXFAM (UK). These NGOs have been very active in promoting savings mobilization among their client members. They have been quite instrumental in training and exposing Vietnamese savings and credit groups and various mass organizations to innovative savings and credit products within savings and credit schemes.

**Foreign NGOs and bilateral donors have introduced international models of microfinance to Viet Nam**

As noted by an analyst of Vietnamese microfinance, there is a wide range of flexibility and variation in these savings and credit schemes. Access to savings facilities among poor rural women was perceived to be even more valuable than loan facilities. In fact, in a number of Action-Aid Viet Nam commune banks, the savings balance exceeds the balance of loans outstanding. Perhaps this is because the households saw savings as particularly useful instruments for smoothing seasonal consumption imbalances and in building household equity.<sup>10</sup>

It should be pointed out that for other international NGOs, savings and credit schemes represent a mere entry point to villages and communes in order to implement their main programs, such as health, family planning, etc. However, some of these international NGOs have attempted to make their savings and credit schemes viable in order to maintain credibility with the local population. International NGOs provide support to 90 savings and credit schemes (Dao 1999). The clients consist of poor women, ethnic minorities, and the poor in remote rural areas. The general experience is that international NGOs' microfinance projects have provided critical financial services to those traditionally excluded by the formal banking system. The high loan repayment rates and the growth of savings in those programs indicate the success of international NGOs in the microfinance sector. Box 3 gives a summary of those microfinance projects, as at 1995.

**Results of projects initiated by international NGOs are encouraging but outreach is very limited**

The savings and credit schemes implemented by international NGOs have the advantage of charging interest rates higher than those allowed to regulated financial institutions. This means that these schemes can have bigger margins. They have demonstrated the ability to reach target clients and generate high loan repayment rates. The main drawback is that these savings and credit schemes have limited coverage, due to high operating costs and relatively limited loan funds.

### **Informal Credit Schemes**

Informal credit schemes consist of credit extended by families, friends, traders, and private moneylenders through simple and convenient procedures. Informal lenders

<sup>10</sup> See CGAP–UNDP (1996) for an appreciation of the wide variety of savings and credit schemes employed by these international NGOs in the country.

**Box 3: Overview of International NGO Microfinance Projects**

Project budget	Average: \$69,287
Loan fund	Average: \$42,039
Projects which form groups	51
Average group size	10
Loan type	Cash: 55; In kind: 4
Loan size	Largest: D6 million Smallest: D25,000 Average: D826,080
Number of borrowers	High: 16,695 Low: 20 Average: 1,265
Interest rate per month	Highest: 3.0 percent Lowest: 0.6 percent Average: 1.86 percent
Repayment schedule	Lump sum, weekly, monthly, quarterly
Repayment rate	Highest: 100 percent Lowest 10 percent Average: 93 percent

Source: Savings and Credit Forum of Viet Nam, Hanoi, December 1995. Cited in Dao (1998).

are found in the vast majority of developing countries. Despite the intervention by VBARD, VBP, and the NGOs in the rural credit market, informal lenders continue to provide credit to the bulk of the population. Families and friends normally extend interest-free credit but as Dao (1999, 33) observes:

... the poor are not likely to borrow from relatives or friends because of the social implications. The culture dictates that one should help poor friends or poor relatives by handing over the money rather than lending it, to maintain good spirit relations.

Informal moneylenders and traders charge interest rates that are twice or more times as high as formal financial institutions. On average, interest rates set by moneylenders are 7–10 percent per month, while the rates charged by banks are 1.7–2.8 percent per month. VBARD and VBP provide loans for investment purposes only, so rural households have to rely on informal moneylenders for consumption loans, especially during lean months — that is, months before the rice harvests (Dao 1998). It was reported that in each village there are two or three permanent, and five to ten seasonal, informal moneylenders.

The 1992–1993 Vietnamese Living Standard Survey (cited in Dao 1998) showed that private moneylenders are the primary lenders in rural areas. Loans from informal sources have been reported to be about 73 percent of total loans to households. Formal financial institutions, such as government banks, provided only 22.7 percent of loans to households.

***Despite the efforts of formal institutions, informal lenders still provide credit to the bulk of the population***

## 2.4 Challenge of Sustainable Microfinance

The Vietnamese government has taken the alleviation of widespread poverty in the country as one of its most important tasks. Thus, it has viewed the provision of subsidized loans to targeted poor households as a critical intervention instrument. Policy lending, that is, lending to target sectors identified by the Government and

***Subsidized "policy" lending has been critical to the Government's anti-poverty strategy, but it is time to review this approach***

using public funds, has been the guiding rationale for VBARD's and VBP's involvement in microfinance.

Both local and international microfinance NGOs and local mass organizations have also involved themselves in microfinance, sensing a strategic weapon for poverty alleviation, especially in the countryside. In this regard, local and international microfinance NGOs have expressed doubt about the sustainability of the Government's highly subsidized credit programs. They have also raised questions about the appropriate role in microfinance of state-owned banks that offer unfair competition to private financial institutions, credit cooperatives, and non-conventional credit intermediaries, such as microfinance NGOs.

At the current stage of development of microfinance in Viet Nam, a serious review of this role of state-owned banks should be undertaken. There is a great need, not only to identify the comparative advantages of various types of finance providers, but also to work out complementary roles for government and the private sector within a framework of sustainable microfinance.

Given the appropriate macroeconomic environment, the correct regulatory policies, and an appropriate institutional framework, microfinance institutions and programs can become viable and sustainable. This will work for the benefit of poor households and microentrepreneurs who traditionally have been excluded from the formal banking system by reasons of asymmetry of information, high transaction costs, and the perception that they are a high credit risk.

### **3 Role of the Central Bank**

Prior to 1986, SBV was the sole financial entity and provider of credit. The socialist orientation of fiscal and monetary policy cast SBV into the role of financier of administratively determined resource allocations. This resulted in substantial credit subsidies to state enterprises and negative real interest rates. Unlimited credit made available through currency issue brought inflation rates peaking at 577.4 percent in 1986. Loan recovery from state enterprises was very low.

Financial reforms led to the transformation of SBV. This was made possible under the Doi Moi (innovation) reform process which, among other priorities, has sought the development of the banking system and the reform of state banks. Before the reforms, SBV was the major provider of funds for state enterprises and financed the budget deficit of the Government. Under the two banking decrees of 1990, SBV acts as the central bank responsible for monetary policy. It has authority over monetary management to control inflation and promote economic growth. The overall intent is to change the financial system from a subsidized and mono-banking system that has made SBV the sole funds provider to the entire economy, to a system that is commercially oriented, with a high degree of private domestic and foreign participation in the banking system. However, SBV remains a government agency and while it has authority over monetary management and the regulation and supervision of the financial system, it also carries out government policy directives.

The formal financial sector is composed of state-owned, private, and foreign-owned banks, and the PCFs and credit cooperatives, all of which are supervised by SBV. Banking decrees passed in 1990 placed commercial banks, credit cooperatives, and other financial institutions under the supervision of SBV.<sup>11</sup> In 1998, SBV yielded its commercial banking role to four government-owned commercial banks.

***Doi Moi has transformed the State Bank of Vietnam, the central bank***

<sup>11</sup> Local People's Committees used to license and monitor credit cooperatives.

## 4 Central Bank Support for Microfinance Initiatives

SBV perceives its role in microfinance in the country as “developmental,” which is narrowly defined as providing funds to the government-owned VBP and VBARD, which both lend directly to targeted poor households. SBV sees itself as an instrument for achieving the Government’s objective of poverty alleviation. Its other “developmental” role is to control the interest rates of financial institutions. It is in charge of licensing and supervising regulated financial institutions and implementing various laws affecting the financial system, for example, the law on cooperatives and the law on credit institutions.

The Government’s top priority is poverty alleviation, which it is addressing through national programs targeted at specific sectors or areas of the country. Under the HEPR program, by the year 2000 the Government was seeking to provide 90 percent of poor households, estimated at 2.7 million households, with loans of D1–5 million, with loan terms of up to three years. This was envisaged to be undertaken through a specialized bank for the poor (*Ngan bang nguoi ngheo*), the Viet Nam Bank for the Poor (VBP) created in August 1995 to “set up lending funds for the poor for poverty alleviation target” (VBP Charter, Article 2, Chapter 1).

The other major role of SBV is to determine the lending and deposit rates that regulated financial institutions may impose on clients and depositors, respectively. Through a carefully regulated interest rate structure, SBV hopes to provide poor households access to microfinance services at the lowest possible cost. Thus, a combination of state-funded subsidies, control of interest rates, and government targeting of the poor are the major intervention instruments used by both the Government and SBV to address the issue of widespread poverty.<sup>12</sup>

The Law on the State Bank of Viet Nam (1 October 1998) states that “the State Bank of Viet Nam shall determine and announce the base rate and interest rates for refinancing” (Article 18). In keeping with this mandate, SBV adjusted the ceiling of the lending interest rate. The short-term lending interest rate was adjusted from 1 percent to 1.2 percent per month; the medium-term and long-term interest rate was adjusted from 1.1 percent to 1.25 percent per month. The ceiling on the PCFs lending interest rate was fixed at 1.5 percent per month. SBV further announced that the interest rate spread of 0.35 percent per month had been lifted (State Bank of Viet Nam 1998).

In 1999, SBV decreed that the ceiling lending interest rate would be decreased by 0.1 percent per month, meaning 1.2 percent per year (*Viet Nam News* 1999). The current ceiling is 1.15 percent per month. According to the same source, “the adjustment will be applied to all credit institutions providing short-term, medium-term and long-term loans in both urban and rural areas.” The ceiling rate for PCFs and RSHBs will remain at 1.15 percent per month.

A related law implemented by the Government and SBV that affects the microfinance sector is the Law on Credit Institutions. The relevant provisions state that:

- (i) The State is in charge of establishing policy banks which operate on a nonprofit basis for the purpose of serving the poor and other underprivileged persons and of implementing the socioeconomic policies of the State.

12 An interesting point is that the experience of bilateral agencies and international NGOs in microfinance programs shows that “not a single scheme (that is, savings and credit) made use of official lists maintained by government agencies such as the provincial Department of Labor.” The general observation was that “there was a need to employ an independent targeting exercise because of perceived deficiencies in the lists of the poor.” See CGAP–UNDP (1996).

***SBV sees its role as “developmental”***

***The interest rate structure is a policy variable in the anti-poverty strategy***

***The Law on Credit Institutions and the Civil Code together set up a tight framework for state and non-state, bank and nonbank, microfinance operations***

- (ii) The State shall issue preferential credit policies on financing, interest rates, lending conditions, and duration applicable to the poor to facilitate the development of their businesses and production.
- (iii) Banking activities of nonbank organizations shall be subject to the relevant provisions regarding permitted banking activities.
- (iv) Nonbank credit institutions such as social organizations and NGOs are permitted to engage in some banking activities as their regular business, but are not allowed to receive demand deposits and to provide payment services.
- (v) Nonbank credit institutions engaged in banking operations are obliged to meet the following conditions: (a) banking activity is necessary and closely related to an institution's main activities, (b) there must be sufficient capital as required for banking services, (c) there must be a team of experts knowledgeable about banking operations, and (d) a feasible business plan on banking operations must be submitted (Dao 1999).

With regard to interest rate restrictions, nonbank credit institutions are subject to limitations imposed by the Civil Code, which states that "interest rates charged by lenders are not allowed to exceed the officially announced interest rates by more than 50 percent."<sup>13</sup> This dampens the market-determined interest rates that social organizations and NGOs charge on loans to their respective clientele, although it does allow them greater latitude than is given to state financial institutions.

SBV has an off-site surveillance system based on monthly returns submitted by banks. On-site supervision is done at the branch or sub-branch level. There is much to be improved in the surveillance system in order to ensure the stability and soundness of the banking system (World Bank 1996). This suggests that supervisory systems and resources available for nonbank credit institutions covered by the provisions of the Law on Credit Institutions are likely to be even less adequate to the task.

## **5 Policy and Regulatory Environment for Microfinance**

Both the Government and SBV wield substantial influence on the growth and development of microfinance. For example, subsidized credit provided through state-owned banks and restrictions on interest rate setting by MFIs affect the viability and sustainability of those institutions. Non-regulated MFIs are also affected because, as mentioned above, a ceiling is put on their lending rates.

Key changes necessary for sustainable microfinance relate to several areas of concern that emerge from an examination of the current policy and regulatory environment in Viet Nam:

- (i) the proper role of state-owned banks;
- (ii) the interest rate policy of SBV;
- (iii) lack of support for deposit mobilization;
- (iv) need for a competitive, market-oriented environment; and
- (v) appropriate regulation and supervision of MFIs.

These issues provide the framework for the following discussion in Section 5.

13 Dao (1999) noted that this is provided under Articles 467 to 475 of the Civil Code that was approved by the National Assembly on 9 November 1995.

## 5.1 Proper Role of State-owned Banks

As discussed earlier, the Government uses two state-owned banks, VBARD and VBP, to provide subsidized credit to targeted poor households. VBP has been created for a very specific purpose: to provide subsidized credit to the poor. According to its charter, VBP is exempted from profit tax and capital tax, and receives “preferential policies from the Government in order to reduce lending interest rate to the poor” (Article 3, Chapter 1). By law, no collateral is required of poor households to borrow from VBP, and loans of poor households are paid “when the loans are matured” (Article 8, Chapter 2).

The Ministry of Labour, War Invalids and Social Affairs, in collaboration with other government agencies, issues the criteria and guidelines for the selection of poor households and poor areas. It provides the official list of targeted poor households who are the expected clients of the Government’s poverty alleviation programs and SBV’s subsidized funding given to state banks. VBP uses the staff and facilities of VBARD branches to reach poor households. The extensive branch network of VBARD helps VBP save on overhead and staff costs. As of May 1999, it is reported that VBP had reached 2 million poor households. At the same time, it had funds provided by the Government for direct lending at the rate of 0.8 percent per month. The problem, though, is that the state banks often target the same poor households as the savings and credit schemes. The overlap and inconsistent interest rate policies can lead to inefficient program implementation and confusion among borrowers, depositors, and the credit intermediaries.

It is not possible for microfinance NGOs, PCFs, and the RSHBs to compete with state-owned banks that are recipients of huge state subsidies covering both operating and financial costs. Private MFIs’ profit-generating activities that should cover operating and financial costs are constrained by the ceiling on interest rates imposed by SBV. On the other hand, VBARD and VBP are recipients of implicit and explicit subsidies from the Government that enable them to penetrate poor areas, but at great expense to the taxpayer and at great cost to the development of sustainable MFIs.

### Key Issues of Policy And Regulation

Key issues of policy and regulation in Viet Nam relate to:

- the proper role of state-owned banks
- the interest rate policy of SBV
- lack of support for deposit mobilization
- need for a competitive, market-oriented environment
- appropriate regulation and supervision of microfinance institutions.

The negative experience of developing countries in using state-owned organizations for providing subsidized credit to target sectors challenges the wisdom of using state banks to reach poor households through subsidized credit. The few honorable exceptions among state banks, of which Bank Rakyat Indonesia is the best known, show that the poor can be reached on a sustainable basis with unsubsidized credit. However, most state banks are still motivated by the belief that transferring cheap credit to the poor is an effective way of combating poverty and underdevelopment. Thus, those governments have assumed the combined roles of planner, supplier, banker, marketing agency, producer, and welfare provider. They use special development finance institutions as special vehicles for transferring cheap credit, often funded by budgetary appropriation, to targeted poor households. This has hampered the growth and emergence of self-reliant local financial intermediaries.

***Two state banks provide subsidized credit targeted to the poor***

***Efforts of the two banks overlap and their policies are inconsistent, resulting in inefficiencies and confusion***

***State institutions have inhibited the development of alternative intermediaries***

Finding an appropriate role for state banks in the microfinance market in Viet Nam is critical. At present, they provide undue competition to savings and credit schemes in the semi-formal sector, and PCFs and RSHBs in the formal financial sector. These institutions' full potential as sustainable MFIs may not be realized because of the distortions in the financial market that are created by state banks. Put differently, the dominant role of state banks in the microfinance sector prevents the emergence of new (private) MFIs. The Government and SBV should carefully review the role in microfinance of the state banks that rely heavily on state funding, in order to transform them into catalytic institutions in the countryside.

## 5.2 Interest Rate Restrictions

*Where loans cannot be priced for risk, lending is repressed and resources are misallocated*

There is a serious concern about the current interest rate policy espoused by SBV. The ceiling on interest rates, in particular, the lending rate as discussed above, allows financial institutions only a very narrow margin with which to cover operating costs, risks, and to generate profits. There is a grave question regarding the sustainability of financial institutions that are not able to charge market rates of interest. Banks are, therefore, reluctant to lend because the ceiling on interest rates and the pressure to lower lending rates are squeezing bank profit margins. Interest rates do not cover the level of risk involved in bank lending. Furthermore, in the event of loan default, mortgaged assets take years to sell in order to cover the nonpayment of debt. This is costly for the banks and, again, does not promote lending (Gainsborough 1999).

Interest rate control leads to a misallocation of scarce financial resources. Financial repression makes interest rates lose their allocative function; financial resources are allocated on the basis of wrong signals and incentives. Indeed, one analyst commented that "financial markets that are not performing their functions efficiently are likely to misallocate resources and contribute to increased vulnerability in the face of growing financial integration" (Rana 1998). In the case of the "special development finance institutions" mentioned earlier, high rates of non-repayment of loans and huge defaults led to the weakening and even closure of some of those institutions which acted as conduits of government funds to target sectors (for example, small farmers, fisherfolk, poor households), often to the great detriment of taxpayers.

The interest rate ceilings imposed on regulated financial entities have resulted in a situation where the interest rate structure in the non-regulated, semi-formal sector is higher than the official lending and deposit rates. This creates pressure against savings and credit schemes implemented by international NGOs, bilateral donors, and mass organizations to provide cheap credit to clients. This raises doubt about the sustainability of both institutions and programs if savings and credit schemes succumb to political pressure to lower their interest rates.

There is hope that interest rate restrictions will eventually be lifted. SBV's 1998 annual report explicitly states that "the State Bank will continue to adjust the interest rate in the manner of a more flexible management on a basis of supply and demand with the aim of phasing out interest rate ceilings and getting prepared for interest rate liberalization whenever possible" (State Bank of Viet Nam 1998, 65). However, the question is whether this will happen in the foreseeable future in view of the large volume of nonperforming loans of state-owned enterprises and the political impact of lifting interest rate controls. Sustainability of microfinance programs cannot be achieved until this major issue is resolved in favour of liberalization.

*The central bank is aware of the need for greater flexibility*

## 5.3 Lack of Support for Deposit Mobilization

Interest rate restrictions create the wrong incentives and retard the growth of financial assets. This is a situation as obstructive to microfinance development as it is to general

financial development. The deleterious effect of financial repression was pointed out many years ago and it will be a pity not to learn lessons from this.<sup>14</sup> Recent field data gathered in Duyen Hai district in Tra Vinh province (Gainsborough 1999, 26) indicate that:

... very few of the formal financial schemes offer savings facilities. VBARD offers the main service but then, mobilization of savings has been relatively poor. PCF has been only marginally more successful in mobilizing savings, although if and when the number of commune level branches increases, this may improve.

Insofar as MFIs fail to mobilize the people's surplus and transform this into financial assets, there will be continuing dependence on subsidized credit. In the countryside most especially, dependence on moneylenders could be heightened, since financially weak and unsustainable MFIs cannot be expected to have a large outreach in the countryside.

The absence of deposit facilities will only serve to increase the motivation to save in gold and jewelry. This is not helpful at all in closing the savings-investment gap of the country. Other developing countries are trying to mobilize deposits as much as they can to close the huge savings-investment gap and reduce dependence on foreign loans and grants. The importance of having accessible deposit facilities in the countryside cannot be ignored. Field observation in a collaborative study on the experiences of NGOs, United Nations agencies, and bilateral donors has indicated that access to deposit facilities among poor rural women was seen to be more valuable than loan facilities (CGAP-UNDP 1996). Correct pricing of savings products and the safety of deposits are important factors in motivating savings mobilization. In the final analysis, the net losers are the poor who do not have alternative savings options and facilities for safeguarding lifetime savings and transforming these into productive instruments.

A major issue for the non-regulated MFIs is their legal status, especially with respect to deposit mobilization. Since many of them carry out quasi-banking activities, it will be necessary for the Government and SBV to review the appropriateness of allowing non-regulated MFIs to take deposits in the countryside. At stake are the savings of thousands of poor people and the stability of the financial system if non-regulated entities are allowed to mobilize substantial deposits without the appropriate prudential standards and norms.

## 5.4 Need for Competitive Markets

Depositors, investors, and other stakeholders want their MFIs to provide positive real returns to deposits and investments. At the same time, they want to be assured that the MFI is viable and sustainable. The agency problem between depositors and shareholders (the principal) on the one hand and the management (the agent), on the other, can be effectively dealt with by market competition among MFIs. Market competition creates the incentive for management and directors to be efficient; otherwise, the institution will lose business.<sup>15</sup> Depositors and investors take their funds to efficiently managed financial institutions. The efficient MFI not only offers positive real returns to deposits and investments, it also provides protection to funds entrusted to it.

It is important for central banks to pursue market-oriented policies and to design regulations that induce financial institutions to become competitive and

***Savings are suppressed and financial intermediation is inhibited***

***Women in particular value access to savings facilities and are disadvantaged by their absence***

***Efficient MFIs in a competitive market offer positive real returns to savers and investors***

<sup>14</sup> For example, McKinnon (1973) and Fry (1988).

<sup>15</sup> This paraphrases Zhuang (1999).

sustainable. Vietnam's formal financial markets are far from being competitive.<sup>16</sup> This reflects the difficulties of transition to market economics and the political and institutional obstacles to financial sector reform. There is a lack of financial policies and regulations that promote competition and that would enable financial institutions to cover their costs and become sustainable. This general problem has its counterpart in the microfinance subsector, where similar conditions apply. Similar principles of reform need to be applied by SBV to this subsector.

## 5.5 Appropriate Regulation and Supervision of MFIs

***SBV would benefit from adopting elements of risk-based supervision and applying these to the operations of both banks and MFIs***

Appropriate prudential regulation and supervision promote microfinance and, at the same time, ensure the stability of the financial system. Interviews indicate that SBV would benefit from recent developments in risk-based supervision that are also appropriate for regulated MFIs, such as the nonbank credit institutions covered by the Law on Credit Institutions. These institutions provide loans without the traditional collateral or security. Risk-based supervision examines the various risks faced by the MFI, creates risk profiles, and introduces appropriate safety measures. It is important for SBV to develop a regulatory and supervisory framework that allows private MFIs to respond adequately to the challenges and risks of the marketplace. Having a market-oriented interest rate policy, appropriate yet simple loan documentation requirements and regulation of unsecured loans, and effective supervision, will be indispensable to the growth and development of the microfinance sector.

The stability problem is accentuated by the well-known problem of information asymmetry in financial markets, where owners, shareholders, and managers of financial institutions have more information on their institutions than do clients and fund suppliers, for example, or depositors. Depositors must rely on adequate regulation and supervision by an oversight agency to assure themselves that they are being given fair treatment by owners and managers. Appropriate regulation and supervision will help generate the needed confidence and trust of depositors (in the case of institutions which take deposits), and of fund suppliers and investors, thereby contributing to the stability of the financial system.

To achieve this objective, SBV has to work seriously on having a market-based information structure in the financial marketplace. According to the World Bank (1996), "an assessment of bank financial performance [in Viet Nam] is problematic as accounting practices deviate in many ways from international standard. Such information as exists on bank operations is scanty, scattered and incomplete." Moreover, audit by an external independent auditor should be established as part of the regulatory and supervisory system. Obviously, this should apply to banks operating conventionally; it should also apply to any microfinance operations of banks.

The regulatory framework and supervisory apparatus for regulated MFIs should be complemented by standardized and transparent accounting practices, financial reporting, auditing, and performance standards for the unregulated microfinance entities. These will provide the basic information infrastructure that can help the market gauge the performance and viability of both regulated and unregulated MFIs. Donors are collaborating with the Government and SBV in introducing appropriate accounting and auditing standards. This should be supported and promoted.

***Market-based information procedures for regulated MFIs, and operational guidelines for unregulated MFIs, would improve the efficiency and transparency of both***

<sup>16</sup> Zhuang (1999) observed that in financial markets, the pervasive information problem prevents market forces from functioning efficiently in allocating funds and monitoring their use.

## 6 Conclusions and Recommendations

### 6.1 Conclusions

In Viet Nam, the formal, semi-formal, and informal sectors provide microfinance services to poor households. Of the formal financial institutions, Viet Nam Bank for Agriculture and Rural Development (VBARD) and Viet Nam Bank for the Poor (VBP) are the major providers of subsidized credit to target households. This is due to their access to state funding for subsidized loans. The rural shareholding banks (RSHBs), credit cooperatives, and People's Credit Funds (PCFs) are the other players in the microfinance market. These formal financial institutions are supervised by the State Bank of Viet Nam (SBV), and have the potential for growth and a wide delivery mechanism for microfinance programs. Their main advantages are the following: (i) the legal status enjoyed by credit cooperatives and PCFs, (ii) a wider delivery network, (iii) support from local authorities, and (iv) flexible savings schemes.

The semi-formal sector also addresses the credit demand by micro-enterprises and other small borrowers. There are two main players here: (i) the national programs for poverty alleviation funded by the Government that provide subsidized credit to poor households, and (ii) the savings and credit projects or schemes implemented by international nongovernment organizations (NGOs) and external donors. The informal sector is still the dominant source of credit for those who cannot access the banks and semi-formal institutions.

The semi-formal savings and credit schemes also have the potential of reaching more poor households than do government banks such as VBARD and VBP. This is due to their geographical proximity to and familiarity with target clients. However, these institutions cannot match the funding made available to VBARD and VBP by the Government for giving subsidized loans to target households. The semi-formal schemes have no legal status. This makes it difficult for them to have access to funds that can be used to expand their outreach and gain financial sustainability through market-oriented microfinance programs. On the other hand, for the formal microfinance schemes, financial sustainability is an elusive goal, given the capped spread allowed them by SBV. Thus, they are unlikely to expand their coverage of low income households.

SBV has moved in the right direction by controlling inflation and pursuing a stable macroeconomic environment. So far as financial development is concerned, there is no substitute for stable macroeconomic conditions. A regime of low inflation and low, but market-based, interest rates breeds confidence in the financial markets and instruments. Financial and macroeconomic reforms have enabled the economy to grow and attract investments.

State banks are used as conduits of government-subsidized credit to poor households. However, the subsidization of microcredit and the use of state banks as credit conduits have created distortions in the credit market. Financial repression, characterized by highly regulated interest rates, has likewise hindered the growth of the financial sector, including the microfinance sector. Government-subsidized funding is unlikely to be sufficient to address the lack of access to credit by poor households. Imposing interest restrictions constrains risk-taking and lending in the microfinance sector. This hampers the viability of microfinance institutions (MFIs) and casts doubt on the sustainability of microfinance programs. In the same vein, unfair competition by state banks has hindered the growth and development of new financial institutions.

The Vietnamese experience with economic growth has shown how the economy profits from having the correct incentives. Market-oriented reforms have contributed to the impressive economic growth record in recent years. However,

***Leaving aside the state banks, other regulated institutions have potential for microfinance, as do some semi-formal institutions***

***Macroeconomic stabilization has been conducive to financial, including microfinancial, development but interest subsidies and controls have not***

there is policy inconsistency in the microfinance sector. MFIs cannot freely set interest rates. This is unfortunate because it is those institutions themselves that know the market, the kind of risks in the market, and the interest rates that will enable them to absorb those risks while reaching out to more poor households. They have access to basic information in the marketplace that the Government may not ordinarily have. Thus, there is a basic inconsistency between regulated interest rates and other types of barriers to market entry (for example, non-competitive policies), and the objective of achieving financial sustainability of MFIs and programs. The experiences of other countries have amply demonstrated this, and one doubts whether Viet Nam can be the exception.

***Deposit taking by unregulated entities is a prudential concern***

The correct market-oriented incentives will be necessary to motivate greater deposit mobilization by MFIs. However, there should be a careful review of the appropriateness of having non-regulated entities mobilizing deposits in the countryside. In the absence of regulated entities in those areas, the critical role of non-regulated entities in mobilizing the rural surplus becomes apparent. Prudential concerns and the advantage of having a stable financial system require SBV to formulate the appropriate regulatory and supervisory framework and an effective supervisory apparatus in the microfinance sector.

***Corporate governance of MFIs needs to be improved, and a more competitive market will lead to such improvement***

Apart from stable macroeconomic conditions and market-oriented policies, there is the need to improve corporate governance among MFIs. MFIs should assure their depositors and shareholders that they are properly run and that positive real return on deposits and investments is assured. Problems between management and the depositors/shareholders can be effectively dealt with by market competition among institutions, which creates the incentive for management and directors to be efficient. The Vietnamese financial markets are far from being competitive, and thus financial policies and regulations that promote competition in the financial markets and enable financial institutions to cover their costs and become sustainable, are indispensable. Those regulations should not only induce financial institutions to become competitive and sustainable, but also provide protection to depositors and investors. Creating the appropriate incentive structure will address, to a very great extent, the agency problem and strengthen the financial system.

## 6.2 Recommendations

### **(1) SBV should continue to pursue a stable macroeconomic environment for financial sector reform.**

***Continue to pursue macroeconomic stability***

SBV should continue its pursuit of stability of the macroeconomic framework. A regime of low inflation or price stability and discipline on the fiscal deficit side is a crucial parameter for creating confidence in the financial system. This of course works to the advantage of the microfinance sector. Unstable financial systems and expectations of high and volatile inflation ruin the chances of the microfinance sector to be viable and sustainable.

### **(2) SBV should help to ensure that private financial institutions do not face an environment of financial market monopoly induced by the behavior of state-owned banks.**

***Ensure real financial market competition***

The Vietnamese government and SBV should define the proper role of state-owned banks versus private financial institutions. Viet Nam wants greater efficiency in the financial markets, but it faces an inadequate number of sustainable private financial institutions in the marketplace. Private financial institutions cannot grow in an environment of monopoly of the financial markets by state-owned banks. The development of private institutions is adversely affected by unfair competition from the state-owned banks.

**(3) In the broader context of government policy, SBV should move toward deregulating interest rates to ensure positive real lending and deposit rates.**

The Government and SBV should move towards deregulation of interest rates to enable regulated financial institutions and nonbank credit institutions to cover their transaction costs and realize an adequate return on risk taking. The short-term objective is to have positive real lending and deposit rates. This should go hand in hand with a firm effort to strengthen the regulatory and supervisory capacity of SBV, which will be necessary to ensure stability of the financial system. This is to counter potential strategic or opportunistic behavior of both financial institutions and clients to exploit a liberalized financial regime. This is the lesson of the recent Asian financial crisis, particularly in Indonesia and Thailand.

*Move towards deregulated interest rates*

**(4) SBV should attempt to provide an environment that supports and encourages mobilization of deposits among poor and low income households.**

SBV should allow real positive deposit rates to materialize; it should discourage the provision of highly subsidized credit that works against deposit mobilization by private financial entities. An important but relatively neglected undertaking is the mobilization of deposits in the countryside (although VBARD is one institution which does succeed in mobilizing a significant amount of savings from low income households). The lack of deposit facilities and the negligible yields on deposit instruments have discouraged deposit mobilization among poor and low income households more generally. Liberal bank entry and bank branching policy reduces the transaction cost for depositors as deposit facilities become available to rural and lower income populations. Sustainable microfinance depends a great deal on the ability of the economy to mobilize deposits and intermediate these successfully to the deficit units.

*Encourage savings mobilization*

**(5) SBV should provide effective regulation and supervision of deposit-taking financial institutions.**

SBV is largely responsible for creating confidence in the banking system through policies that allow the appropriate pricing of savings products and that provide support to the development of an accounting system that is at par with international standards. Effective regulation and supervision of deposit-taking financial institutions also breed confidence in the financial system.

**(6) The Government and SBV should examine the strategy of using subsidized credit to alleviate poverty.**

The Government and SBV should examine the strategy of using subsidized credit to alleviate poverty. The distortions and the wrong incentives that this instrument creates are too well known to be ignored.

*Reconsider credit subsidies*

**(7) SBV should support research on micro-enterprise finance and informal credit markets and best practice in the delivery of microfinance services.**

SBV should also encourage and provide funding to research on micro-enterprise finance and informal credit markets that will provide information on best practices. The research and policy analysis will stimulate discussion that can lead to the adoption of appropriate financial policies and innovative microfinance.

**(8) SBV should collaborate on the formulation of appropriate accounting, reporting, and performance standards to ensure adequate prudential oversight for MFIs.**

SBV should formulate an appropriate regulatory framework and effective supervisory apparatus for regulated MFIs to ensure adequate prudential oversight and the stability of the financial system. There is a significant role to be played by SBV in developing and promoting uniform and transparent accounting practices, auditing and financial reporting, and performance standards for MFIs.

*Establish standards for oversight of MFIs*

These practices will help ensure their good performance and behavior. In this regard, collaboration with donors and outside microfinance experts is recommended.

**(9) SBV should provide funds and support for institutional strengthening and capacity building of MFIs.**

SBV should provide funds for the institutional strengthening of MFIs and for the capacity building of their staff. A principal drawback in the development of microfinance in many developing countries is the lack of absorptive capacity of MFIs for the funds that are made available from various sources, for example, donors. Among other training needs, there is great need for capacity building which exposes and trains MFIs in financial innovation and best practice in microfinance.

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## Appendix: Persons Consulted

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