The Role of the Asian Development Bank in Promoting the Development of Microfinance in Lao PDR and Viet Nam

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I. Introduction

1. The Asian Development Bank (ADB) has provided assistance to develop the Lao and Vietnamese financial sectors generally since the early 1990s, and we have concurrently provided support for rural and microfinance (RMF) initiatives in particular. However, in the past four years we have intensified our assistance to the RMF sectors in these countries, and more importantly, developed a more coherent, strategic approach to developing the sectors. This is especially true in the Lao People's Democratic Republic (Lao PDR), as we'll see below, and is becoming more so in Viet Nam.

2. It should not be surprising that the development of a more strategic approach to develop RMF in Lao PDR and Viet Nam occurred in the past four years. In 1999, ADB began preparing its formal policy document on microfinance, "Finance for the Poor: Microfinance Development Strategy", which was approved by ADB's Board of Directors in May 2000. Our approaches in both these countries have been greatly influenced by the lessons learned and strategic approach laid out in our Microfinance Development Strategy. It is therefore worth reviewing some of the key aspects of this Strategy, especially those that directly inform our interventions in Lao PDR and Viet Nam.

II. ADB's Microfinance Development Strategy

A. Background to the Strategy

3. ADB's definition of microfinance is similar to that used by most other development agencies:

ADB's Definition of Microfinance

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their microenterprises. Microfinance services are provided by three types of sources:

- formal institutions, such as rural banks and cooperatives;
- semiformal institutions, such as nongovernment organizations; and
- informal sources such as money lenders and shopkeepers.

Institutional microfinance is defined to include microfinance services provided by both formal and semiformal institutions. Microfinance institutions are defined as institutions whose major business is the provision of microfinance services.

4. From 1988 to 1998, ADB approved 15 microfinance projects totaling about $350 million, 6 more projects with microfinance components valued at $53 million, and 34 TA activities for $18 million. However, many of these projects were ad hoc responses to the financial needs of the poor and were provided without a well-defined strategy. A review in 1999 found that the early projects in general (a) focused on microcredit delivery, (b) allowed subsidized interest rates, (c) paid little attention to financial viability, and (d) were poorly targeted. Moreover, institutional microfinance evolved during the previous decade from the domain of donors and experimental credit projects, into an industry with prospects for financial viability. The prospects for financial sustainability have revolutionized the microfinance field and suggest that a large proportion of the millions of poor people in the region can be provided access to institutional microfinance.

5. This is not to say that ADB was not learning and adapting along the way. The same review also found that lending operations in recent years support a wider array of institutions, go beyond credit services to promote voluntary savings on a limited scale, emphasize market-oriented interest rates, and pay more attention to financial viability than did earlier projects. Recent projects have shown a distinct bias toward reaching women in poor households, and most included social mobilization components to enhance women's capacity to access financial services delivered through project supported mechanisms. They have also been designed to encourage greater participation of the private sector in microfinance. Policy dialogue and sector work have received increasing attention. While microfinance policy issues did not figure importantly in the general policy dialogue on the financial sector in the late 1980s and early 1990s, ADB began paying more attention to these issues in the late 1990s. In countries where the policy environment was unfavorable (particularly where interest rate policies were repressive), ADB has refrained from assisting microfinance but has continued policy dialogue to improve the environment.

6. As ADB developed its Microfinance Development Strategy, we also knew that we could not lose sight of the raison d'être of microfinance—to extend financial services to the poor. Indeed, given that ADB has adopted poverty reduction as its overarching objective, supporting the development of sustainable microfinance institutions (MFIs) that can reach the poor provides ADB an opportunity to make a significant contribution to its poverty reduction objective and the development of the overall financial system in its developing member countries. Key questions then became: (i) How should ADB support improvement of the quality of microfinance services in the region? and (ii) How can ADB help expand microfinance services to achieve the maximum development impact, including a reduction in the incidence of poverty?

B. Lessons Learned from Past Experience

7. ADB's review of past microfinance experience in the region found that, despite general improvement in the policy environment for ***financial sector*** programs, the policy environment for ***microfinance*** in many countries remains unfavorable for sustainable growth in microfinance operations. Most of the state-sector institutions or programs that provide microfinance services have been created within a distorted policy environment characterized by various degrees of financial repression, including interest rate ceilings and directed credit. They do not have a business culture. Even new institutions created by the governments in most of ADB's developing member countries are unable to provide good quality services, let alone expand their services on a sustainable basis.

8. While distortionary policies like interest rates ceilings and directed lending limit the ability of MFIs to provide permanent access to financial services by excluded households, we have

also found that most retail level institutions do not have adequate capacity to expand the scope and outreach of services on a sustainable basis to most of the potential clients. Inadequate emphasis on financial viability is the most serious problem of MFIs in the region. This prevails among many NGOs, government-directed microcredit programs, state-owned banks, and cooperatives providing microfinance services. As a result, only a few MFIs are sustainable, and most are not moving toward sustainability.

9. Inadequate financial infrastructure is another major problem in the region. Financial infrastructure includes legal, information, and regulatory and supervisory systems for financial institutions and markets. Most developing member country governments have focused on creating institutions or special programs to disburse funds to the poor with little attention to building financial infrastructure that supports, strengthens, and ensures the sustainability of such institutions or programs and promotes participation of private sector institutions in microfinance. Another major problem in some countries is the lack of a legal framework conducive to the emergence and sustainable growth of small-scale financial institutions. And even where such a legal framework exists, MFIs' portfolios cannot be safely funded with commercial sources in the long term, especially public deposits, unless appropriate performance standards and regulation and supervision regimes are developed and enforced and measures are introduced to protect public deposits.

10. In summary, the lessons ADB learned from our past experience and that of other development agencies include the following:

(i) Adoption of the financial system development approach is the key to achieving sustainable results and to maximizing development impact. This approach emphasizes an enabling policy environment, financial infrastructure, and the development of financial intermediaries that are committed to achieving financial viability and sustainability within a reasonable period and that can provide a variety of financial services, not just credit, to the poor.

(ii) Microfinance clients are more concerned about access to services that are compatible with their requirements than about the cost of the services.

(iii) Given the diversity of demand for financial services, a broad range of institutional types is required to expand the outreach.

(iv) Strong retail institutions committed to outreach and sustainability are essential for extending the permanent reach of financial services and to have a significant impact on poverty reduction. Thus, building the capacity of institutions with a commitment to reach the poor is vital.

(v) Financial institutions committed to provide microfinance services in most DMCs require considerable technical assistance for capacity building. This is particularly true for institutions that target potential clients in resource-poor areas and the poorest of the poor.

(vi) The demand for savings services by poor households and microenterprises is as strong as or stronger than the demand for credit. Expansion of the outreach of savings services can have a potentially significant impact on both institutional sustainability and poverty reduction.

(vii) Because microfinance is primarily targeted to the poor who are disadvantaged, social mobilization is necessary to introduce them to a formal or semiformal, market-oriented institutional environment. This is particularly true for poor women and the poorest of the poor. It is important, however, to distinguish between financial intermediation and social intermediation in designing support programs.

11. Three key recognitions on which ADB's Microfinance Development Strategy is based are that, (i) without ***permanent*** access to institutional microfinance, most poor households continue to rely on meager self-finance or informal sources of microfinance, which limits their ability to actively participate in and benefit from economic opportunities, (ii) given the amount of resources needed to meet the high demand for microfinance services, ADB and other agencies cannot meet the demand individually or as a group, and (iii) microfinance can contribute to the development of the overall financial system through integration of financial markets. Embedded in these recognitions is the need for a financial systems approach to developing RMF.

C. The Strategy

12. The goal of ADB's proposed Microfinance Development Strategy is to ensure permanent access to institutional financial services for a majority of poor and low-income households and their microenterprises. The purpose is to support the development of sustainable microfinance systems that can provide diverse services of high quality. Therefore, the strategy focuses on (i) creating a policy environment conducive to microfinance, (ii) developing financial infrastructure, (iii) building viable institutions, (iv) supporting pro-poor innovations, and (v) supporting social intermediation.

1. Policy Environment

13. Per the Strategy, ADB is broadening the scope of financial sector reform programs to include issues concerning microfinance. The policy reforms focus on interest rate reforms relevant for microfinance within the broader financial sector reforms, creating a flexible environment to accommodate a wide range of MFIs to meet the diverse demand, and redefining the role of the state and the central banks in microfinance development to facilitate participation of private sector financial institutions. ADB will not go beyond policy-related operations in countries where the policy makers are not committed to adopting appropriate reforms for sustainable development of microfinance.

2. Financial Infrastructure

14. ADB's assistance will focus on critical elements of financial infrastructure, such as (i) developing information systems and training facilities necessary for microfinance development; (ii) eliminating legal barriers that prevent the establishment and operation of a diverse set of MFIs, or that prevent banks from establishing business relationships with informal or semiformal bodies such as community-based organizations or self-help groups; and (iii) creating regulatory and supervisory systems to ensure that MFI depositors are protected and that MFI failures do not adversely affect the overall financial system.

3. Institutional Development

15. Financial viability is critical for expanding the outreach. Only viable financial institutions involved in microfinance can ensure permanency of services to an increasing number of the poor and contribute significantly to poverty reduction. Thus, financial viability of the institutions

committed to serve the poor is seen as a tool to achieve the primary objective of outreach. For the same reasons, the strategy emphasizes institutions providing a broad range of financial services to the poor and low-income households, and microenterprises. These diversified institutions have a better chance to (i) achieve viability within a short period than the institutions that focus exclusively on the poorest clients, and (ii) reach more of the very poor than exclusively-focused institutions. In countries where state-owned agricultural and rural development banks continue to undermine development of sustainable microfinance operations, ADB will explore possibilities for and support reforms of such banks. However, in some circumstances, especially in transitional economies that lack appropriate institutions to efficiently provide microfinance services, new institutions may be needed.

4. Pro-Poor Innovations

16. The Strategy recognizes that ADB needs to support institutions to develop and offer products and services compatible with the socioeconomic characteristics of the poor to improve their access to permanent services and to reach the poorest of the poor. To ensure that financial institutions will continue to expand the services to the poor, ADB will support innovative programs and development of financial technology that contribute to breaking these barriers through pilot projects and other measures that aim at establishing sustainable linkages between formal financial institutions and informal service providers.

5. Social Intermediation

17. Social intermediation is necessary to increase the capacity of the poor to access and productively use microfinance services. Hence, the Strategy emphasizes supporting investments aimed to improve the capacity of the poor to actively participate in microfinance markets. Such investments will cover, among other things, (i) awareness building programs on a broad range of microfinance services; (ii) information dissemination on service providers; (iii) basic literacy, numeracy, and skills training for women, ethnic minorities, and other disadvantaged groups; and (iv) social mobilization for formation of community-based organizations and solidarity groups to actively participate in microfinance markets.

D. Implementing the Strategy

18. To achieve the objectives of the strategy effectively and efficiently, ADB decided to:

(i) base assistance on a thorough financial sector review and a country-level sector development strategy;
(ii) provide assistance through long-term partnerships rather than as one-time project operations;
(iii) emphasize the catalytic effect and the potential development impact in considering assistance;
(iv) take into account the conditions under which microfinance can play a significant role in promoting pro-poor, broad-based economic growth;
(v) consult major stakeholders including NGOs and potential clients of microfinance projects extensively, and coordinate closely with other funding agencies;
(vi) focus on development of sustainable institutions within an enabling environment, and appropriate financial infrastructure;
(vii) systematically monitor the progress of MFIs toward achieving their sustainability, and insist that they adopt best practices; and

(viii) specify how ADB will stop supporting MFIs that do not clearly comply with conditions for assistance, and effectively cease such support as appropriate.

19. ADB will pay more attention than in the past to policy reforms to create a better policy environment for the development of sustainable sources of microfinance. Microfinance policy issues will be incorporated into broader financial sector reform programs supported by ADB to address critical policy constraints more effectively and comprehensively. For this purpose, ADB will promote establishment of high-level rural finance policy groups and workshops, in close coordination with other development agencies and in consultation with major stakeholders.

20. One noteworthy aspect of the implementation plan is a reorientation of the use of loans. Loans will continue to be important in ADB's assistance for microfinance. However, the emphasis of loans will shift from providing funds for onlending to developing sustainable microfinance systems that can efficiently mobilize domestic resources to expand the outreach of services. ADB's loans will be used to (i) catalyze needed policy and institutional reforms; (ii) promote domestic savings mobilization and insurance services; and (iii) develop cooperatives and link community-based, autonomous savings and loans associations with sustainable formal and semiformal financial institutions to expand the services. ADB loans will not be used to support institutions that are not prepared to implement meaningful reforms to move toward market-based systems and achieve financial viability, or to subsidize interest rates to the clients of MFIs.

21. To enhance the effectiveness of microfinance technical assistance, ADB will: (i) ensure that technical assistance is prepared based on a longer term perspective than in the past; (ii) design advisory technical assistance based on comprehensive institutional analysis and in partnership with concerned institutions, and ensure their focus on capacity building and policy reforms; (iii) increase effective stakeholder participation and ownership in designing technical assistance; and (iv) use measurable and monitorable indicators to assess performance. The Strategy also supports the use of the technical assistance cluster approach for microfinance.

III. ADB's Role in Lao PDR's Rural and Microfinance Sector

A. Background and Key Issues

1. General

22. Lao PDR remains largely rural and agricultural. Some 85% of the workforce is engaged in agriculture, which generates over half of the gross domestic product. Thirty-nine percent of the country's population is poor, but over 90% of the poor live in rural areas. Development of sustainable RMF can therefore have a significant impact on economic growth and poverty reduction. The demand for RMF, including credit and secure savings facilities, is significant. However, the financial sector in the Lao PDR has, to date, achieved a low level of outreach in rural areas.

23. The financial sector is dominated by the state-owned commercial banks (SOCBs), but they are not active in rural areas, nor do they provide microfinance services.[1] The main

[1] Lao PDR's two state-owned commercial banks, Lao Development Bank (LDB) and the Banque pour le Commerce Exterieure du Laos (BCEL), generally confine their lending to urban areas, although LDB (which has a branch in each province) conducts some SME lending in provincial towns with linkages to the agriculture sector. Branches of several foreign banks started operating in Vientiane in the early 1990s,

institutional source of rural finance is the Agriculture Promotion Bank (APB). According to its own records, APB had 130,000 clients (consisting of 120,000 borrowers and 80,000 depositors) as of April 2002, which represents about 13% of rural households. Another 4% are estimated to have access to savings and credit services in the semi-formal sector (primarily project initiatives). The remaining 83% of rural households either do not have access to any financial services or rely on friends, family, or moneylenders. Moneylender interest rates can reach 20% per month. The Lao population in rural areas is highly dispersed, and limited infrastructure adds to the cost of financial intermediation and inhibits information flows for lenders and borrowers. These factors combined with the small-scale nature of transactions pose serious challenges for developing rural finance.

24. In Lao PDR, the Government began a significant financial sector reform program in 1989, when it transformed its mono-banking system into a 2-tiered system by separating central bank and commercial bank functions. ADB took the lead role among multilateral and bilateral development agencies, and provided two financial sector program loans (in 1990 and 1996) and 18 technical assistance projects throughout the 1990s. In 1993, ADB also provided a credit line to the newly created APB for the Industrial Tree Plantation Project (Loan 1295-LAO for $11.2 million). An associated TA was provided to assist APB to take over the agriculture loan portfolio of the SOCBs and strengthen APB's capacity to extend agricultural credit. The TA, however, had little or no impact because it did not address issues related to the business culture. Although the loans and TAs improved the policy environment of the broader financial sector, serious policy and institutional issues remained in the RMF sector.

2. APB's Role and Status

25. The Government's policy to support access to rural finance has been implemented primarily by APB, which has carried out substantial policy lending and acted as a channel for Government and donor funds and subsidies. APB has one branch in each of the 17 provinces and Vientiane Municipality, a Head Office in Vientiane, and sub-service units in 55 of the country's 141 districts, giving it by far the largest branch network in the country. As of June 2002, APB had entered into 70 funding arrangements with the Bank of Lao PDR (BOL), ministries, provincial governments, and international donors. These funds support about 75% of APB's lending operations, which is directed at sectors chosen by the Government (in agreement with international donors in the case of credit lines funded by the donors). Major donor-funded credit lines still outstanding as of December 2001 have come from ADB ($7 million), the Government of Japan ($2 million in equipment), IFAD ($500,000), EU ($200,000), and GTZ ($40,000). APB's interest rates have been determined either by the Government or by agreements with donors. Typically, these are very low and insufficient to cover ADB's costs—e.g., the interest rate on the ADB credit line is capped at 7%. The other 25% of APB's lending is funded from deposits, with onlending rates closer to commercial terms (e.g., 20% for crops and livestock; 24% for handicraft; 26% for small industry; 30% for trade and services; and 34% for overdrafts). These rates are set by APB's Board, but they reflect rates elsewhere in the state sector and are not based on APB's actual risks.

26. APB's outreach is limited because it depends on the limited funding available from the Government and donors, and because its policies, inefficient and subsidized operations, and weak financial condition prevent it from mobilizing commercial funding. Institutionally, APB carries out financial and non-financial activities (e.g., distributing fertilizer and equipment),

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but deficiencies in the banking environment, particularly the legal framework, and limitations on their activities have limited their contribution to the domestic economy.

reflecting its mixed mandate as a financial institution and development organ of the state. As a result, its operations are inefficient, and management autonomy and responsibility are limited. Subsidized interest rates and the common practice of rolling over loans have prevented the development and adoption of realistic credit risk assessment and loan pricing practices, which have contributed to a weak credit culture and resulted in very high levels of non-performing loans (NPLs). Consequently, APB has been operating at a significant loss since it was established in 1993. However, prior to 2002, APB had never been audited, making its financial situation (and, therefore, costs to the Government budget) unclear.

27. APB's legal status is somewhat ambiguous. It was established by prime ministerial decree no. 92/PM on 19 June 1993 as a development bank, with the Ministry of Finance (MOF) holding 80% of its shares. Per Article 5 of this decree, "the state budget encourages reduced lending rates and guarantees minimum prices of major agricultural products … so that farmers need not be concerned with the marketing of their production". Per article 6, "BOL … shall implement the required conditions concerning the establishment of this bank, to determine its organizational structure, and to establish regulations governing the management and the action program of APB, which will be submitted for approval of the Government." Presidential decree no. 02/PR on Commercial Banks of 22 March 2000 appears to bring APB largely under its provisions, superceding the 1993 establishment decree. However, the wording of this decree could be interpreted to leave APB's status as a "commercial" or "development" bank uncertain; and in effect, APB has continued to be treated as a development bank, separate from the other state-owned commercial banks. BOL has not conducted on-site supervision of APB, nor has it required APB to comply with prudential ratios, nor has it required APB to submit standard reports and information for off-site supervision. APB has effectively gone unregulated and unsupervised by BOL since its establishment.

3. Microfinance Institutions

28. APB's operations have tended to distort the rural finance system and resulted in misallocation of resources, low deposit mobilization, and crowding out of microfinance institutions (MFIs) and other banks, further limiting outreach. They have also created a climate of unrealistic expectations on the part of potential borrowers and central and local officials regarding the cost of credit, making it difficult for microfinance institutions to charge sustainable interest rates even in areas where APB's outreach is limited. Village revolving funds established by the Lao Women's Union (LWU) in some 1,600 villages (sometimes with the support of international donors) reinforce these expectations—in general, they channel a limited amount of subsidized credit to a few households, do not mobilize local resources, have low repayment rates, and are not sustainable. It is unknown how many are still operational.

29. Projects or MFIs that attempt to charge sustainable interest rates are typically discouraged or prevented from doing so by local officials. The lack of a clear legal and regulatory framework for microfinance gives MFI practitioners little recourse to counter interference from officials. Current regulations cover only credit cooperatives (regulation no. 02/SB of 15 November 1994 issued by BOL) and provide limited or no guidance on operational rules of governance, conflicts of interest, auditing requirements (external and internal), prudential discipline, reporting requirements, sanctions, and experience or qualification of board members. Commensurate with the lack of a legal and regulatory framework for microfinance, BOL has no experience and limited capacity to supervise MFIs.

30. As a result, very few MFIs operate in the country. Most microfinance is delivered through one-off projects and other unsustainable initiatives; capacity is low and accounting practices are

weak or non-existent. Approximately 35 bilateral donors and international NGOs have established various village revolving funds, usually as a component of a larger project, often in-kind, and typically through LWU. Most give subsidized credit, do not mobilize savings, and do not focus on sustainability. Three projects, however, are operating institutional microfinance systems in the Lao PDR. The largest is the Microfinance Project originally supported by UNDP and UNCDF, which serves about 3,000 clients. However, UNDP and UNCDF ended their support for the Microfinance Project in December 2002 after they failed to reach agreement with the Government on the next phase of the project; the Government now manages the Microfinance Project, but the Microfinance Training Center established by the project has been unable to retain its staff and has stopped functioning. A private Lao system of 9 credit unions called the Cooperative de Credit pour le Soutien de Petites Unités de Production (CCSP) serves about 1,000 clients. And the Phongsaly District Development Project (PDDP) supported by Agence Francaise de Développement (AFD) serves about 2,000 clients. Although the experience is limited, some of these programs have demonstrated the potential of sustainable, market-oriented MFIs in the Lao PDR.[2]

B. Recent Developments in Rural and Microfinance Supported by ADB

1. TA Cluster for Rural Finance Development

31. In March 2000, ADB approved a TA cluster for $2 million for Rural Finance Development in the Lao People's Democratic Republic (Lao PDR). The goal is to develop a sustainable, market-oriented rural financial system to contribute to poverty reduction. As indicated in the discussion of key issues above, it was recognized that weaknesses in the policy environment and institutional capacity were major constraints to developing sustainable rural finance and expanding outreach. Therefore, the policy environment needed to be improved; the capacity of the state-owned Agriculture Promotion Bank (APB) needed to be developed; and other institutional mechanisms, such as credit unions and involving the private sector, needed to be promoted to increase competition.

32. The objectives of the TA cluster are to (i) strengthen the capacity of BOL to support sustainable rural finance development, (ii) assist APB to build its capacity to expand outreach on a sustainable basis, and (iii) introduce innovative MFIs, specifically best-practice savings and credit unions (SCUs), on a pilot basis. A key to achieving these objectives was and is the building of knowledge and consensus on an approach to rural and microfinance development.

33. The original TA cluster comprised six subprojects: (i) Building Awareness and Understanding of Rural Finance, (ii) Diagnostic Study of APB, (iii) Establishment of Pilot Credit Unions, (iv) Building BOL's Capacity for Training in Rural Finance, (v) Pilot Tests of Best Practice in Rural Finance in APB, and (vi) Institutional Reforms of APB. A consortium of consulting firms (PricewaterhouseCoopers in association with Enterplan, Ltd.) was engaged by ADB to assist in implementing all TA cluster subprojects.

(a) Subproject 1—Awareness Building

[2] E.g., the Microfinance Project charges 4% per month and was reporting 95% repayment rates under UN sponsorship; current repayment performance is not available. CCSP charges 3% per month (though was influenced by officials to lower its rates from 3.5%) and reported repayment rates of 94% and 85% in 2001 and 2002, respectively. PDDP's rates have varied from 18 to 89% per year, depending on the inflation rate; PDDP reports 100% repayment rates.

34. Subproject 1 was started in October 2000 and was completed in July 2001. It involved (i) awareness creation workshops, which reviewed international best practice in rural finance; (ii) four guided study tours with senior officials from the Ministry of Finance (MOF), BOL, the Prime Minister's Office, the Ministry of Agriculture and Forestry, and APB to the Bank for Agriculture and Agricultural Cooperatives in Thailand, the Central Credit Fund and People's Credit Fund system in Viet Nam, Bank Pertanian Malaysia, and Bank Rakyat Indonesia; (iii) a study tour review workshop chaired by the governor of BOL; (iv) preparation and review of a policy and institutional issues paper through a series of provincial workshops and a national wrap-up meeting; and (v) preparation of a feasibility study for the three pilot SCUs to be established in subproject 3. The policy and institutional issues paper identified policy reforms needed in the economic and legal framework and institutional strategies to address the current constraints in rural finance. Subproject 1 was a key first step to enhance knowledge of key issues and best practices in rural and microfinance, as evidenced by the quality of policy dialogue that ensued in preparing subsequent subprojects.

(b) Subproject 2—Diagnostic of APB

35. Detailed design of subproject 2 took place in February 2002. The subproject was started in May 2002 and completed in December 2002. Under this subproject, a diagnostic study of APB was carried out and diagnostic reports on 12 topics were prepared: (i) governance; (ii) strategic planning; (iii) organizational structure; (iv) human resources management; (v) pricing policies and procedures; (vi) credit policies and procedures; (vii) risk management policies and procedures; (viii) products and demand; (ix) compliance review; (x) financial and accounting systems; (xi) management information systems; and (xii) financial analysis. The diagnostic study suggested improvements to APB's policies and procedures, including governance, strategic planning, organizational structure, pricing, credit, products and services, risk management, information technology and management information systems, and accounting.

36. The diagnostic study also included the first external audit of APB. This was a key addition to the diagnostic study as the Lao authorities had not undertaken an audit of APB since its creation in 1993. The audit found that as of December 2001, a large percentage of APB's loans were nonperforming, and provision for doubtful debts was inadequate. The poor financial position of APB was the result of its lack of profit orientation, a lenient credit culture in an environment of directed subsidized lending, and a lack of recognition of provisioning requirements.

37. The findings were reviewed by the Government and ADB and discussed in a 3-day workshop in September 2002. This led to the production of a draft restructuring plan for APB in October 2002, designed to transform APB into a financially self-sustainable, market-oriented rural finance institution. Consistent with the ADB Microfinance Development Strategy's policy not to support institutions that are not prepared to implement meaningful reforms to move toward market-based systems and achieve financial viability, the TA cluster agreement stated that, "Within two months of the completion of the second subproject, MOF will be required to submit to ADB a letter of commitment to carry out the reform programs formulated through the subproject as a condition for continuation of the TA cluster."

38. Following a review of the draft by the Government and ADB, a final plan was agreed in December 2002, and MOF submitted to ADB on 22 January 2003 a letter of commitment to carry out the reforms formulated by subproject 2. Implementation of the restructuring plan began under subproject 5 (see below). However, even prior to formally adopting the restructuring plan, APB adopted a new vision statement in November 2002:

"*The Agricultural Promotion Bank will be the premier provider of financial services in rural Lao PDR. It will operate in a market-oriented, financially self-sustainable way in order to make a long-term contribution to poverty reduction and economic growth and prosperity. In the market context, APB will endeavor to extend the outreach of financial services to rural people and their enterprises, both directly and by fostering linkages with other financial institutions.*"

(c) Subproject 3—Pilot Savings and Credit Unions

39. The objective of subproject 3 is to demonstrate the viability and benefits of best-practice, private, member-owned and operated savings and credit unions (SCUs) in Lao PDR by piloting three SCUs in the provinces of Vientiane, Savannakhet, and Luang Prabang, based on the feasibility study carried out during subproject 1. These locations were chosen because of their strong market linkages and relatively high population densities, giving a strong potential for success. These are not among the poorer areas of Lao PDR; however, given the near-absence of sustainable MFIs in the country and the hesitancy of some officials to liberalize financial markets, ADB and our counterparts in BOL determined that Lao PDR needed microfinance success stories as a demonstration effect before taking on the more difficult task of extending sustainable microfinance into more remote and poorer areas.

40. Not all SCUs are alike, however. Some SCUs have failed to supply sustainable and expanding financial services to communities and/or protect members' savings. This traditional SCU model has been characterized by: limited financial services that focus on lending; a lack of the scale and scope economies necessary for sustainability; institutionally unsafe and unsound operations with little or no institutional capital, weak to non-existent financial management capacity, high delinquency, insider lending, high loan concentrations among immediate and extended family, and inadequate loan loss provisioning; and dependence on external funds rather than members' savings as the prime source of liquidity.

41. By contrast, the model implemented under subproject 3 is characterized by economies of scale and scope that support increased outreach, institutional sustainability, and minimization of transaction costs and risk. It is privately owned by its members, market-driven, and supplies a complete set of financial services to meet the effective demand of its membership; it permits thorough supervision and regulation (both internal and external); it meets the costs associated with regulatory compliance; meets legal and regulatory capital requirements; it protects members' savings; and it replaces external funds with savings as the most important source of liquidity for continued growth. It is also professionally managed by hired managers, accountants, cashiers and other staff.

42. Drafting appropriate regulations and bylaws for the SCUs promoted under this subproject is also necessary because of weaknesses in the current credit union regulations in Lao PDR. Current regulations address some areas of SCU registration, powers, governance, prudential standards, supervision, and the general powers of the SCU to acquire, hold and dispose of assets, to enter into contracts, to offer deposit and loan services, to determine its own interest rates, to borrow and to invest in authorized investments. However, certain provisions are absent, notably those needed to cover investment of funds; field of membership; loan write-offs; fixed assets; liquidity management; records preservation; external audit; external borrowing; loan portfolio concentration; organization of internal controls; and delinquency calculation.

43. Therefore, specific subproject activities include:

- developing a detailed guidebook and training materials for establishment, operation, and performance monitoring of safe, sound, professionally managed SCUs, incorporating all necessary policies, procedures and tools and drawing on successful experiences in other countries, particularly in the region;

- drafting regulations and model bylaws for the pilot SCUs;

- training selected staff of the SCU organizers, including selected trainers, in all aspects of SCU establishment;

- supporting the organizers to establish the three SCUs, specifically in the organizing and training SCU steering committees, identifying premises, and conducting pledge drives;

- assisting to finalize the SCU business plans, and (subject to the viability of the business plans) supporting the launch of SCU operations;

- providing initial and on-going training and counseling to SCU board, management, and staff in start-up and operational skills including management and supervision, accounting, internal controls, and credit and risk management;

- assisting SCU management to comply with BOL reporting requirements; and

- training BOL staff in supervision of SCUs by carrying out, in conjunction with BOL staff, two on-site inspections and the first annual audit of the pilot SCUs.

44. As of the date of this paper, pledge drives in all 3 locations have resulted in over 300 members in each SCU (compared to a minimum of 250 required for licensing[3]). Regulations have been prepared and adopted by BOL; business plans and licensing applications have been prepared; training of management in several areas (including in Microbanker software) has taken place. It is expected that all 3 SCUs will begin operations in January 2004.

(d) Revised Subproject 4—MFI Regulations and Strategy

45. Implementation of subproject 4 began in April 2003. The scope of subproject 4 was changed from that originally envisaged. Under the microfinance project supported by UNDP and UNCDF, a local microfinance training institute was established. Although this training institute stopped functioning when the UN agencies withdrew their support for the project, the original subproject to build microfinance training capacity in BOL was considered inappropriate in the new circumstances.

46. More importantly, following on the work of subproject 1, which identified weaknesses in the policy, legal, and regulatory environment, ADB and the Government agreed to prepare a national strategy for rural and microfinance development and an enabling legal and regulatory

[3] This licensing requirement is based on the estimate of the minimum number of members required to achieve the economies of scale necessary for sustainability.

framework.[4] Till now, most microfinance in Lao PDR has been delivered in an ad hoc manner through one-off projects and other unsustainable initiatives in which capacity is low, and accounting practices are weak or non-existent. As mentioned above, 35 donors have established various village revolving funds, usually as a component of a larger project, often in-kind, and typically through LWU, which has neither the capacity nor knowledge of sustainable microfinance. Therefore, it is crucial to develop a coherent national strategy that focuses on building sustainable, market-oriented MFIs.

47. Other than the previously inadequate credit union regulations, there is currently no legal space for MFIs. As a result, most microfinance operations are informal and/or have "project" status. In the absence of a legal framework, microfinance projects cannot transform into formal, registered or licensed MFIs. Projects are also subject to terms of project agreements, thus inviting interference from officials on product and pricing decisions better left to the market. Adoption of genuinely enabling regulations that create the legal space for a variety of sustainable MFI models is crucial to attracting investment in the RMF sector from international donors and, eventually, the private sector. Commensurate with the lack of a legal and regulatory framework for microfinance, BOL has no experience or capacity to supervise MFIs, so this will need to be built up.

48. As a first step in developing the strategy and legal framework, the Government's Rural and Microfinance Committee, with support from ADB, Concern Worldwide, the Financial Sector Reform and Strengthening Initiative (FIRST), and the World Bank, recently finalized its "Policy Statement for the Development of Sustainable Rural and Micro Finance Sector".[5] The thrust of the Policy Statement is the development of a market-oriented, sustainable rural and microfinance sector, which includes active private sector participation, removal of subsidies channeled through interest rates, removal of interest rate and other restrictions, transforming APB per its restructuring plan, and development of an enabling policy, legal, and regulatory framework. All future microfinance initiatives should be consistent with this policy framework.

49. The strategy and legal/regulatory framework are currently undergoing revisions following a workshop attended by key stakeholders in Vientiane to discuss a first draft in September 2003. A second workshop is scheduled for the week of 8 December 2003.

(e) Subproject 5—Restructuring APB

50. Subproject 5 began in March 2003. The TA cluster's original subprojects 5 and 6 were combined into a singled subproject 5. The original subproject 5 would have pilot tested some of the reforms in selected branches of APB, and subproject 6 would have rolled out reforms throughout APB. However, given the recognition by the Lao authorities and ADB of the urgent need to restructure APB based on the diagnostic and audit, as well as the momentum built up after subprojects 1 and 2, pilot testing of reforms was not considered necessary. Subproject 5 has therefore begun to implement high-priority aspects of the APB restructuring plan agreed under subproject 2, including:

[4] ADB mobilized parallel cofinancing for this subproject from the Financial Sector Reform and Strengthening Initiative (FIRST), a multi-donor program including the World Bank, IMF, and the bilateral development agencies of Canada, the Netherlands, Sweden, Switzerland, and United Kingdom.

[5] As of the date of this draft, a "final" draft Policy Statement has been approved by the Governor of BOL and forwarded to the Prime Minister's Office for final endorsement.

(ii) phasing out directed lending and subsidies from interest rates and project-based credit agreements, and replacing them with centralized funding;

(iii) adopting a market pricing policy and simplifying the loan product line;

(iv) putting in place a 3-year rolling corporate planning process and preparing business plans identifying measurable and time-bound targets;

(v) developing and implementing a systematic workout plan for nonperforming loans and establishing prudent loan classification and provisioning systems;

(vi) achieving progressive recapitalization conditional on the achievement of specific corporate plan targets;

(vii) improving the credit manual and policies and procedures;

(viii) revising the functions, responsibilities, and composition of the Board; and revising the management and organizational structure to include bank marketing, treasury, branch operations, organization and methods, risk management, legal, and training functions;

(ix) carrying out job analyses for all positions in the new structure; preparing comprehensive written job descriptions; and recruiting on a competitive basis to fill gaps; and

(x) conducting a detailed training program to support restructuring activities.

51. The Lao authorities have stressed that phasing out policy lending is a sensitive issue and that the phase-out needs to be given adequate time. The consultant team is therefore developing a detailed phase-out plan, including transferring all policy lending off of APB's balance sheet and onto the relevant ministries' books; finalization of the phase-out plan will take place in December 2003. However, by agreement, we know that APB will continue to channel some policy lending as an agent for ministries and funding agencies over a 3-year period. The key issues are to (i) remove policy lending from APB's balance sheet; and (ii) make policy lending, and its costs to the Government budget, transparent rather than mixing it with APB's commercial operations.

2. Linkage with ADB's Banking Sector Reform Program Loan

52. Consistent with ADB's Microfinance Development Strategy, the TA cluster has been coordinated with ADB's Banking Sector Reform Program Loan (BSRPL), approved by the ADB Board in November 2002.[6] The policy matrix includes conditions that reinforce the actions being taken in the TA cluster, including:

- For APB:

[6] ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Lao People's Democratic Republic for the Banking Sector Reform Program*. Manila.

- APB Board to approve corporate vision that includes the goal of market orientation and self-sustainability (November 2002);

- APB to adopt and initiate implementation of operational and financial restructuring plan consistent with corporate vision (December 2003);

- MOF/BOL to issue all necessary instructions required to enable APB management autonomy, market orientation, and self-sustainability, including instructions that APB management will be allowed to freely set interest rates on loans and deposits, and that all future lending by APB be subject to commercial criteria (June 2004);

- BOL to adopt and implement appropriate regulatory framework for prudential supervision of APB (December 2004); and

- APB to implement the time bound measures outlined in its operational and financial restructuring plan (June 2005).

- For an improved MFI policy environment:

  - Rural and Microfinance Committee to commence a participatory program to prepare a vision statement for the rural and micro finance sector; identify impediments to sustainable, market-oriented rural and microfinance; including a time-bound action plan to remove those impediments (September 2002; note, this was an early step in preparing the Policy Statement);

  - BOL to license three commercially oriented member-owned pilot savings and credit unions (SCUs) following international best practice and disseminate experience to stakeholders (June 2003); and

  - BOL to adopt and implement regulatory framework for microfinance institutions (MFIs) and enhanced SCU regulations, based on a participatory process, allowing for multiple MFI models and products with minimum starting regulations, interest rate autonomy, and private ownership (December 2004).

3. Next Phase of ADB Support

53. The key objective in the next phase is to maintain the momentum built up since 2000 through the TA cluster and supported by the 2002 BSRPL. The primary ADB instruments in the pipeline are:

- A Rural and Microfinance Sector Development Program Loan, programmed for 2004, which is currently being designed and processed by a project preparatory TA (PPTA) that has been in the field since October 2003. Possible program components include:

  - a policy component to support reforms in APB, including (i) performance conditions for financial restructuring, (ii) phase out of policy lending, (iii) legal recognition of APB as a commercial bank, (iv) prudential norms for

APB and supervision and auditing regime; and (v) implementation of APB's loan workout plan;

- a policy and TA package for implementing the legal, regulatory, and supervisory framework for microfinance developed under the TA cluster and BSRPL;
- an investment component to provide further support to implement APB's restructuring plan, including upgrading its IT system;
- a component financed by ADB TA and/or grants from the Japan Fund for Information and Communications Technology (JFICT) to support APB capacity building in support of reforms;
- an investment component (possibly supported by a grant from the Japan Fund for Poverty Reduction [JFPR]) for lending support, start up grants, and/or capacity building for new MFIs expected to be established under the new legal framework, as well as facilitating the creation of an MFI association, or assisting with the establishment of a Microfinance Code of Conduct;
- a TA to build knowledge and capacity in LWU; and
- capacity support for microfinance training.

- Depending on the evolution of the sector, an ADB ADTA in 2007 has been proposed to assist to transform mature microfinance projects into formal, registered MFIs (and transform registered credit-only MFIs to licensed deposit-taking MFIs) and promote MFI linkages in the financial system, including further development of infrastructure such as apex services, prudential supervision, and/or a microfinance credit bureau.

IV. ADB's Role in Viet Nam's Rural and Microfinance Sector

A. Background and Key Issues

1. General

54. Some 80% of Viet Nam's poor live in rural areas, and 45% of rural households are poor. Viet Nam's poor depend largely on farming and are characterized by relatively low agricultural productivity resulting partly from low access to capital and land. The poor are also highly vulnerable to shocks from illness and death in the household, commodity price fluctuations, and natural disasters. Development of sustainable rural and microfinance can therefore have a significant impact on economic growth and poverty reduction.

55. Efforts to increase access to financial services in Viet Nam coincided with agricultural reforms in the early 1990s, particularly the formation of private farms. These reforms created a demand for capital by the 12 million rural households, of which about 10 million constitute decollectivized farms and about 6 million are considered poor. Strategies to expand rural finance have been pursued mainly through the state sector using specialized banks and credit unions. For example, the Viet Nam Bank for Agriculture and Rural Development (VBARD) has nearly 4 million clients; the Social Policy Bank (SPB, formerly the Viet Nam Bank for the Poor [VBP]) has about 2.5 million clients; and the credit union network of the Central Credit Fund (CCF) and its affiliated People's Credit Funds (PCFs) have almost 1 million clients. The expansion of the banking network made financial services accessible to about 7 million rural households, including about 3 million poor households. While expansion of outreach has been impressive, nearly half of rural poor households do not have access to financial services from

institutional sources. Recently, policy makers have recognized that, in addition to the state-owned institutions, the approaches and methods of microfinance institutions can make an important contribution in Viet Nam, particularly in extending outreach into the remoter areas where poverty is concentrated.

2. Formal Rural Finance Sector

56. Formal sector provision of rural financial services is dominated by VBARD, the CCF/PCF network, and the recently established SPB, which took over the assets and functions of VBP in January 2003. Combined, they represent over 90% of outreach. VBARD and the SPB are owned by the state. CCF is partly owned by SBV and partly by its member PCFs. PCFs are in turn owned by their members.

57. In principle, VPB borrowers had to be listed as a "low income household" (LIH)[7] to borrow from VBP. However, in practice local committees nominated borrowers to VBP, and in 2001 less than half of VBP's 2.57 million customer households were listed as LIHs; the large subsidies implicit in the low interest rates mean that these loans are likely rationed to influential persons who can gain access to them. Other than its headquarters and representative offices, VBP used the VBARD branch network to deliver its services. In January 2003, VBP's loan portfolio was taken over by the newly created SPB. Other preferential lending schemes (e.g., of various ministries—see section ii below) were to be taken over by SPB by 30 June 2003. It is envisaged that subsidized lending will continue through this channel for the foreseeable future. It is the Government's intention that all commercial banks, particularly VBARD, will be relieved of the cost (but not necessarily the delivery) of subsidized loan programs. At present VBARD continues to support the delivery of the services of SPB.

58. VBARD has a nationwide network covering all 61 provinces and 527 districts, giving it the largest branch network in Viet Nam. VBARD does not explicitly target the poor, but approximately 47% of its clients are poor (only slightly less than VBP's 49%) which are reached using conventional lending methods, putting its aggregate outreach to the poor significantly higher than that of the ostensibly poverty-focused VBP. VBARD reports that its non-performing loan ratio is 5%. However, this rate is based on Viet Nam Accounting Standards (VAS), which differ in provisioning from International Accounting Standards (IAS), and is after rescheduling and write-offs. VBARD has been fairly successful at mobilizing deposits—retail and enterprise deposits constitute more than 80% of its resources. However, VBARD does not mobilize significant deposits from the poor. Deposits of less than 500,000 VND (about $33) account for only 2% of its deposits.

59. The PCF system was established in 1992, after the 1990 collapse of the earlier cooperative system. PCFs are commune-level, autonomous, small-scale financial institutions. In 1997, the system had nearly 1,000 PCFs, 21 Regional Credit Funds (RCFs) managed by SBV, and the CCF. The 1998 economic crisis impacted on the PCFs and, mindful of the former collapse of credit cooperatives in Viet Nam, SBV intervened and restructured and strengthened the existing network, including closure of many PCFs. There were 889 PCFs as of January 2003. SBV has done an admirable job of building up the network and requiring adherence to prudential regulations. PCF capacity in numerous areas (e.g., risk management, human resources development, IT systems, marketing) remains weak however, and it has received

[7] In Viet Nam, this term is technically defined as (i) in mountainous areas and island areas, average income of 80,000VND/person/month; (ii) in rural areas, average income of 100,000VND/person/month; (iii) in urban areas, average income of 150,000 VND/person/month.

little TA.[8] PCFs are intended to depend on savings mobilization. In 2001, 66% of the total the financial resources of PCFs were mobilized from savings. Deposits are mainly short term, and PCFs do not have medium and long-term capital resources. In 2001, 56% of its borrowers were LIHs.

3. Semi-formal Sector

60. The "semi-formal sector" (as it is termed in Viet Nam) consists of (i) Government ministries providing microfinance services, such as the Ministry of Planning and Investment (MPI), the Ministry of Labour, War Invalids, and Social Affairs (MOLISA), and the Ministry of Agriculture and Rural Development (MARD); (ii) mass organizations including the Viet Nam Women's Union (VWU), the Viet Nam Farmer's Union (VFU) and the Viet Nam Youth Union (VYU), which also provide small loans on their own account, implement programs for international NGOs, and facilitate the formation of credit groups for VBARD; and (iii) some 58 international NGOs that reported operating microfinance programs, for the most part channeled through the mass organizations. Virtually all deliver services at below-market interest rates, following the lead of VBP and VBARD. These organizations are recognized by Government, but are not legally regulated or supervised in their financial sector operations by SBV. The semi-formal sector is small and accounts for only about 5 percent of the rural credit market. It primarily targets those excluded from access to formal finance. Ministerial programs were due to be transferred to SPB in June 2003. Of the donor programs, UNICEF operates in 22 provinces, but all others operate in only one or a few provinces. Most had no plans for expansion according to a 2000 survey by DFID and SBV. Most also collect little savings. However, most programs also cited the lack of a clear legal and regulatory framework, as well as crowding out by VBARD's and VBP's subsidized lending, as reasons for not planning to expand.

4. Bank Restructuring [9]

61. Viet Nam's banking system has problems common to many countries in the region: a history of directed lending, interest rate subsidies, high non-performing loans, poor management practices, and an inability to intermediate effectively between savers and borrowers. The cost to the economy of these weaknesses is high in terms of growth, efficiency, and vulnerability to crisis. The Government is currently both regulator of the banking system, via SBV, as well as an active participant, via the state-owned commercial banks (SOCBs) that dominate the sector. The failure to separate these roles has produced conflicts of interest and a policy environment that is inconsistent with sustainable financial intermediation.

62. Viet Nam's banking system continues to be dominated by the large four SOCBs, accounting for about 70 per cent of the total assets in the system.[10] Over the past decade the four SOCBs have evolved from specialized policy lending vehicles to state-owned banks that are expected to operate in a more commercially sound basis. While the state-owned enterprises' (SOEs) share of bank credit has fallen from 90 percent to levels of 50 or 60 percent,

[8] Other than TA from SBV, CCF has received some assistance in the past from CIDA (through Des Jardins), but it is not receiving any TA from international donors at present.
[9] This section draws on the World Bank's "Vietnam Banking Sector Review", June 2002.
[10] The four SOCBs are: (i) Vietnam Bank for Agriculture and Rural Development, which focuses on rural and agricultural finance; (ii) Bank for Investment and Development of Vietnam, which focuses primarily on medium- to longer-term project financing to SOEs; (iii) Vietcombank (or Bank for Foreign Trade of Vietnam), whose core businesses is money, particularly foreign exchange, markets and trade; and (d) Industrial and Commercial Bank of Vietnam, which has evolved to a conservative commercial bank.

continued policy lending practices through the 1990s, coupled with the banks' limited credit skills in the wake of rapid credit growth and significant change in borrowing clientele, resulted in a worrisome level of NPLs in the banking system. Hence, the Government has embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalization program with the support of the IMF and World Bank. The main challenges for restructuring are to create a market-oriented credit culture and to strengthen management sufficiently to prevent the recurrence of high levels of NPLs. The measures taken to date include deregulation both in the banking sector and the interest rate regime, putting into place restructuring plans for SOCBs, establishing Asset Management Companies for NPL resolution, phasing in SOCBs' recapitalization, and phasing out directed policy lending by the state. SBV is also undergoing restructuring giving it exclusive control over monetary policies and bank regulation and supervision, but requiring it to relinquish all commercial activities.

63. The SOCB NPL resolution and recapitalization program aims to clean up the banks' balance sheets and bring the four SOCBs to the level of capital adequacy that meets the international Bank for International Settlements (BIS) standards. However, given the significant annual growth of total assets in all of the SOCBs and the sizable annual credit expansion, the future capital base will have to provide for not only the pre-2000 lending but also for building conservative provisions for their recent and future increase in lending through the restructuring and recapitalization period. It is difficult to estimate the size of required provision and recapitalization need for the SOCBs. While banks are required to make loan classification and set aside provisions, the prevailing rules under Vietnamese Accounting Standards (VAS) are quite liberal, inconsistent with international practices, subject to interpretation, and not uniformly applied. Only the overdue installment portion is classified as NPL. International auditors have been unable to consistently estimate the size of NPLs of the four SOCBs.

64. In developing the RMF sector, it is noteworthy that the largest share of SOCBs' loan portfolio is lending to the agricultural and fisheries sectors, which make up 27% of total SOCB lending. More than 60% of SOCBs' loan portfolio is short-term reflecting the importance of short-term working capital funding to agricultural and trade & service sectors, with a exception of Bank for Investment and Development of Vietnam (BIDV) that continues to focus on medium to long term project finance.

65. The private sector, particularly small and medium sized enterprises, is underserved by the banking sector. The incentives for SOCBs to lend to the private sector appear still quite weak, as the regulatory framework and the Government's explicit and implicit backing of SOEs over privately owned enterprises constrains the ability of the private sector, particularly SMEs, to access bank lending. While the Government has removed obstacles for the private sector to operate and have access to bank credit, various forms of regulatory prejudice still remain, particularly in prudential regulation. For example, although banks are now allowed to provide unsecured lending to private enterprises this applies only to firms with two consecutive years of profits, thus precluding start-up enterprises from accessing bank financing. In addition, lending officers of the SOCBs may be reluctant to extend credit to the private sector out of concern for possible consequences of potential losses to the bank as a government entity.

5. Interest rate policies

66. Historically, the formal sector has been characterized by a mix of market and subsidized interest rates. Subsidized interest rates, foreign borrowing (especially from donors), and budgetary allocations have meant that the focus has been mainly on credit. Consequently, savings mobilization has suffered, although VBARD and CCF/PCF have mobilized significant

deposits. In June 2002, SBV revised interest rate policy. In principle, credit institutions (except SPB) are now able to determine their own interest rates. However, with VBARD, CCF, and other state-owned financial institutions lacking full autonomy, past policies and continued Government influence mean that, in practice, subsidized interest rates remain embedded in the system, and VBARD's current interest rates (on the order of 12 to 14%, with an average spread of 4.3%) are likely still below cost-recovery levels.[11] The NGO and mass organization schemes have generally followed VBARD in setting interest rates. As a result, savings mobilization in these schemes has not been given particular emphasis and is absent altogether in some schemes; overall, savings total about 10% of total outstanding loans in these schemes. The relaxation of interest rate controls was permitted only after VBP (as the forerunner of the SPB) gained one-fifth of rural households as its customers. As of December 2002, VBP was charging 6% annualized interest rates. According to SBV, cumulative losses in VBP cost the Government $46 million equivalent during its first five years of existence (1995-2000). SPB is expected to continue subsidized lending, which risks further entrenching expectations about the price of credit, crowding out of otherwise viable MFIs, and continuing to inhibit deposit mobilization. SPB is also not subject to prudential supervision, although it is authorized to mobilize deposits.

6. Legal and Regulatory Framework

67. Laws that impact on the operation of financial markets include the Law on the State Bank of Viet Nam, which clarifies its roles and responsibilities as a central bank; the Law on Credit Institutions (October 1998)[12], which covers the operations of licensed bank and non-bank financial institutions; the Civil Code, which clarifies rights and obligations with regard to private lending and borrowing; and the Co-operative Law, which provides a framework for the development of credit cooperatives.

68. However, there is currently no comprehensive legal framework for microfinance services because they effectively fall outside the Law on Credit Institutions. As a result, the legal status and the legality of activities currently being carried out under MF projects supported by ministries, mass organizations, and international donors is ambiguous. This lack of clarity in the legal and regulatory environment is a major reason for the reluctance of donors and potential investors to become involved in the sector other than small projects implemented through mass organizations, especially the Viet Nam Women's Union (VWU), which is authorized by Prime Minister's Letters to carry on credit and savings activities (e.g., Official Letters No. 209 of 17 Jan 2000 and No. 699 of 17 July 2000). The absence of an effective legal form for MFIs means that the transition from mass organization or NGO activities to formalized MFI is not possible; for schemes that want to attain legal status, the PCF model is the only one currently available. However, as adoption of the PCF model results in membership of the CCF apex, it is currently not possible for an MFI to emerge on a national scale.

69. The SBV Banking Inspectorate Department (BID) is responsible for the inspection of all credit institutions, which must be inspected on-site at least once each year. Off-site inspection is done monthly based on financial institution reporting to BID. Because microfinance services are effectively outside the Law on Credit Institutions, there is no inspectorate system for them. SBV carries out on-site and off-site supervision through the review of reports and other materials

[11] VBARD's interest rates have inched up only about 1% since liberalization of interest rates over a year ago.

[12] In Viet Nam, a "credit institution" is legally defined as "an enterprise established under this Law and other provisions of law to deal in currencies, provide banking services through taking deposits and using deposits for granting credit, and provide payment services"

submitted by credit institutions. The focus is on compliance with laws and regulations, the financial health of the institutions, and the potential risks facing them. SBV carries out its supervision through its branches in all provinces of the country. Under the World Bank's Second Rural Finance Project, BIDV has been appointed to accredit MFIs that satisfy eligibility criteria (in this context MFIs can mean commercial banks, joint stock banks, cooperatives, PCFs, and NGOs) and wholesale credit to them for onlending provided that they satisfy the accreditation criteria. In the course of the project, BIDV will undergo substantive institutional reform. If successful, a future consideration may be the use of BIDV as a supervisory intermediary, but for the time being, SBV is effectively the only institution qualified to supervise.

B. Recent Developments in Rural and Microfinance Supported by ADB

1. VBARD Corporate Governance TA

70. ADB provided TA worth $900,000 to VBARD for 24 months in 2000-02 with the objective of strengthening VBARD's corporate governance to ensure its competitiveness and effectiveness as a financial institution. The TA was comprehensive and conducted a review of the organization, operations, and systems of the institution and made recommendations on them. The TA addressed a wide range of issues integral to good governance. Specifically, the TA assisted to: (i) establish a corporate planning process in VBARD, (ii) establish an organizational strategy, (iii) establish an asset-liability committee (ALCO) and train various staff in risk management, (iv) train staff in preparing a training plan to support corporate plan implementation, (v) train staff in the design and preparation of a MIS development plan, (vi) strengthen credit appraisal and supervision, and (vii) prepare a systems development plan. The TA conducted 11 formal workshops in various aspects of corporate governance. A total of 231 officers and staff from the branches and head office attended these workshops.

71. A key output of the TA was the "VBARD Action Plan", consisting of some 170 recommended actions for VBARD to undertake in the areas of: (i) corporate structure, (ii) human resource development, (iii) training, (iv) product and services development, (v) risk management, (vi) budgeting and accounting (including provisioning for doubtful debt), (vii) MIS development, and (viii) other areas. VBARD has fully adopted the recommended Action Plan. VBARD's Restructuring Plan of 25 September 2001 covers the period 2000-2010 and includes VBARD's commercialization, debt restructuring, and organizational and operational remodeling. The Action Plan is more detailed than the Restructuring Plan, which is a higher level strategic document. However, the Restructuring Plan is consistent with the Action Plan and explicitly includes many of the Action Plan recommendations. In some cases Action Plan recommendations are not included, but VBARD is implementing them. Implementation of the Action Plan is being monitored under the Rural Enterprise Finance Project, discussed next.

2. Rural Enterprise Finance Project

72. ADB is supporting onlending activities of VBARD and CCF/PCFs through loan 1802-VIE: Rural Enterprise Project (REFP). The REFP loan of $80 million equivalent was approved by ADB in November 2000 and became effective in August 2001. The Project aims to support the Government's efforts to reduce poverty and promote private sector investments in rural and agro-based businesses primarily through credit provision. The scope comprises (i) a credit line of $45 million to VBARD to finance about 14,900 micro and small rural enterprises (MSEs) and 18,500 income-generating activities of LIHs; (ii) a credit line to CCF to finance 7,500 MSEs and 31,000 income-generating activities of LIHs; and (iii) strengthening the capacity of VBARD and CCF/PCFs in providing efficient and improved services to rural clients.

73. A February 2003 review mission indicated that the impact of the credit line was not to increase medium- and long-term lending, but rather to assist VBARD to better manage its liquidity and to match its funding with its lending. Access to a long-term credit line from ADB allows it to reduce the amount of medium- and long-term lending that is financed from short-term funds. Ironically, by freeing up short-term funds that would have otherwise backed medium- and long-term lending, VBARD is able to conduct more short-term lending as a result of its access to the credit line. Unlike the credit line to VBARD, the credit line to CCF does appear to increase medium- and long-term lending. Funds are transferred from CCF to autonomous PCFs, whose access to these funds allows them to pass them on directly to clients.

74. While recognizing these impacts of the credit line, it is important to note that, consistent with ADB's Microfinance Development Strategy, disbursement of the credit lines is directly linked to institutional reforms, which are monitored by ADB. In the case of VBARD, this includes implementing its Action Plan, developing a risk premium scheme for uncollateralized loans, developing an incentive scheme to reward staff for on-time collection of loans, developing a training plan to improve staff skills, and constructing a training center. In the case of CCF, this includes developing a similar risk premium scheme for uncollateralized loans, and preparing a training and technology plan (with implementation funded by a portion of the profits on lending from the credit line).

3. Microfinance Policy Framework and Regulations

75. Under ADB TA 3741-VIE: Preparing the Framework for Microfinance Development, a Policy Framework for developing the sector has been produced, as well as a draft decree on the regulation and supervision of microfinance. The vision for the rural and microfinance sector laid out in the Policy Framework is that of a growing market-oriented formal sector, consisting of both public and private banks and MFIs, which operate professionally and sustainably, and which are linked to the formal banking sector through commercial relationships. Microfinance projects should focus on institutional sustainability from the outset, and in time the sector should be served primarily by fully licensed, regulated, and supervised MFIs that are profit-oriented.[13]

76. As in Lao PDR, an enabling legal, regulatory, and supervisory framework that provides incentives to invest in the sector while remaining focused on the poor will be a key to the sector's development. Numerous donors and others with potential interest in investing in microfinance in Viet Nam have cited the unclear and repressive legal and regulatory environment as a principle reason for not entering the sector. Simultaneously, the legal and regulatory framework must also make it incumbent upon MFIs to follow best practices, e.g., undergoing prudential supervision if they take deposits, meeting performance targets, reporting regularly to the supervision authority, and following good governance and accounting principles.

77. The draft decree prepared under the TA is still undergoing review and revisions, and its final form is uncertain. Given the importance with which ADB and the Vietnamese authorities view the development of the microfinance sector, submission and approval of an "enabling" decree are now base-case and high-case triggers, respectively, under ADB's Performance Based Allocation exercise, which determines the annual allocation of concessionary Asian

[13] Unlike in Lao PDR, there was no advance agreement that the Policy Framework would become official policy. As discussed below, ADB is considering support for a national strategy, which would be subject to official endorsement, as a follow-up to development of the Policy Framework.

Development Fund (ADF). The aide memoire of a June 2003 review mission clarified that an enabling decree would adhere to some basic principles including:

- allowing for a diversity of MFI models and ownership structures, including private and foreign ownership;
- MFI autonomy in determining interest rates and profit-orientation;
- encouraging good governance in MFIs through regulations and guidelines consistent with OECD and BIS corporate governance guidelines, including accounting and reporting guidelines;
- appropriate capital requirements, including adequate capital for deposit-taking MFIs and no legal capital for credit-only MFIs; and
- a level playing field through a similar regulatory and tax regime regardless of MFI ownership.

78. Consistent with our Microfinance Development Strategy, ADB will likely condition future support in Viet Nam's microfinance sector on the issuance of an "enabling" decree.

4. Future Initiatives

79. The February 2003 review mission of REFP found that, while VBARD was making good progress in implementing much of its Action Plan, it needed additional TA to implement certain actions. For example, as VBARD has started to expand its borrower base while substantially increasing its lending, there is a need for improvement in the credit skills of staff in areas such as credit assessment, credit extension, and especially credit and risk management. ADB has therefore put a small-scale TA in the pipeline for 2004 to assist VBARD in these areas.

80. Assuming that an enabling decree is forthcoming, ADB will likely support, also in 2004, (i) the development of a national strategy to develop the sector, and (ii) a small-scale TA to build capacity to implement the legal and regulatory framework. The first activity would build on the Framework already developed, and the second activity would focus on building capacity in SBV to implement the supervisory framework, as well as building capacity in MFIs and MF projects to meet their regulatory requirements.

81. With progress in improving the legal and regulatory framework and its implementation, and based on an initial request by SBV, a sector development loan with policy and investment components for 2006 or 2007 may be appropriate. Policy areas to be addressed in such a loan could include:

- further, effective interest rate liberalization;
- refinements to the regulatory and tax regime as identified during the early stages of implementing the new regulations;
- continued VBARD restructuring, including cessation of directed lending, increased autonomy, continued implementation of its Action Plan, publication of IAS accounts, recapitalization, and possible equitization as a first step to privatization;
- reforms in SPB to reduce its distortionary effects; and
- delegation of MFI supervision to an appropriate institution such as VBARD, BIDV, a credit bureau, or MFI Association.

82. Areas for investment to be financed by the loan could include:

- further capacity building in MFIs and SBV, as it can be expected that capacity will be weak in the nascent stage of the sector's development;
- capacity building in CCF/PCFs;
- assisting VBARD and other commercial banks to create a wholesale lending function to link MFIs with the commercial bank sector;
- facilitate the formation of an MFI credit information service, MFI Association, a MF code of conduct to promote best practices, a microfinance equity fund, and/or a Microfinance Training Institute; and
- providing general purpose funding for MFIs.[14]

83. This sector loan could be supported by a combination of TA grants, JFPR grants, and JFICT grants.

[14] It is reasonable to assume that commercial markets will be slow in lending to MFIs in the nascent stage of this sector. Therefore, funding support for MFIs' general purpose lending, at commercial terms and subject to strict performance criteria of the MFIs, may be justified. But care must be taken not to crowd out commercial funding sources, including savings deposits.

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AFD	–	Agence Francaise de Développement
APB	–	Agriculture Promotion Bank
BID	–	Banking Inspectorate Department
BIDV	–	Bank for Investment and Development of Viet Nam
BIS	–	Bank for International Settlements
BOL	–	Bank of Lao PDR
BSRPL	–	Banking Sector Reform Program Loan
CCF	–	Central Credit Fund
CCSP	–	Cooperative de Credit pour le Soutien de Petites de Unites de Production
DFID	–	Department for International Development
DMC	–	developing member country
EU	–	European Union
FIRST	–	Financial Sector Reform and Strengthening Institute
GTZ	–	Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)
IAS	–	international accounting standards
IFAD	–	International Fund for Agricultural Development
JFICT	–	Japan Fund for Information and Communications Technology
JFPR	–	Japan Fund for Poverty Reduction
LIH	–	low-income household
LWU	–	Lao Women's Union
MARD	–	Ministry of Agriculture and Rural Development
MFI	–	microfinance institution
MOF	–	Ministry of Finance
MOLISA	–	Ministry of Labor, War Invalids, and Social Affairs
MPI	–	Ministry of Planning and Investment
MSE	–	micro and small rural enterprise
NGO	–	nongovernment organization
NPL	–	nonperforming loan
OECD	–	Organisation for Economic Co-operation and Development
PCF	–	People's Credit Fund
PDDP	–	Phongsaly District Development Project
PPTA	–	project preparatory technical assistance
RCF	–	Regional Credit Fund
REFP	–	Rural Enterprise Project
RMF	–	rural and microfinance
SCU	–	savings and credit union
SME	–	small-and medium-sized enterprise
SOCB	–	state-owned commercial bank
SOE	–	state-owned enterprise
SPB	–	Social Policy Bank
SRE	–	small rural enterprise
TA	–	technical assistance

UN	–	United Nations
UNCDF	–	United Nations Capital Development Fund
UNDP	–	United Nations Development Programme
UNICEF	–	United Nations Children's Fund
VAS	–	Viet Nam Accounting System
VBARD	–	Viet Nam Bank for Agriculture and Rural Development
VBP	–	Viet Nam Bank for the Poor
VFU	–	Viet Nam Farmer's Union
VWU	–	Viet Nam Women's Union
VYU	–	Viet Nam Youth Union