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**World Bank**

**Vietnam: Developing a Comprehensive Strategy to Expand  
Access [for the poor] to Microfinance Services.**

**Promoting Outreach, Efficiency and Sustainability**

**Volume II: Options for a Comprehensive Strategy**

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## Vietnam: Developing a Comprehensive Strategy to Expand Access [for the Poor] to Microfinance Services.

### Promoting Outreach, Efficiency and Sustainability

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## 1. Executive Summary

Vietnam has made considerable progress in reducing poverty in the last decade, but there are still about 4.6 million households (slightly more than 20% of the population) living in poverty, and it remains one of the poorer countries in the world. As Vietnam continues its stable and effective economic and financial policies and deepens its market-oriented policies and as the positive effects on (primarily) urban employment creation of its entry into WTO are felt, poverty will also be reduced by the effect of the continued absorption of rural underemployed labour into the more dynamic urban areas (or to other countries through migration) and the increase in rural wages.

The microfinance industry has been growing rapidly, and it is widely believed that it has been a major positive contributor to poverty reduction. It is estimated that between 70-80 per cent of the poor are able to access some form of financial service, mostly in the form of short-term credit and savings (and the remaining 20-30 percent probably fall more within the area of action of the government's social safety net). However, Vietnam has not had a coherent and comprehensive strategy for the microfinance sector, and until recently not even contemplated the regulation of the industry and its eventual integration into the financial sector. Probably as a result, the microfinance industry is still characterized by fragmentation, lack of regulation and a degree of inefficiency both, on the lending and savings side, that reduce the quality of outreach, threaten its sustainability, limit its development and make it impossible to more fully integrate with the financial sector of Vietnam.

More specifically, the industry is characterized by: (a) an inefficient and distortionary policy framework, resulting from subsidized credit mechanisms, distorting interest rate subsidies and forced transfer of savings (b) an insufficient attention to the institutional and human capacity needed for the industry to be part of the rapidly modernizing/reforming financial sector in Vietnam, and (c) an evolving legal and regulatory framework not well adapted yet to the needs of the microfinance sector. These issues have arisen in part because of the tendency in Vietnam to confuse financial services with social transfers. Social transfers, especially to the poorest regions and provinces, definitely have their place for some years to come in Vietnam. However, the poor throughout the world have persistently demonstrated that consistent and convenient access to credit and other financial services is more important than their price.

The major issues that impede a more **enabling policy environment** are

- (a) the government-imposed interest rate VBSP charges which is about half the "market" rates charged by most of the other MFPs. This policy discourages savings mobilization and results in credit "rationing" to the poor. It also constrains the ability of the other microfinance institutions serving the low income and poor to compete in the market place and reduces their potential for growth.
- (b) The policy mandated transfers of some 80% of the financial resources mobilized by Vietnam Postal Savings Bank (VPSC) to the new Vietnam Development Bank (VDB).

The mismatch between the terms of resources mobilized by VPSC (about 80% long-term) and transferred as loans to VDBs (mostly medium-term), negatively affects VPSCs liquidity and profitability and leads VPSC periodically to reduce their resource mobilization efforts in both rural and urban areas for non-market reasons.

- (c) VDB lends to SMEs at subsidized rates under the premise that subsidization is necessary for SMEs to invest in remote rural areas and to be able to compete in external markets. The subsidized interest rate policy may make it less attractive for the SOCBs and the JSCBs that also lend to SMEs – and increasingly to the urban consumer market – to downscale further

The broad and relatively deep **institutional coverage** of the microfinance industry in Viet Nam (few of the 24% poor and low-income households people are fully excluded from access to some form of financial service) masks deep seated institutional, human capacity and organizational issues in the industry in part due to the policy issues described earlier. These systemic issues manifest themselves in four specific areas:

- (a) Limited range and relatively low quality of microfinance products provided by the MFIs;
- (b) Serious financial profitability concerns and therefore sustainability issues of many MFIs;
- (c) Considerable market fragmentation and inexistent economies of scale (except for VBARD and VBSP), and;
- (d) An ambiguous role of the Mass Organizations in microfinance.

In March 2005, the Government of Viet Nam passed Decree no. 28 on the “*Organization and Operation of Micro-finance Institutions*” in Viet Nam to provide a specific **legal and regulatory framework** for microfinance. Decree 28 introduces a legal foundation for the present semi-formal (and unregulated) microfinance activities in the country by requiring the transformation of MFPs into regulated financial intermediaries and therefore their incorporation into the more “formal” financial system and provides legal legitimacy to transformed MFIs. Thus, it provides the framework for the integration of the microfinance providers into the more formal financial sector.

However, there has been no consensus on the specific application and implementation details of Decree 28 and therefore the needed operational circulars have never been issued (they are presently under preparation or consultation). The lack of apparent consensus reflects the risk that implementing Decree 28 as scheduled by March 2007 and in the form presently proposed could result in the drastic reduction of the number of semi-formal MFPs presently operating in Viet Nam that may provide specific niche services or reach the very poor in not easily accessible areas. This could have negative effects on outreach. Implementing the decree would also impose a huge supervisory and regulatory burden on SBV for which it is not prepared.

The report proposes a menu of strategic policy, institutional and organizational, and legal and regulatory options and measures for the government and the donor community to consider. The options eventually chosen (and the report makes some suggestions of the preferable ones) would

together constitute the signposts for the development by the Vietnamese Government under the joint leadership of MF and SBV, of a microfinance sector strategy as a self-sufficient financial sector segment with a social mission (rather than as a poverty lending instrument) which would help Vietnam achieve its stated objectives of ensuring enhanced access to higher quality and broader range of microfinance services for the poor, increased efficiency of the “formal” and semi-formal institutions that comprise the microfinance sector and ensure therefore their sustainability in an integrated financial sector. The main measures and options proposed are:

1. To achieve a **more enabling policy environment**;

- VBSP could become a permanent wholesale lending facility at market (or close to) market rates specifically for MFIs serving the poor and low-income population and maintain a separate but much smaller retail capacity.
- Alternatively (and preferably), VBSP should have two well differentiated lending “windows”. One for activities which may continue to require subsidization (e.g., student loans) financed from annual budgetary allocations and the second for general “banking/credit” developmental activities funded exclusively from VBSP’s present capital and additional saving resources VBSP may be able to mobilize from the market.
- VBSP’s lending rates in either alternative will need to **gradually** increase to market levels, i.e., cover credit risk, cost of capital and all operating costs so as to fully develop VBSP’s potential for resource mobilization.
- Some activities presently “financed” by VBSP are more in the nature of social safety-net and they should be transferred to the corresponding line ministries.
- The compulsory nature of transfers from VPSC to VDB should be progressively eliminated and VDB’s, lending interest rates should also be **gradually** raised to market levels so that they will be able to mobilize resources in market terms (including, government paper and VPSC’s resources).

2. To strengthen the **Institutional and Organizational** framework of the industry and permit formal and semi-formal MFIs to expand as they see opportunities in the market, the following are two key actions that should be undertaken:

- To increase the banking and credit risk skills of their staff and the quality of management and audit, as well as the use of MIS.
- Donors should increase the share of resources in their loans/grants that is devoted to training staff and managers of formal and non-transforming MFIs. The resources should ideally be channeled to help improve the training capacity of existing training institutions, e.g., the Bankers Association, CCF (for the PCFs), or BTC (supported by IFC) that provide training to a broad range of MFIs in banking skills, accounting methods.

- Within an MFI sector that would consist of a number of formal institutions (VBARD, VBSP, PCFs, the transformed MFIs) and semi-formal institutions, under a well defined Code of Conduct, the Mass Organizations and particularly the Women's Union should continue to play the role in which they excel and show an excellent track-record: that of *facilitators* of increased access by poor (women in the case of VWU) to financial and non-financial services, rather than as a sustainable microfinance service *provider*, a role for which VWU or the other MOs are neither structured nor prepared.

### 3. To strengthen the **Legal and Regulatory framework**

- The operational circulars for Decree 28 should be issued as soon as possible. The circulars should, if legally feasible, allow for some additional time for the MFPs that intend to transform to do so. If the circulars cannot extend the timing of implementation of the decree, consideration should be given to amending the decree to allow this extension.
- Help develop a Code of Conduct for existing MFIs with capital of less than 500 million VND that would choose not to transform and allow them to continue to operate "unregulated" by SBV but under the strict code of conduct to be developed and approved by the government. Future MFIs with capital less than 500 million VND would also be allowed to operate under the Code of Conduct.
- Enforce the requirement that existing and future MFIs with capital between 500 million and 5 billion VND be subject to Decree 28 but allow them to choose whether to accept or not voluntary savings which would subject them to different requirements to be licensed by SBV, as indicated in Article 8 of the decree.
- Strengthen SBV's ability to maintain a consistent, updated database of information on all financial institutions serving the market, including asset quality, outreach, funding sources and market segment in order to improve risk management;
- Consider changing the rules and progressively (and prudentially) allow PCFs to expand beyond the commune boundaries presently limiting them so as to improve their chances of capturing a bigger share of the market and reduce their costs
- Support the development of a credit reference system (bureau) with at least a loan default registry system to reduce the risk of over-indebtedness and thus undetected portfolio risk in the well-served market;
- Develop a regular rating system of medium and larger MFPs/MFIs (formal and semi-formal alike) to improve capital market understanding and confidence in the industry.

The adoption of a coherent new strategy to which this report (Volumes I and II) hopefully makes a contribution, should help develop an overall consensus among all stakeholders and drive the development of a microfinance sector adhering to performance-based, results-oriented good practices in an inclusive financial sector that would help the development of Vietnam.

## **2. Introduction**

Vietnam has made considerable progress in reducing poverty in the last decade, but there are still about 4.6 million households (slightly more than 20% of the population) living in poverty, and it remains one of the poorer countries in the world. The financial sector in Vietnam has been growing rapidly and with it the coverage of low income and poor people (“outreach”) by microfinance institutions. And improved access to a range of appropriate, affordable and demand-driven financial services by the poor has been demonstrated globally and in Vietnam to be one of the factors that underpin the ability of the poor and low-income people to extricate themselves from poverty or increase their incomes on their own terms in an efficient and sustainable way. As Vietnam continues its stable and effective economic policies and as the positive effects on (primarily) urban employment creation of its entry into WTO are felt, poverty will also be reduced, as it has happened in all developing countries, by the effect of continued absorption of rural underemployed labor into the more dynamic urban areas (or to other countries through migration) and the increase in rural wages. However, for the foreseeable future, Vietnam’s social and distribution policies will require that attention continue to be paid to lessening the still relatively high number of people, mostly in rural areas, that live in poverty. And the financial sector and particularly the microfinance industry will continue to play a key role in this process.

However, the microfinance industry in Vietnam still displays some characteristics, namely fragmentation, lack of regulation and a degree of inefficiency that reduce the quality of outreach, threaten its sustainability, limit its development and make it impossible to more fully integrate it within the financial sector of Vietnam. Despite the best intentions of the government and despite the support of international donors and of the stakeholders themselves, Vietnam has not had a coherent and comprehensive strategy for the microfinance sector and until recently not even contemplated its eventual integration into the financial sector. Thus, the purpose of this report (Volumes I and II) is to provide the government an outline of the elements of a sustainable microfinance strategy in the country which include a number of options for interventions to increase outreach, efficiency and the sustainability of the sector that are consistent with the country’s relevant policies and strategies as well as internationally accepted best practices.

The absence of a coherent strategy framework for microfinance, which takes into account the particularities of Vietnam, as well as the internationally accepted microfinance best practices, is fiscally costly, distorts the financial market for microfinance and results in inefficiencies in the allocation of resources. It may therefore reduce the positive effect that the sector should have on poverty alleviation. In effect, the absence of a coherent strategy has led to:

- a) A set of financial policies in the industry that are inefficient in some respects and distortionary in others,

- b) An insufficient attention to developing the institutional and human capacity in the industry to enable microfinance to become an integral part of a rapidly modernizing/reforming financial sector in Vietnam and;
- c) An evolving legal and regulatory framework which as presently drawn is not well adapted to the needs of the microfinance sector and makes difficult its full integration into the overall financial sector.

Overall these issues may not have affected the number of the poor that have access to some form of financial services (“outreach”). Out of the about 4.6 million poor households in Vietnam, it is estimated that between 70-80 per cent of them are able to access some form of financial service, mostly in the form of short term credit and savings and the remaining 20-30 percent are probably not subject of credit and unlikely to be able to mobilize saving resources in the short run, hence falling within the area of action of the government’s social safety net. An even higher percentage of the low-income people may access financial services, particularly in urban areas. However, in terms of financial product availability, effectiveness and cost of the financial services and others, the quality of outreach tends to be low. And particularly, medium and long term financing for all segments of the population is not generally available for most segments of the population. Moreover, the policy, legal and regulatory and institutional issues have resulted in inefficiencies in the mobilization and use of financial resources and threats to the sustainability of some of the institutions involved in providing microfinance services and to the availability of these services.

Thus, a comprehensive strategy for enhanced access to microfinance in Vietnam should target the 24% of the low income and poor households in Vietnam and incorporate enabling policies; an appropriate legal and regulatory architecture; and support to strengthen the retail providers resulting in larger, more efficient and more sustainable institutions providing more diversified and higher quality financial services particularly to the targeted population. This will help the integration of the microfinance industry into the overall financial system and contribute to the development of a sounder and deeper financial market, itself a key factor in economic growth and development.

This report constitutes Volume II of the document: “Vietnam: Developing a Comprehensive Strategy to Expand Access [for the Poor] to Microfinance Services.” It complements the description and analysis of the microfinance landscape presented in Volume I of the report by presenting a series of strategic options, which in the short to medium term could help alleviate the existing constraints for enhanced access to microfinance. Together, the options provide a series of signposts to help frame a comprehensive strategy for enhanced access to microfinance, which in the medium to long term would integrate sustainable microfinance providers (MFPs) into the financial system of Vietnam and improve their efficiency and sustainability. The options will be presented in terms of: (a) options for the development of an appropriate policy framework particularly in relation to the subsidized credit mechanisms, the interest rate levels and the role of VBSP; (b) options and measures to enhance support to develop the institutional, organizational

and human capacity within the microfinance institutions that comprise the financial sub-sector that would facilitate the development of the microfinance industry as an integral part of the financial sector in Vietnam; and (c) options for overcoming the current impasse in the development of the regulatory environment revolving around Decree 28.

The report is structured in four chapters. **Chapter 2** deals with *policy issues and constraints*, the *institutional, organizational and human capacity issues* and the *legal and regulatory issues and constraints* revolving around Decree 28 that exist in the microfinance industry in Vietnam. Resolving the issues and relaxing the constraints would facilitate the gradual transformation and strengthening of the microfinance institutions, improve the quality and variety of the microfinance services they offer, increase their profitability and the quality of their assets, reduce their costs, and in general, permit their development as an integral part of the financial sector in Vietnam. **Chapter 3** presents a *set of possible options for consideration by the central agencies of the government for the microfinance sector* to progressively develop a more efficient and sustainable policy framework in the microfinance sector, a stronger, more resilient and more sustainable set of institutions seen from the perspective of the present actors in the industry: central agencies of the government and regulators, the formal banks and non-banks, the semi-formal institutions (eventual MFIs and other, possibly non-regulated institutions) and the Mass Organizations. The chapter will also discuss the additional support mechanisms (donor and INGO involvement and coordination) and the possible measures to be applied to improve the legal and regulatory framework. The wise selection among the possible options would undoubtedly enhance the ability of the microfinance industry to reach the low income and poor in Vietnam and help accelerate its integration into the financial sector of Vietnam. And finally, **Chapter 4** posits *the conditions and summarizes selected elements of the possible strategy* and the expected positive impact of the new strategy on outreach, efficiency and sustainability in the microfinance sector.

### ***3. Key Constraints and Issues in Microfinance in Vietnam***

#### ***A) The Policy Environment, Issues and Constraints: Subsidized Credit Mechanisms, Interest Rates and Forced Transfers.***

A sustainable and efficient microfinance industry requires an enabling policy environment. A key element of this environment is for the Government of Vietnam to continue to pursue stable macroeconomic conditions and deepen its market-oriented policies, especially with regard to levelling the playing field for providers in the market. A second key enabling policy for microfinance is the gradual elimination of subsidized credit mechanisms and distorting interest rate subsidies, complementing the development of an appropriate legal framework and sustainable institutions that operate in accordance with good practices and rely on professional management and sound technology and systems.

The gradual elimination of subsidized credit mechanisms and other distortions in the sector is crucial to the development of sound microfinance. While social transfers, especially to the poorest regions and provinces definitely have their place for some years to come in Vietnam, it is important not to confuse financial services with social transfers. As documented across the world, microfinance institutions work best, and thus serve the poor better, when they are oriented towards the demands of their customers; when they emphasize performance (quality) rather than coverage (quantity); and when they are allowed to operate and compete as “market” entities within an inclusive financial sector supported by enabling legislation and regulations that remove constraints to growth.

Micro-credit has gained popularity in Vietnam as a means to enhance public social development efforts to alleviate poverty, but the focus on credit for social development may have led to oversight of the importance of financial systems development. The difference between financial services and social transfers has been misunderstood in the past by the government, by the development community (with donor-supported multi-sector programs which include credit lines) and by the Mass Organizations partnering or managing MFPs. This amalgamation of market and non-market elements has meant that expectations of financial service provision are not always compatible with accepted good practice for microfinance, especially the importance of sustainability, and that sound financial management principles have often been violated

The clearest manifestation of this confusion is the perpetuation of subsidized credit mechanisms and government interest rate subsidies which may have discouraged banks or other actors from entering the microfinance sector and thus may have limited competition among the formal MFI institutions. This policy has almost certainly had a negative effect on outreach and sustainability in Vietnam and has led to results that are all too often suboptimal from an efficiency perspective. In the accepted and recognized division of microfinance providers in Vietnam into formal microfinance (bank and non-bank) institutions, semi-formal institutions and an informal system,

the existing interest rate policy in the sector affects more directly the so-called formal (bank and non-bank) providers as it results in an environment which mixes market and non-market elements but where the institutions are expected to operate in financially profitable terms. But it also affects indirectly the semi-formal institutions as they attempt to work in a market-oriented environment. Moreover, as Decree 28 comes into effect and some of the semi-formal providers of microfinance become de facto and in a relatively short period of time, “formal” and regulated microfinance providers, they too will be subject to the policy distortions in the sector that reduce the effectiveness of the “formal” and SBV-regulated microfinance providers.

Slowly, and with few exceptions, the widespread belief that microfinance needs to be subsidized to benefit the poor has begun to recede in Vietnam. The global microfinance industry has learned from the poor that consistent and convenient access to increasing credit and other financial services is more important than the price. From the perspective of poor clients, sustainability is key to ensuring that they have *permanent* access to financial services to help them take advantage of opportunities and manage risks, as opposed to ‘one-off’ loans or ‘stop-and-go’ credit available as and when MFPs succeed in raising external capital. And even in the government there is wide (but not complete) consensus that subsidized interest rates in VBSP are neither necessary nor helpful. However, interest rate subsidies and other distortions still exist which among other issues, may result in reducing the ability of the system to mobilize financial resources and threaten the sustainability of the microfinance sector by weakening the financial situation of many of the current MFPs.

In effect, with the exception of a number of PCFs and some semi-formal microfinance providers which appear to be on an operationally solid financial footing at present (mostly in the case of the latter due to the structure of their predominantly grant capital), few of the microfinance providers in Vietnam today, including the larger formal MFIs (VBARD and VBSP and a number of PCFs) are financially profitable and therefore sustainable to the extent that they can service the immediate demand for credit and other financial services among their customers and guarantee their long-term survival in the market. True enough, the reason for this cannot be ascribed only to the government-determined interest rate subsidies through VBSP and the effect it may have on the return on their assets. The cost of operation and the lack of banking skills of many of the formal and semi-formal MFPs are also serious issues that will be noted in the following paragraphs and addressed more fully in the institutional section.

Some of the major policy issues relate to the subsidized credit mechanisms in place in Viet Nam, the level of interest rates, and forced resource transfers. These policy issues relate to (and affect) VBSP, VPSC and VDB and impinge on the efficiency and sustainability of the sector. They therefore also negatively affect the competitiveness of the other institutions (VBARD, PCFs and even some of the semi-formal MFPs) that lend to the low income and poor. They are:

1. The government-imposed interest rate that VBSP charges is about 50% of the “market” rates charged by most of the other MFPs, (which range from 8.6% to 24% per annum).

The rate charged by VBSP is insufficient to cover the “market” cost of capital, its credit risk and the high operating costs of the very large network of branches it has throughout the country, if VBSP was required to mobilize the market resources required for its lending (only about 53% of the resources are mobilized from the market – the rest come from forced transfers, donor money and the budget). This policy strains the ability of the other microfinance institutions (PCFs and unregulated providers) which also serve the low income and poor segment of the population to compete in the market place and reduces their potential for growth. Even in the case of VBARD, Vietnam’s largest bank, this may lower its profitability (as a SOCB, it is required to transfer 2% of their deposits to VBSP), and hence their ability to diversify the product mix and to deepen their penetration in the lower segments of the population.

2. The low interest rate on loans charged by VBSP, and the availability of forced transfers, donor loans and the budget discourage this institution from mobilizing resources on the savings side, since each dollar mobilized at, or near, market rates (as there is much more competition on the savings side) adds to their already considerable operational losses, resulting in part from higher than reported levels of bad debts (there has been however an improvement in formal repayment figures) and high operating costs. This is reflected also in the level of interest rate that VBSP pays on savings which is in the lower range of the rates paid by other MFPs. Not surprisingly, despite the fact that this institution has a large network of branches throughout the country, as of end of 2005 it had less than 2% of the total number of savings accounts in the country (and with smaller average US\$ deposits per account, the share of total resources mobilized is even smaller). In contrast, VBARD, also by end 2005, had 7 million savings accounts with total savings deposits of US\$7.5 billion compared with VBSP’s US\$58.5 million in 167,000 accounts. Even when the comparison is made in terms of number of accounts among the low income and poor, VBSP ranks last among MFPs. While the lack of savings in VBSP reflects also the perception among many people that VBSP as at presently run is an unreliable and non-sustainable financial institution, it is clear that low interest rates in the asset side of VBSP, translates into reduced resource mobilization and therefore it lessens the opportunities for poor people to earn interest and increase liquidity.
3. Both factors, i.e., lower than market interest rates on the asset side and the discouragement of resource mobilization in the part of VBSP, combined with the dependence of this institution on fiscal and forced transfers and limited donor support, to carry out their lending programs, result on credit to the population served by VBSP being effectively “rationed”. Thus, we are positing that the fact that average loan size by VBSP at US\$280 is much lower than for instance VBARDs (US\$1,320) or the PCFs, (over US\$700) reflects not only differences in the demand side, i.e., the type of clientele (mostly low income and poor people) which in principle may require or be able to afford less credit, but also on the supply side, i.e., the lack of resources in VBSP, which result

from the combination of lower interest rates and their dependence on fiscal transfers rather than on resource mobilization.

4. The financing mechanism of VBSP, largely through fiscal resources, not only results in credit rationing, but it also may reduce the availability of “outside” capital to the rural/poor sector in Vietnam. In effect, multilateral and bilateral institutions are less likely to provide financial resources for the microfinance sector while structural constraints and subsidized interest rates exist in the sector. Certainly VBSP has not met the minimum eligibility criteria to participate in the large apex Rural Finance II project financed by the World Bank and therefore it is unlikely to access any rediscount facility built on market terms and conditions.
5. The non-transparent and mandated transfers of financial resources from VPSC to the new VDB (80% of VPSC’s total resources mobilized are transferred by decree to VDB) also potentially contribute to reducing resource mobilization in rural and poor areas of the country (about 50% of total resources mobilized by VPSC come from rural areas). In effect, there is a mismatch in the term of the resources mobilized by VPSC (about 80% long term) and the term in which the resources are transferred to VDB (mostly medium-term). This can (and does) affect negatively the liquidity and profitability of VPSC and leads VPSC, as its management readily acknowledges, to periodically reduce their resource mobilization efforts for non-market reasons in both rural and urban areas.
6. In addition to the mismatch of term borrowing/lending, the mandated transfer of resources from VPSC to VDB redirects the flow of at least some resources from the rural to the urban areas without convincing market evidence that such flows are in response to higher rates of return to the underlying investments or that such flows would still take place in market conditions due to higher yields to loans in urban areas resulting from lower transaction costs. Thus the transfers may distort the flow of financial resources.
7. Although it does not affect the microfinance sector, at least directly, VDB, as VBSP does for low-income people, lends to SMEs at subsidized rates under the premise that subsidization is necessary for SMEs to grow and to be able to compete in external markets (they also lend for remote rural infrastructure projects). While VDB’s portfolio for SMEs (other than SOEs) is relatively small, the subsidized interest rate policy may make it more difficult for the SOCBs and the JSBs that also lend to SMEs – and increasingly to the urban consumer market – to go “down-market” and enter the microfinance sector by possibly reducing their profitability. Even though in the medium-term, these banks are unlikely to directly provide micro credit or other microfinance services to the low income and poor, the majority of them have plans to expand their activities to more provincial towns in the expectation of continued rapid economic growth and increased profitability. By financing SMEs, these banks will help create the job opportunities in rural areas that will increase the incomes of the poor and make them increasingly able to access

microfinance services. Thus, at the margin, the potential reduction in the profitability of SOCBs and JSBs due to VDB's interest rate policy may affect the low income and the poor by slowing the development of their branch network and their banking activities in the rural areas.

## ***B) Institutional, Human Capacity and Organizational Issues and Constraints***

### **a) Institutional and Human Capacity Issues and Constraints**

The institutional landscape of the microfinance sector has been evolving rapidly in the last few years with the changes in VBSP and the creation of a new cooperative system (PCFs/CCF) replacing the failed cooperative system in the early 90s. The implementation of Decree 28 will create a new legal and regulatory environment that will demand additional institutional and organizational changes if the sector is to maintain the present level of outreach, improve efficiency and be sustainable.

Three regulated financial institutions (VBARD, PCF and VBSP) in Viet Nam play a dominant role in provision of financial services to BOP, and reach an estimated total of 3 million BOP customers with savings services and 5 million with credit, relatively deep and wide into the poorer segment. Targeting the market of the poorest, semi-formal microfinance is provided primarily by (I) NGO programs in partnerships with the socio-political mass organizations (particular the Vietnam Women's Union), and reach in the vicinity of 350,000 clients at present offering primarily small loans and savings services. Completing this supply, a plethora of local, semi-structured and truly 'private' informal finance mechanisms exist in almost every hamlet of Vietnam as a well-integrated part of the communal safety net.

The quantitative outreach of microfinance (financial depth) in Vietnam is impressive, and very few people indeed are fully excluded from access to some form of financial service. There are under-served niche markets of very poor people in remote and under-served areas (ethnic minority communities) but the biggest market segment for microfinance in Vietnam are the 24% poor and low-income households that by and large already have access to some financial services. Contrary to perceptions, the 'unmet demand' in Vietnam is very small, especially within the traditional *microfinance* market.

Thus, the institutions operating in Vietnam when taken as a whole provide a quantitative coverage (outreach) of the microfinance sector, which is largely "acceptable". The institutions range from "formal" bank-like institutions such as VBARD, covering the upper ranges of the low income, to some small MFPs that provide services to small groups of low-income people generally in a few communes in a single province, generally in poor areas of difficult access. In-between there is VBSP, providing subsidized credit largely to the poor with a broad network of branches reaching the four corners of Vietnam; the PCFs system working generally in individual

communes but geographically in all the country's provinces, and some of the larger MFPs that are likely to transform into more formal MFIs under Decree 28.

Larger and more commercial banking institutions such as the SOCBs and the JSCBs, also play an important role in the institutional landscape of microfinance in Vietnam, not because they lend to low income and the poor which, with a few exceptions in urban areas, they do not (nor are they likely to go “down-market” and lend directly to low income and poor people any time soon). But they play an important role in the microfinance spectrum by helping increase incomes in rural and urban poor areas by financing SMEs, which create employment. Productive investments by SMEs, financed by the banks, increase income and reduce poverty in two ways. First, by creating employment in urban areas, they contribute to moving underemployed and low productivity people away from rural areas, which over time tends to increase the rural wage rate. Second and more directly, by creating employment in some of the rural areas where some of the investments are located. And there are clear signs and plans in the part of many of the JSBs to expand their branch network to outlying areas of the country rather than concentrating exclusively in the three major cities, as has been the case heretofore. The resulting rise in income increases the demand for microfinance services including micro credit in the part of the poor and potentially provides an increasing, more efficient and more sustainable market to MFIs, once the policy constraints outlined in the previous are alleviated.

However, the broad and relatively deep institutional coverage of the sector masks deep seated institutional issues in the industry in terms of quality and range of services for the poor, managerial, banking and auditing capacity in most formal and semi-formal MFIs, limited market share (except for VBARD and VBSP, generally small highly fragmented markets that do not allow for economies of scale), and human capacity. These issues combined with the policy issues described before result in serious financial profitability concerns and raise questions about the financial sustainability of many of the MFIs both formal (VBARD, VBSP and some PCFs) and semi-formal. These issues need to be addressed if outreach is to be maintained (with higher quality of service and broader ranger of services), efficiency improved and the institutions to remain financially sustainable.

In addition, the largely absent coordination and information-sharing among providers has hidden the overlap of customers (primarily at the upper end of the BOP segment) and even suggests credit ‘over-supply’ in some areas, where widespread multiple borrowing among very poor households raises concerns about over-indebtedness and potential, if currently unrecognized, portfolio risk. The absence of a credit reference system (CRS) or a Credit Bureau that can identify cases of multiple borrowing and possible over-indebtedness in the part of MFIs clients presents a potential but un-assessed systemic credit risk to the portfolio of each provider. The SBV, supported by the IFC-MPDF. Is presently developing a private credit bureau focusing on private companies. But this will not help in the microfinance market in the near term. Finally, there are also organizational issues in the industry that relate to the role of the Mass Organizations in the microfinance sector as well as the need to develop a Code of

Conduct for MFPs that do not transform, assuming that the government chooses the option that this report favors of allowing for a longer period of transformation and the possibility that a number of small MFPs may continue to operate in the country without license or supervision by SBV.

Within the industry itself, there is a need to improve corporate governance, management and operational practices among MFPs and apply international good practices more stringently and with stronger technical capacity. Institutional and human capacity building will be key to the successful transformation of currently semi-formal MFPs under Decree 28, 2005 and VBSP. For formal and semi-formal providers alike, institutional viability and competitiveness needs to be strengthened, and innovative products, services and delivery systems should be developed and adapted to the evolving demands of the market (the customers). Moreover, the financial and banking skills of the staff and management level of MFIs needs to be improved

#### *i) Range and Quality of Microfinance Products*

The range of microfinance services provided by the different retailers except for VBARD is limited, reflecting both the relatively low level of income in the country, which results in relatively low effective demand for services other than credit and savings in the part of the poor and the relative immaturity of the industry. The product range offered to BOP households is supply-driven and standardized and somewhat focused on credit provision. Hence, microfinance services, other than credit and savings, are just starting to be available and the outreach is still very limited for the poor and in general the quality of the services tend to be low. This is the result of the unsophisticated nature of the clientele as much as to the low level of human skills in the microfinance sector and the slow development of the banking systems in the institutions that serve the poor.

In general, semi-formal providers focus more on credit than on deposits. Even access to savings through VPSC and commercial banks appears limited for the very poor because of the relatively limited branch coverage, even in the case of VBARD and VPSC, when compared to the 11,000 communes in the country. The micro insurance sector is insignificant with shallow market penetration. Recent developments in the general insurance industry involving Bao Viet and its potential interest to work with MFIs that have been handling some microinsurance products (e.g. TYM) may be a forerunner for new products in this area. But this is a slow process that will require time before it gains traction.

This segment of the market will demand increasingly diverse and sophisticated financial services from the providers in the coming years, and successful microfinance providers will be those that adjust products, services and delivery mechanisms to the market demand while growing their portfolio safely and attaining financial sustainability.

This process of developing new and innovative financial products by the MFIs should be demand-driven and be tested on a pilot basis before being fully developed. Some of the products for which demand exists or will gradually develop include:

- New loan, savings and deposit products (covering school fees, healthcare costs);
- Schemes for loan security and repayment;
- Life insurance and, potentially, health insurance;
- Insurance for money transfers;
- Pensions;
- Crop and livestock insurance; and
- Other products that might expand the range of rural financial services and enhance the rural clients' access to them, including eventually loans on the basis of cash flow analysis.

#### *ii) Financial Performance and Sustainability Issues*

Even the more specialized financial service providers (VBARD, JSCBs, and the PCF network, CEP, TYM and a few other MFPs to some extent) that have focused on results-oriented performance monitoring and have brought in technical assistance via donor projects (e.g. BIDV training for VBARD, ILO trainings for MFPs in general and CARD Bank and GSB support for TYM in particular), need to improve the performance of their bank managers and staff particularly at branch level. In general, the lack of appropriately trained staff, low pay and the lack of other incentives are pervasive in the microfinance sector.

This is particularly the case for the more recently established PCFs where in addition, the accounting and performance monitoring systems are still inefficiently handled manually and with little technology support. And it would also be the case for VPSC, should it become a bank, one of the options being discussed, as presently, its staff only handles savings and would need to undergo much deeper credit analysis training.

As for the semi-formal MFIs, they are often run as 'projects' of Mass Organizations and do not have the managerial or technical capacity to track, record, report or analyze performance data from their operations. They are generally satisfied with meeting quantitative targets set by management, government or funders rather than monitoring their relevance in the rapidly changing market, and on accounting for the project funds spent, rather than documenting their impact. Moreover, the financial business support services to build the capacity of the MFPs are in limited supply. The approach to make available capacity building has been primarily embedded advice (from INGO staff) and generic classroom courses, and this will need to change to more flexible and needs-based, on-site technical assistance of a higher quality than hitherto experienced.

These managerial, banking and accounting performance and monitoring issues combined with the policy issues reviewed in the previous sections have resulted in financial efficiency, productivity and profitability ratios in many MFPs that are low. Data on portfolio quality is unreliable and while overdue loans and bad debts seem to have declined, the frequent use of loan refinancing in the part of some MFPs, makes the data inconsistent. All these factors combined, raise questions about the financial sustainability of many of the MFPs unless the underlying institutional and human capacity issues are also addressed through substantive and well-focused training programs aiming to strengthen the managerial, banking and accounting skills in the MFPs.

### *iii) Market Fragmentation and Economies of Scale*

Microfinance has largely developed outside the realm of the formal financial sector, as a specialized industry targeting a relatively narrow range of clients with separate standards and techniques, spearheaded by NGOs. But these services have not been well integrated into the overall financial system of Vietnam, in part, as the previous section shows, because of the lack of a legal and regulatory architecture and the absence of a strong and accountable industry, resulting in a highly fragmented industry.

The fragmentation of the industry into myriad small providers presents a series of challenges. The relatively small scale of operations of some formal and most semi-formal MFPs increases their cost structure per client served and limits the development of economies of scale. Moreover, the small size of the accounts both loans and savings, increases transactions costs and combined with lack of economies of scale makes them less cost-competitive than could be the case. This is particularly the case for many PCFs which are generally of recent creation and fall under prudential regulations of SBV that limit their operation to a single commune until they can establish their operational performance and sustainability. Because of this, they tend to exhibit relatively high staffing costs per credit granted and per number of clients served. There are also relatively large differences intra-PCF industry with wide disparity of performance/efficiency indicators, often reflecting that some of them were developed from an original INGO operation for which reaching objectives, but not costs, was the major concern. Anecdotally, in visits to selected PCFs this wide disparity was evident with one PCFs with 825 members and an outstanding portfolio of 3.5 billion VND had 16 staff members while another PCF with 1,370 members and an outstanding portfolio of 10 billion VND had a staff of 12.

This effect is even more pronounced in the case of the smaller semi-formal MFPs, those that are not expected to be able to transform in the short- to medium term, or perhaps never. There are approximately 45 semi-formal MFPs listed in the MFWG with a total clientele of about 350,000 households served. The three largest MFPs account for about one third of the households. Thus, slightly over 40 MFPs serve on average about 5,000 households each, although the variation among them is huge, with some covering hardly a few hundred households. This

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