Vietnam's New Law on Microfinance: On the Way to an Enabling Environment

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ABOUT THE SERIES

The *Essays on Regulation and Supervision* series has been commissioned for the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

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Background

Despite Vietnam's accelerated economic growth in the last decade, the country remains poor with 28.9% of its population living under the poverty line. Most reside in rural Vietnam, where the poverty rate is at 45%. Many of the poor (and near-poor) are still vulnerable to slipping back into a cycle of poverty if confronted with adverse shocks such as illness, crop failure, and natural disaster. The most recent *Vietnam Household Living Standard Survey* found that only 32.46% of poor households have access to formal and informal credit (GSO, 2004), despite the successes of the microfinance sector. These facts highlight the need for sustainable and pro-poor microfinance in Vietnam, as creating effective service delivery channels remains a puzzle.

Box 1

Vietnam: Quick Facts	
Total Population	80,300,000
Annual GDP Per Capita	US $436
Poverty Rate	28.9%
Adult Literacy Rate	90.3 %

Sources: GSO 2004 and UNDP

The Government of Vietnam's (GOV) firm commitment to poverty reduction and support of microfinance has resulted in the issuance of the new decree on microfinance in March 2005 that would allow independent MFIs to be established. This paper discusses a brief history of microfinance, the development of the legal framework, an overview of the sector, and an assessment of the new law to arrive at an outlook of the sector and recommendations toward an enabling environment for microfinance in Vietnam.

Historic Perspective

THE GOVERNMENT OF VIETNAM'S commitment and efforts to expand financial services in Vietnam began right after the economic reforms of the 1980s. These efforts brought about the establishment of commune-level[1] credit cooperatives supervised by a local authority, with some 7,100 established by 1985. However, these credit cooperatives collapsed in the late 1980s due to a lack of capacity and proper supervision. A subsequent agricultural reform in the early 1990s created a huge demand for productive capital that remained largely unsatisfied despite the establishment of the state-owned Vietnam Bank for Agriculture and Rural Development (VBARD) in 1990. As a result, People's Credit Funds[2] (PCF) were established in 1993 as

1. Vietnam is organized administratively into 64 provinces, each of them having an average of 10 districts divided into communes. In total, Vietnam has about 11,000 communes.

2. By Prime Minister's decision No390/TTg dated March 27, 1993.

Deleted: , People's

commune-level small-scale credit cooperatives, modeled after the *Caisse Populaire* in Quebec, Canada. Two years later, in 1995, the state-owned Vietnam Bank for the Poor (VBP) was established[3] to provide subsidized credit to poor households. Today, VBARD and the successor to the VBP (see below) dominate the sector, servicing almost 80% of the microfinance market with subsidized credit.

The 1990s also saw the emergence of NGO microfinance schemes; the first microfinance scheme was developed by the Vietnam Women's Union (VWU) in the provinces of Ha Tay (north of Hanoi) and Can Tho (south of Ho Chi Minh City). Inspired by their initial success, the VWU and other mass organizations[4] have expanded microfinance schemes into thousands of communes in Vietnam with the support of international NGOs and development agencies. In spite of their small scale, these microfinance schemes remain the best examples of reaching the poor in Vietnam. Two of the most notable microfinance models include: the Compassionate Fund (TYM), managed by Central VWU; and the Capital Aid Fund for Employment of the Poor (CEP) of the Ho Chi Minh City Labor Federation, both of which are set up and effectively managed as independent MFIs.

With recognition of the need for large scale, independent, and sustainable MFIs, donors and practitioners started advocating for an enabling microfinance law. In September 2002, the first quarterly issue of the Vietnam Microfinance Bulletin was launched with the support of Save the Children USA, with the author of this paper as the founder. In March 2004, there was an official re-launch of the Microfinance Working Group with support of Save the Children USA and Plan International. The bulletin and the working group have been instrumental forums for policy makers, donors, and practitioners in Vietnam to advocate for an enabling legal framework for microfinance.

The GOV has been supportive of the banking sector in general, and particularly of microfinance practices. Since 1996, the GOV has been gradually liberalizing interest rates; in May 2002, interest rates in Vietnam were fully liberalized[5]. In 2000, the VWU was officially granted permission to provide microfinance services, although permission was granted only in the form of Prime Minister's official letters[6]. Realizing the gap in micro-financial services, the GOV commenced the development of a new legal framework with ADB's technical assistance. The decree was finally approved on March 9, 2005, allowing for independent MFIs to be established.

3. By Prime Minister's decree N°525/1995/TTg in August 1995 as a not-for-profit bank.

4. Also known as socio-political organizations, whose budgets derive mainly from the central government. They include the Vietnam Women's Union, the Vietnam Youth Union, the Vietnam Labor Confederation, etc.

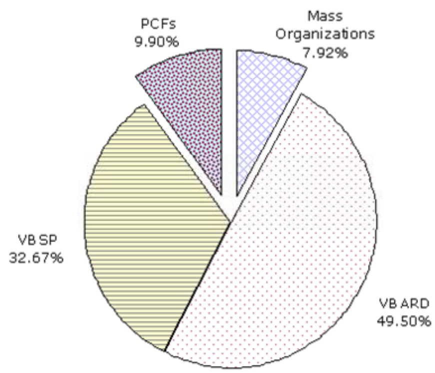
5. State Bank of Vietnam's decision N°546/2002/QD-NHNN dated May 30, 2002.

6. Prime Minister's official letters No. 209 dated January 17, 2000 and No. 699 dated July 17, 2000.

Microfinance Sector Review

DESPITE the lack of a legal framework, the microfinance sector in Vietnam has made remarkable achievements in high penetration (an estimated 10 million households or 70% of rural households), thanks to the support of the GOV. In addition, the government has allowed small schemes to operate, facilitating key innovation and allowing best practices to be adopted. However, most of the programs still provide a limited range of products (mainly credit and mandatory savings) while micro-insurance and micro-leasing are generally neglected. Interest rates of most of the small microfinance schemes are too low to break even, and there is a lack of commercialized distribution channels that can reach the poor effectively. The sector is still in its infancy, suggesting a great opportunity for future development, especially with the legal framework in place.

Figure 1. Market Share in 2003



Who Are the Service Providers?

The sector remains dominated by two state-owned banks as shown in the market share figure:[7] the VBARD and the Vietnam Bank for Social Policy, recently established as a social policy bank.

The VBARD has the most extensive network, reaching some 5 million clients with an average loan size of US$405. It lends up to US$625, primarily to farmers without formal collateral if the loan application is backed by mass organizations that co-service loans, such as the VWU. The VBARD also serves as a distributor for the VBSP, which was established in October 2002[8] as a state-owned policy bank.

The VBSP took over the portfolio and functions of the VBP and a number of national programs previously managed by the Ministry of Agriculture and Rural Development and Ministry of Labor, Invalids, and Social Affairs, among others. It is supervised by the SBV and exempted from tax and deposit insurance. The VBSP only lends to individuals (rather than enterprises) on a collateral-free basis for productive purposes, with an average loan size of US$125. However, loan applications are usually backed by either the local authority or mass organizations that co-service the loans. Including the loan portfolio from the VBP, the VBSP claims to have lent to 3.3 million borrowers (WB, 2004).

Box 2: Market Segmentation by Loan Size

Average Outstanding Loan / Annual GDP per capita

7. Data is compiled from various sources. It would be inaccurate to interpret current market share data in terms of client base, as it is common that a rural household has outstanding loans from more than one source. Data from mass organizations are estimated excluding loans financed by the VBARD and the VBSP but channeled through mass organizations.

8. Prime Minister's decision N°131/2002/QD-TTg dated October 4, 2002, with the bank charter approved later by decision N°16/2003/QD-TTg dated January 22, 2003.

Low-end market	Less than US $150
Broad Market	US $159-654
High-end Market	US $654-1,090
Small Business Market	Over US $1,090

Source: Adopted from MIX, 2003

The fast-growing People's Credit Fund (PCF) system included, as of 2003, a Central People's Credit Fund, 21 branches, and 889 small scale commune-level PCFs, reaching about 1 million clients with collateral loans provided at US$301 on average.

Several non-state commercial banks have entered the microfinance market. However, most of them stay in the small and medium enterprise market segment. One exception is the Saigon Commercial Bank, which entered the microfinance market in 1992 and operates in several big cities in Vietnam, offering collateral loans from US$314–1,255 to small market vendors, typically with a daily repayment schedule.

There are also some 76 microfinance programs implemented by mass organizations with the support of international NGOs, international development agencies, and thousands of small-scale commune-level schemes. In these schemes, mass organizations co-service loans using their grassroots network and as a result, most of their clients are their own members. According to the most recent statistics available from some 40 schemes, the average loan size across the board is US$89 (MFWG, 2005). Many of these schemes are known to follow international best practices, to have high repayment rates, and to reach the poor effectively, especially women.

Box 3

The Five Largest NGO Microfinance Schemes
(By number of active members)

CEP/Ho Chi Minh City Labor Federation	65,685
Vietnam-Belgium Credit Project/VWU	52,505
TYM/VWU	20,848
Credit and Savings Funds/Ha Tinh WU	16,765
Microfinance Program/Thanh Hoa WU	9,984

Source: MFWG, 2005

While loans are widely available, other microfinance services are relatively neglected, especially risk-management products[9] such as emergency loans, savings, micro-insurance, and remittances.

Aside from the 1000+ registered pawnshops operating on a small scale, none of the service providers currently offers emergency loans.

Experts estimate that more than 50% of public savings are kept as cash outside of the banking sector. Both market leaders (the

9. For the purpose of this discussion, risks are defined as a chance that an event will cause damage or loss. These include illness, accident, death, theft, and a rise in short-term expenses such as funerals, weddings, etc.

VBARD and the VBSP) have failed to provide savings services to the poor. The VBARD has been quite successful in mobilizing public savings, but mainly from big cities and provincial towns. Deposits of less than US$31.39 account for only 2% of its deposits (Coleman B., 2003).

The Vietnam Postal Savings Service Company (VPSC) is a recently established subsidiary of Vietnam Post and Telecom Company (VPT) whose main function is the provision of savings services to the underserved through its nationwide post office network. It has nearly 500,000 accounts but does not seem to reach the poor effectively, as too few among the poor know about the service and the average savings account balance is US$477.

Mass organizations have demonstrated the best example in providing saving services to the poor, as evidenced by the fact that savings mobilized by the largest 40 microfinance schemes accounts for 29.79% of their aggregate outstanding loan portfolio, with an average savings account balance of US$23.

The insurance sector is focused on salaried workers and on those who are better-off, neglecting rural Vietnamese. The only exception is the TYM Fund, which offers a type of limited micro-insurance in the form of a mutual fund.

How Does the Sector Operate?

Despite significant success in reaching rural households, the lack of a commercialized distribution channel suggests a need for substantial improvements in the sector. The market leaders in the low-end segment - the VBSP, VBARD, and all national programs - do not have their own distribution channels. Therefore, all of the loans from the VBSP and a significant portion of the loans from the VBARD that reach the low-end segment are channeled through mass organizations[10]. Their services include provision of a loan guarantee, group formation and monitoring, checking clients' credit history, delinquency management, etc. By providing a loan guarantee, mass organizations have the most influential role in loan approval, and hence have a more significant 'effective market share' as shown below. Their role goes beyond market distribution to cover coordination. Together with local authorities, mass organizations allocate credit sources to ensure a more 'even' distribution among communities and among individuals within the same community.

Despite their inevitably important role in extending credit to the rural population, the involvement of mass organizations in coordinating credit distribution also means that the credit distribution system limits options for the end users. It also does not address common systematic biases in the allocation of credit both at community and individual levels. This allocation is not always based on market need and therefore is suboptimal.

Although the industry map suggests that the mass organizations play a greater role, the market is still largely influenced by the VBSP, which defines lending policies. The VBSP offers below-

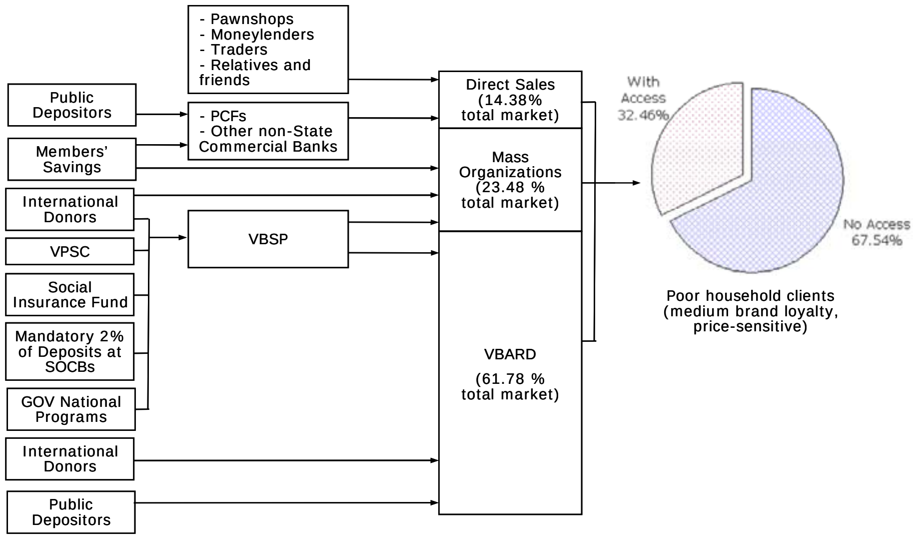
10. Even in the cases where loan applications require the endorsement of a local authority, mass organizations remain a key reference for local authorities to make a final decision on the applications.

market interest rates (typically at 6% per annum) and easy credit restructuring.[11] On the supply side, it creates disincentives for commercial banks and MFIs to enter the microfinance market: since existing service providers are pushed to lower their interest rates, their ability to reach financial sustainability is undermined. Most of the mass organization programs are pushed to offer interest rates only between 12-18% per annum, at which level they rarely break even[12].

11. The VBSP is subsidized at 4.8% per annum (WB, 2004).

12. In general, Asian MFIs (including those in Vietnam) need to charge 30-35% per annum to break even. This is becoming a much bigger issue with the annual inflation rate in Vietnam being revised up to 9% in 2005 from just a few percentage points in previous years.

Figure 2. Industry Map



Source: Doan, 2005

On the demand side, the VBSP creates higher-than-effective demand due to cheap credit. In addition, it makes clients even more price-sensitive and less brand-loyal even in underserved market segments. With lowered brand loyalty, it becomes more expensive for the suppliers to provide reliable services, as credit history is less available and less useable. At the same time, the VBARD and VBSP's loan portfolio qualities are questionable, as they are said to have default rates of up to 30% and 70%, respectively, in some areas (WB, 2003). The effectiveness of the directed lending remains questionable, as evidenced by the fact that only 18.75% of households perceived by community leaders as poor have had access to loans from the VBSP (GSO, 2004).

Although there is some debate as to the extent of market fragmentation in Vietnam,[13] it is clear that there are a huge number of small scale microfinance schemes, each operating in a small geographical area of one or a few communes and with a limited range of products. Because of this fragmentation, the microfinance sector will struggle to develop into a professional and efficient sector, and it is likely to create a heavier supervisory burden in the future. Key historical reasons for the market fragmentation include:

- Low Barriers to Entry: Most of these schemes were established by small grants in a commune, sometimes with only US$10,000. Mass organizations, which are the legal owners of these schemes, do not have to contribute financially to the programs and often use their existing network as a distribution channel without additional major investment. In addition, because they are unregulated, these

13. A market is considered fragmented when there is a large number of small and medium-sized service providers, none of which have a significant market share or can strongly influence the industry outcome. In the microfinance sector in Vietnam, the VBARD and the VBSP dominate and influence the market, even in the low-end segment.

programs are not subject to any capital requirements or licensing applications.

- Low Overhead of Affiliated Programs: Keeping these programs small allows them to be affiliated with mass organizations, to benefit from mass organizations' legal cover and governance structure, and to save overhead costs such as personnel, office rent, and utilities. Despite the weaknesses of this approach, it is relatively favored by mass organizations' management because it helps them to strengthen their role and avoid market competition by predominantly serving their captive market (their own members).

- Impediments to Scaling Up: The lack of a legal framework for microfinance has made it impossible to establish MFIs that can reach a large scale. In addition, legal constraints have prohibited commercial players who can reach scale from entering the sector.

Constraints to Development

Analysis of the operating environment suggests some key constraints for the development of microfinance in Vietnam, which are discussed below.

- Prevalence of Subsidized Lending and Limited Participation: As discussed above, the provision of below-market rate loans by the government distorts the market and minimizes the number of options available for the poor, both in terms of services and service providers. Diverse participation and services are crucial for meeting the different needs of the poor, as well as for encouraging innovation in an emerging microfinance market such as Vietnam.

- The Historical Lack of a Conducive Legal Framework: Since the microfinance schemes historically could not be established as independent MFIs, they have been operating as 'projects' affiliated with mass organizations, and hence do not have a clear vision. As a result, these schemes have neither developed their own systems and distribution channels, nor provided sustainable and customer-oriented microfinance services.

- Absence of Infrastructure: Major infrastructure that is needed for the sector's development does not exist. This includes distribution channels, training facilities (plus qualified trainers and staff for MFIs), external auditors, rating agencies, etc. Microfinance programs and practitioners do not operate under agreed-upon performance standards, and as a result are limited in sharing common performance indicators.

The New Law in Microfinance

The Development of the Law[14]

Inspired by the success of microfinance in contributing to poverty reduction, the GOV signed an agreement with the Asian Development Bank (ADB) on January 2, 2002 on the technical assistance project TA VIE-3741, to embark on the development of new legislation to support microfinance development. The development of the decree has been participatory and consultative. The management and staff of the SBV have taken a number of field trips to microfinance schemes in Vietnam, as well as to some other countries in the region, including Bangladesh and Indonesia. The SBV has shown firm commitment and has been an excellent example of how consultative the process could be despite constraints such as the SBV's limited resources and a major staff transition at the Department of Banks and Non-Bank Credit Institutions (which was previously leading the development of the new decree). During this process, microfinance practitioners have played a critical role in facilitating dialogue with policy-makers and contributing to their learning through various meetings, workshops, and field trips.

SBV's first draft of the decree, developed in May 2003, was mainly based on a draft proposed by ADB's technical team. Both drafts allowed for foreign ownership and specified that MFIs could operate under the following legal forms: fund or limited liability company. Major differences included:

- SBV's draft specified minimum capital requirements for non-deposit-taking and deposit-taking MFIs of US$ 62,800 and US$ 125,600 respectively; while under the ADB's draft, no minimum capital was required for the former, and the latter was required to be US$ 62,800;

- Permissible activities for MFIs were more limited under the SBV draft (only credit and savings), instead of credit, savings, payments, and remittances under the ADB draft; and

- Power and authority of the SBV were not specified in SBV's draft but were suggested in the ADB draft.

A major concern raised by practitioners was the future of small-scale microfinance schemes; the minimum capital requirement was too high for small-scale commune-level microfinance schemes, and it was unclear if such levels of capital were at all needed. Policy-makers were concerned about the limited supervisory capacity of the SBV, the need to have a separate law for MFIs when their operations were similar to the PCFs,[15] the broad scope of business for the MFIs, and other issues.

Eventually, all parties involved, particularly the Ministry of Finance, were convinced that there should be a separate law for

14. Since the statutory regulations are under development, the assessment in this paper is based mainly on the decree, with limited reference to the draft of the first implementation circular.

15. Official letters of the Vice Finance Minister N°583/TC-TCNH dated January 15, 2004.

MFIs[16]. However, there were still concerns about the limited capacity of MFIs and the supervisory capacity of the SBV. Other stakeholders insisted that the decree should give MFIs comparable treatment to other non-bank credit institutions such as the PCFs in terms of minimum capital requirement, allowable owners, permissible activities, etc. As a result, the draft decree was revised in July 2004, eliminating foreign ownership and lowering – but not eliminating – minimum capital requirements for non-deposit-taking MFIs. The decree in its final form was almost identical to the current version.

The final decree was submitted to the GOV for approval in November 2004. It passed on March 9, 2005 under the title of *Government Decree on Organization and Operations of Small-Scaled Financial Institutions in Vietnam Nº28/2005/ND-CP*. The decree was developed with the objective of transforming all microfinance schemes then implemented by mass organizations and local NGOs to regulated MFIs by March 2007, including TYM and CEP. However, the decree does not regulate other existing microfinance service providers such as credit cooperatives (PCF) and the VBSP.[17] MFIs can be established as non-deposit-taking or deposit-taking MFIs with a minimum capital requirement of US$31,400 or US$314,000, respectively. The establishment of a deposit-taking MFI requires stricter conditions, including higher minimum capital, at least three years of experience in mandatory (forced) savings collection, and three years of sound performance, fulfillment of prudential rules, etc. Hence, deposit-taking MFIs will have to be established as non-deposit-taking MFIs first in order to demonstrate three years of sound operations before a deposit-taking license can be granted. Non-deposit-taking MFIs can be established without having to operate as an NGO initially. However, the establishment of both types of MFIs requires the participation of either mass organizations or local NGOs as the “license-applying organization”.

The decree appears not to allow for foreign and domestic private-sector ownership of MFIs. Only mass organizations and local NGOs are allowed to establish MFIs. Although entities other than mass organizations and NGOs are allowed to “contribute capital,” it is not clear if they could have an ownership stake or any decision-making power. Under this new law, non-deposit-taking MFIs are still allowed to collect mandatory savings from borrowers, while deposit-taking MFIs are allowed to take public deposits. Both types of MFIs are also allowed to use donor funds for specific on-lending purposes (these are called *entrusted funds* in Vietnam) and to borrow from domestic and foreign entities, although prior approval from the SBV is required for foreign loans. MFIs are allowed to provide loans, savings, and limited remittance services, and they may serve as agents for insurers. The loans can be for productive or consumption purposes, as long as they are given to improve the living standards of the poor.

The decree articulates also that the SBV will be the regulator, issuing licenses for and supervising the MFIs. It will hold key

16. Official letters of the Vice Finance Minister Nº7877/TC-TCNH dated July 16, 2004.

17. There is no law prohibiting government subsidies, including to the VBSP. This creates a major implication that is discussed later.

rule-making power, specifically on prudential regulations, the delineation of regulatory tiers, risk concentration limits, product limitations, etc. However, the decree does not articulate specific actions that the SBV can take in case an MFI violates the law.

Assessment of the Law

The decree is expected to have a significant positive impact on the development of the microfinance sector in Vietnam. For the first time, independent and dedicated MFIs are allowed to be established. In that sense, the decree has addressed the most critical need for the development of the sector. Operating as independent entities, MFIs will have the opportunity to develop professional business practices and to have access to larger donor funds and commercial borrowings to expand outreach.

The decree, however, appears to be restrictive in some key areas such as ownership structure, scope of operations, etc. The current decree appears not to allow private-sector ownership of MFIs; instead, only mass organizations and local NGOs are allowed to establish MFIs. Although recognizing the important role of social organizations in maintaining the MFIs' social objective, the decree does not take into account the fact that private participation would facilitate commercial borrowing and the development of an efficient sector. Furthermore, NGO MFIs cannot respond effectively to a capital call issued by the superintendent. Although not guaranteed, this is more likely to be addressed by private participation.

The minimum capital requirement for deposit-taking MFIs is much smaller than that for commercial banks, and is affordable for a couple of market leaders such as TYM and CEP. Compared to other countries in the region, the capital requirement is reasonable, only 724 times annual per capita GDP in Vietnam. In Pakistan, where the scope of business is relatively wide (similar to a commercial bank operating nationwide), the minimum capital required for an MFI to operate at a national level is 21,078 times the country's annual GDP per capita. In contrast, the capital requirements for the Development Bank in Nepal (with limited banking license) and MFIs in Cambodia (which are prohibited from providing certain services such as payments) are 609 and 195 times their annual per capita GDPs, respectively.

While the minimum capital requirement is low for commercial banks and may facilitate downscaling initiatives, it is too high for non-deposit-taking MFIs. In fact, it is probably not necessary for the commune-level small schemes, as these schemes only put their own capital at risk.[19] The capital requirement for non-deposit-taking MFIs puts commune-level microfinance schemes at risk of closing down after March 2007. It should be noted that these small-scale schemes are the most effective at reaching the poor, maintaining high repayment rates, and introducing innovation into the sector. The lack of support for these very low-end segment service providers would risk diminishing the effectiveness of the whole sector and would leave the superintendent with an overwhelming workload if these small

19. It is important to recognize that non-deposit-taking MFIs should include those that take mandatory savings that are actually part of the loan contract, but that do not provide an independent saving service. Most borrowers are net borrowers and hence, their deposit is not at risk.

schemes all registered, as in the case of small-scale PCFs in Vietnam.

In general, the required licensing dossier is straightforward. Although the ultimate approval lies with the SBV, the requirement to seek approval from the respective local government in license applications and new branch applications means that the local government still plays an influential role in the sector's development. This is likely to bias the SBV's actual supervisory practices[20] (WB, 2003).

20. In fact, the Vice Chairman of the local authority (People's Committee) is the Chairman of the VBSP board at the same administrative level (e.g., province or district level). As the VBSP shares a similar market with the MFIs, this presents a conflict of interest and leaves room for discretionary action.

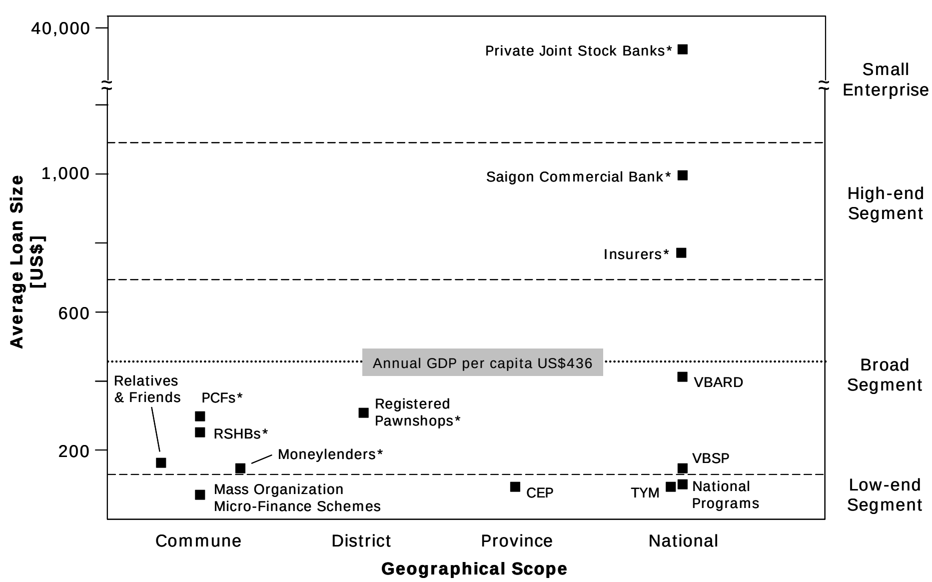
Outlook for the Sector

Given the abstract primary legislation, it is hard to provide a clear picture of the outlook for the sector at this point, while the secondary legislation is still under development. However, one can see that the decree has already provided a key foundation for the sector to grow. There will be opportunities for MFIs to be more professional and market-oriented, and the disadvantaged population in Vietnam will benefit eventually from this. The decree has made a significant contribution to shape the sector positively.

The NGO transformation will be a temporary phenomenon, as donors are no longer likely to start with an NGO as a legal status. Instead, new projects will be started as commercial entities or those likely to be commercialized soon. There will probably be nearly half a dozen microfinance schemes that qualify for deposit-taking licenses, while the rest will qualify for a non-deposit-taking status. Being independent, they have to cover operating expenses and survive market competition. Thus, registered MFIs will have to improve their overall performance.

Figure 3. Market Segment by Average Loan Size

(Those with asterisk provide collateral loans.)



Source: Doan, 2005

The level and nature of competition will depend upon the level of participation of the private sector, which is still distanced from the microfinance sector, as suggested in the figure above. In the immediate term, there will be limited private-sector participation, and mass organizations' MFIs are likely to focus on their captive market to strengthen their position. Mergers of small-scale microfinance schemes are not likely due to the high ownership level within the local community. The state-owned VBARD will remain in a strong position given its nationwide network and strategic positioning in the market. It will take some time for VBSP to develop its own distribution network. In the meantime, it will rely on mass organizations. Mass organizations will have to make decisions on their longer-term role, e.g., whether they still want to co-service the VBSP's loans or focus on their own MFIs.[21]

In the long run, regulated MFIs will develop into more market-oriented entities due to increased competition, especially in urban settings where more commercial players will enter the market. Competition will also come from other players such as the VPSC, which has been quite aggressive in expanding its market and was given a green light by the GOV recently to expand its scope of business.[22] With the increased participation of commercial players, there will be a commercial distribution channel that can be fully developed; diverse services also will be offered to support the GOV better in its poverty reduction efforts.

In the short term, competition will be seen mainly in: the resource market, i.e. the labor market of qualified personnel; and the competition for donor funds. The current human resources available will neither be sufficient to meet the new MFIs' demand as required by the SBV for licensing, nor will they be sufficient to perform to the standard expected by the donor community. The competition will increase with participation from commercial players who are likely to attract skilled personnel, as evidenced by the experience in Latin America. Microfinance schemes will initially compete for donor funds required for transition costs and post-transition capacity building of newly-registered MFIs. In the long run, MFIs will compete for clients and expand their market shares. All in all, the market competition will push MFIs to perform more efficiently and effectively in order to survive.

21. The decree is silent on this partnership between mass organizations and the VBSP and VBARD. In fact, some officials from the Women's Union insist that they are still allowed to co-service loans from the VBSP and VBARD and collect small savings, by power of the Prime Minister's official letters mentioned earlier.

22. The VPSC will be allowed to provide full payment and deposit services, such as issuing checks and ATM cards and opening individual savings accounts. It signed an agreement with the VBARD in October 2005 that would allow VPSC's clients to access their postal savings accounts at VBARD branches across Vietnam.

Challenges

Effective Supervision

The SBV has made numerous efforts to improve its supervision of financial institutions, and it has shown major progress. However, the supervision process is very much rule-based and does not involve sufficient assessment of the financial institutions' policies and procedures, such as loan approval. Other factors such as the effectiveness of the off-site surveillance system in assessing risk-based profiles of the banks, ambiguous regulations, weak reporting requirements,[23] etc. make supervision even more challenging. These current practices and shortcomings of the mainstream banking sector do not provide a platform for the SBV to practice effective supervision of the MFIs.

23. The first report on non-performing loans in the mainstream banking sector that is considered close to international practice is expected by the end of 2005.

The SBV established a dedicated Microfinance Unit in October 2005, which has assumed the responsibility of developing the secondary legislation and supervision of MFIs in the future. The task is obviously too large given SBV capacity at present, as currently there are only three members at the Microfinance Unit and a potentially thin budget. The Unit's work is even more challenging given that the country is large, making on-site supervision expensive. Moreover, requiring non-deposit-taking MFIs to conform to prudential standards would make it impossible for the SBV to practice effective supervision.

The decree does not articulate clearly what power the SBV has to enforce the law, making it a difficult task for the SBV to practice effective supervision. Specifically, the involvement of other government bodies in supervision would bias actual supervision practice.

Microfinance Scheme Transformation

Due to the historical lack of a legal framework, these microfinance schemes remain 'programs' hosted within mass organization. Transformation into regulated MFIs poses some major challenges, listed below.

- Lack of Vision: Framed as projects, many of these microfinance schemes have not had their own long-term vision and institutional plan for a clear future. Transformation, creating a new entity with a new mission and a different organizational culture, will not be possible without a clear and strong vision.

- Ownership and Governance: The new legal framework requires that MFIs operate at a distance from their parent organization. In other words, the parent organization is not supposed to be involved in the MFI's daily management. This will not give the parent mass organization leaders the level of comfort to which they are accustomed. The mass organizations will have to re-define their role in the new relationship.[24]

- Human resources: The MFIs will have a difficult time finding qualified staff, especially for key positions such as managing director, finance manager, and human resource manager. The task may be even more difficult given that they are likely to compete in the labor market with commercial players who are entering the sector. It will also be challenging for them to find qualified board members who can practice effective governance, given that it is not a common practice in the sector or at the parent mass organizations.

24. It could get very complicated if the parent mass organization would continue to support other microfinance schemes and the two became direct competitors. A classic example is the parent NGO PRODEM and Bancosol in Bolivia. PRODEM is an NGO, which founded the MFI Bancosol, which in turn took over all microfinance portfolios from PRODEM. The NGO could not decide on its new role in the presence of its subsidiary MFI and ended up resuming its own microfinance operations, so the institutions became direct competitors.

- Prudential regulations: There were no prudential regulations for MFIs in Vietnam, and most of the microfinance schemes do not have their own internal regulations. They will need training to upgrade their staff capacity to abide by the new regulations and improve their management systems to capture the information required by the new regulations.

- Institutional Capacity: Most of the newly-registered MFIs will need assistance in developing their management systems with respect to the following: standardizing operational policies and procedures; MIS; accounting systems; and developing new skills such as liquidity management, asset/liability management, etc. Even well-established MFIs such as CEP and TYM will have to revise their operational policies and procedures, manuals, MIS, etc. to ensure full compliance with the new regulations. Such upgrades will require not only financial resources but also technical assistance that is not readily available. The task is even more challenging given that all of this must be done with minimum interruption in operations. The table below shows that not more than six of the existing microfinance schemes are ready for transformation into deposit-taking MFIs, and many of them are obviously not qualified. Given the minimum capital requirement, many of them would not even qualify for a non-deposit-taking license.

Table 2. How ready are Microfinance Schemes in Vietnam for the Transformation?

Requirements	Province Based Micro-Finance Program	District Based Micro-Finance Program	Commune Based Micro-Finance Program	Revolving Fund Typed Schemes
How many are there?	~ Few	~ Dozens	~ Thousands	Many
Legal Capital Requirement	●	◒	◒	◒
Qualified Boards	●	◒	○	○
Business Plan Developed	●	○	○	○
MIS	●	◒	◒	◒
Reporting System	◒	◒	◒	◒
Asset/Liability Management	●	○	○	○
Liquidity Management	◒	○	○	○
Internal Control	●	◒	◒	◒
Compulsory Saving Capacity	●	●	●	●
Voluntary Saving Capacity	◒	◒	◒	◒
External Audit Conducted	●	○	○	○

Note: ● Ready; ◒ in place but significant improvement needed; ○ Not yet.

Source: Doan, 2005

Finally, transformation means that the MFIs will be integrated into the financial system and will operate on a commercial basis, e.g., with no subsidization and in competition with other commercial players for clients as well as resources. Thus, these newly-registered MFIs will be faced with market competition that dictates the *real* transformation – from a socially-oriented institution to a market-oriented institution – if they are to survive.

Recommendations

Recommendations for the Government of Vietnam and the Superintendent

In order to develop a conducive environment for microfinance growth, the following recommendations are suggested for the consideration of regulators and superintendents:

- The government should take the role of facilitator, rather than direct participant (the case of VBSP's subsidized lending can serve as an example). The elimination of subsidization is the single most vital requirement for the microfinance sector to grow, for the MFIs to reach sustainability, and for the poor population to benefit in the long term. At least, the VBSP should be focused in geographical areas where microfinance is not likely to be the best vehicle for poverty reduction, such as remote and very low population density areas.

- The regulations to be developed should encourage the active engagement of the private sector and allow for diverse forms of MFIs in order to support the development of an efficient sector that can meet the diverse demands of the poor.

- The regulations should be developed with a goal of not subjecting non-deposit-taking MFIs to capital requirements and prudential regulations. They should only be required to report on the most essential performance indicators. For the secondary legislation to be feasible, microfinance practitioners and schemes such as TYM, CEP, Binhminh Co. Ltd., etc. should be involved and used as a test case. The focus should be on the deposit-taking MFIs to ensure the SBV's effective supervision.

- The role and power of the SBV in MFI supervision should be articulated clearly in the regulations. The participation of other agencies such as the People's Committee should be reassessed towards their elimination from any participation in the supervision of MFIs.

- Regulations should be designed to ensure the soundness of microfinance operations, yet not to discourage them from innovation. In order to do so, the regulatory framework should focus on the performance of MFIs – such as loan concentration and portfolio quality – not on approaches such as lending methodology and operations management. It should be noted that many practices common in the mainstream banking sector are simply not advisable for MFIs because of the potential increase in operating costs that MFIs cannot afford.

Recommendations for Donors

The transformation will be a costly process, yet vital for the long-term development of the sector. During this period, donor agencies will remain critical players in providing financial resources and technical assistance to the MFIs and the superintendent. Key recommendations are as follows:

- Concerted efforts should be made (along with practitioners and the superintendent) to develop the capacity required for effective supervision, through active participation of the SBV staff and practitioners. Above all, hands-on experience for SBV staff at local MFIs and the development of a timely and accurate reporting system are crucial.

- Wholesale microfinance facilities or guarantee funds should be developed that would facilitate access to commercial-based borrowings. These could potentially support the superintendent in supervising retail MFIs. Although the wholesale facility or guarantee funds are not regulatory agencies, they can require MFIs that borrow from them to perform to certain standards. If they were major lenders in microfinance sector, they would have significant influence.

- Efforts should be made towards facilitating the development of a training facility on a cost-recovery basis, although the initial donor subsidization can be justified with a clear exit strategy. This should be organized as a forum with a coordinating unit of microfinance practitioners who effectively hold the expertise.

- Donors should also explore the possibility of establishing a private MFI rating agency, which would be instrumental to MFIs' access to commercial borrowings. A good approach is to start as a unit within a wholesale finance facility or a guarantee fund, although in the long term, it should be separate to avoid any conflict of interest. Experience can be brought in through a partnership with an existing rating agency in the region.

Recommendations for MFIs and Practitioners

While policy-makers and donors play a critical role in this transition period, the real work will be done mainly by practitioners and MFIs. Since they hold essential assets of knowledge in the field, recommendations to them include:

- Working closely with regulators to improve their understanding of microfinance and their capacity to supervise MFIs in a conducive manner. The microfinance sector is unique in that most of the knowledge about the industry is within the entities to be supervised. Some knowledge, such as testing the portfolio, must be transferred to the regulator, and the future of MFIs will depend upon how effective this knowledge transfer is.

- Private-Sector Involvement: The lack of understanding and confidence in the microfinance sector would be a constraint for regulated MFIs looking to tap into commercial borrowings. Practitioners should seek to actively involve the private sector – particularly commercial banks – in microfinance. Prior success involving policy-makers suggests that practitioners could be successful.

- Technology Upgrade: While computerized MIS can be very helpful for those MFIs that can afford it, many NGOs transforming to regulated MFIs may lack such technology. Coming from an informal manner of operations – i.e., a lack of standardized operating procedures and a lack of formal internal control and audit function – these MFIs would probably need some time to refine their operations, especially to comply with new regulatory requirements. Until operational procedures and products have been standardized and refined, computerized MIS should not be introduced, particularly given the high cost for such very small MFIs. Similarly, new products should not be provided during the transformation, even though some might like existing clients to see immediate benefits from the transformation. Such good intentions may result in delays, as staff struggle with new products (on top of new procedures and systems of existing products).

Despite the challenges, transformation and commercialization are expected to result in a positive impact for MFIs and eventually for clients. A study conducted with 39 MFIs in 15 countries (Fernando N. A., 2004) found that there has been a positive impact on governance, increased access to commercial borrowings, increased outreach, a broader range of services, and almost no mission drift in most cases of transition. However, it should also be noted that, according to the study, in most cases the founder NGO holds only 12-60% of the share and only 3 MFIs in the sample own more than 60% share. None of the MFIs is owned by a single entity.

The GOV deserves some credit for its support to the development of the microfinance sector, as evidenced in the sector outreach and the issuance of the decree. For the decree to facilitate a truly enabling environment and for the microfinance sector to maximize its potential, careful consideration and full participation of donors and practitioners will be needed.

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