DEVELOPING MICRO-FINANCE INSTITUTIONS IN VIETNAM

Implications for establishing an enabling regulatory environment

by

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Abstract

Based on results from a three-month field trip in the poorest regions of Vietnam, and on an extensive review of the literature, this thesis analyzes the current state of the micro-finance sector in Vietnam in terms of practices used by micro-finance institutions (MFIs) and in terms of the characteristics and needs of the regulatory environment they evolve in.

The thesis identifies the conditions that constitute an "enabling environment" for sound MFIs on the basis of a review of international case studies and analysis. The literature review also leads to the development of a definition of poverty as "an exclusion from society and its productive systems, rooted in a lack of choices and opportunities", and *human development* as "the goal and process of enlarging people's choices". It explains how developing access to adequate micro-financial services can allow the poor to create micro-enterprises, accumulate saving, and increase their standards of living. A set of criteria for determining the soundness of micro-financial programs is developed, and the characteristics of a regulatory enabling environment that can facilitate the efficient operations of a wide network of local MFIs are pointed.

It then presents a picture of current poverty eradication strategies and MFI practices in Vietnam, and of the regulatory environment MFIs evolve in. It then analyzes those findings in the light of the sound practices generated from the review of international experience.

A set of implications is derived that reviews to which degree (i) Vietnam's national micro-finance strategy should be re-oriented to promote the creation or formalization of MFIs and allow them to operate on a market-pricing base; (ii) the Government should adapt the practices of its Bank for the Poor to fit international sound practices, and should use its wide outreach potential to disseminate such practices among local MFIs; (iii) a consultative process between all relevant actors should be undertaken to devise an appropriate set of regulations to govern formal MFIs and create a supervisory framework adapted to the characteristics of MFIs; and (iv) better use should be made of the existing micro-finance capacity by developing linkages between all players.

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List of Acronyms

CPVN:	Communist Party of Vietnam
CSEAR:	Centre For South East Asia Research
GDI:	Gender Development Index
GEM:	Gender Empowerment Measure
HDI:	Human Development Index
HEPR:	Hunger Eradication and Poverty Reduction Program
HPI:	Human Poverty Index
MFI :	Micro-finance Institution
NGO:	Non-Governmental Organization
PCF:	People's Credit Funds
PRA:	Participatory Rural Appraisal
ROSCA:	Rotating Saving and Credit Association
S&C:	Saving and Credit
SOE:	State-Owned Enterprise
UNDP:	United Nations Development Programme
VBA:	Vietnam Bank for Agriculture
VBP:	Vietnam Bank for the Poor
VLSS:	Viet Nam Living Standards Survey
VND:	Vietnamese Dong (used at US$1=VND11,000)
VWU:	Vietnam Women's Union

Important Working Definitions

Micro-Finance Institution (MFI): Institution providing financial services to the micro-economy. MFIs can be regular banks (private or governmental), specialized branches of commercial banks, or financial intermediaries such as governmental and non-governmental development agencies whose main area of expertise is not banking *per se*. Services offered are essentially: credit extension (for production, consumption and emergency), access to saving facilities, and the provision of basic insurance (life, health and cattle insurance).

Effectiveness of a MFI: Ability: to provide services to the largest population accessible (*outreach*); to operate in a financially viable way, covering its operating and financial costs with revenue generated from operations and becoming financially independent from external sources of funds (*sustainability*); and to empower members to improve their productive potential and overall well-being (*eradicating poverty/promoting human development*).

Enabling environment for MFIs: Characteristics of the financial/economic/regulatory operating environment that facilitate the operation of MFIs and the micro-economy. It relies on the flexibility of regulations (for MFIs to adapt to local conditions), on a trust-worthy supervisory system and confidence in the banking system (through transparency and fitness of reporting system and adapted prudential regulation), and on a stable and predictable environment for (micro-) investment (political and economic stability, low inflation and an effective rule of law).

Sustainability (for a MFI): the ability of an MFI to cover its costs from operations and mobilize its own resources to use them profitably.

Poverty: a situation of exclusion from society and from its social and productive systems.

Human Development: The goal and a process of enlarging people's choices - the three essential choices are for people to lead a long and healthy life, to acquire knowledge and to have access to resources needed for a decent standard of living. Additional choices range from political, economic and social freedom to opportunities for being creative and productive, and enjoying personal self-respect and guaranteed human rights

1. RESEARCH QUESTIONS AND THEORETICAL FOUNDATIONS

1.1 Research Purpose

This study intends (1) to assess the adequacy of the current regulatory environment of Micro-Financing Institutions (MFIs) in Vietnam, and (2) on the basis of the findings, to identify the regulatory changes and interventions needed at the macro level to create a more enabling environment for MFIs to provide micro-financing services to the poor on a sustainable basis.

1.2 Objectives of the Thesis

1. To define indicators of the effectiveness of MFIs in empowering people to durably emerge from extreme poverty and contribute to sustainable human development.
2. To determine the enabling and disabling factors that affect the potential of MFIs in Vietnam to effectively and efficiently deliver their services and promote human development.
3. To clarify the causal relationships between those enabling/disabling factors and the effectiveness of the major local micro-financing schemes.
4. To draw out the policy directions that will provide an enabling regulatory environment for MFIs to promote human development among a significant number of the extreme poor while being commercially viable institutions.

1.3 Assumptions

The main assumption of this study is that MFIs in Vietnam can be instrumental in eradicating poverty and promoting human development while being financially viable institutions if they (i) base their operations on tested sound practices, (ii) collaborate with other MFIs (governmental or not) to build the capacity of communities to manage their financing needs (not limited to credit needs), and (iii) are provided with a facilitating, or *enabling* operating environment.

The responsibility for the use of sound practices and for an effective collaboration between MFIs lies with those institutions themselves, but the creation of an enabling operating environment for MFIs, addressing structural conditions of access to financial resources, is a responsibility of the government. This operating environment is constituted by the diverse elements that facilitate or impede the economic activities of the communities in which MFIs operate. These elements can be described in terms of informal financial practices, ease of access to information, state of the infrastructure, banking and business regulations, etc. (see Box 10 p. 46 for a review of the characteristics of the operating environment).

As it is not possible to review in depth all the elements of the Vietnamese operating environment for MFIs in this study, the thesis concentrates on analyzing the enabling environment from a regulatory view point. It thus clarifies the relations between the current regulatory environment and the potential success of MFIs in alleviating poverty in Vietnam and leads to practical policy implications to improve MFIs' operating conditions.

1.4 Theoretical Foundations

This section reviews the importance of clarifying the relationships between the effectiveness of MFIs and the characteristics of their regulatory environment. As a working definition, the *effectiveness* of a MFI refers to its ability to (i) provide adapted financial services to the largest poor population possible *(outreach)*; (ii) cover its own operating and financial costs with revenue generated by interests on loans and become independent from external sources of funds *(financial sustainability)*; and (iii) empower its members to improve their well-being in the long term *(promoting human development)*. The *regulatory environment* is constituted by the banking laws and regulations, and by the supervisory mechanisms that allow MFIs to operate in a predictable business environment and that insure clients and investors that their deposits and investments are managed in a safe and professional manner.

Micro-finance aims at providing access to financial services vital to the poorest. The main component of such services is credit, a service traditionally not extended to the very poor who are deemed 'credit unworthy' because of a perceived high non-repayment risk and significant costs associated with extending tiny loans to borrowers with no collateral. MFIs give access to credit to the 'unbankable' and provide them with other adapted financial services (mainly micro-saving, micro-leasing or micro-insurance). The development objective is for the poor to invest into profit-generating activities with the ultimate goal of increasing their standards of living and overall well-being.

Through their saving component, local MFIs also help members accumulate and protect their capital, and empower the communities to create people-owned, independent saving-and-lending funds. Successful schemes hence not only provide funding to communities, but also build up their capacity to manage their own development process. At the individual level, access to micro-loans can be a powerful tool for the entrepreneurial poor to break away from the vicious circle of poverty as it gives them the means to integrate into the economic and social fabric of their communities.

The success of some MFIs in profitably providing credit to the poor for micro-investment in spite of a lack of collateral suggests that the poor can improve their socio-economic status through developing micro-enterprises if given an opportunity. This opportunity is unlike welfare hand-outs which create dependence. Rather, MFIs succeed because they empower communities to manage their own funds. It is thus important to facilitate the access to micro-finance as one part of putting together an enabling environment for poverty alleviation and human development.

Not all MFIs are successful though, and there is not a single "model of MFI" to follow that can be directly transposed from a place to another. Yet, most MFIs that succeed in empowering their clients to integrate the economic lives of their communities have adopted rather similar basic principles: (i) they recognize the importance of becoming financially independent and thus structure their operations around the use of a cost-recovery interest rate structure; (ii) they emphasize the importance of adapting their services to the local needs of their clients and offer them "appropriate" services (e.g., fast access to loans, interest-bearing and liquid savings, leasing and insurance), rather than simply "cheap" standardized loans; and (iii) they emphasize the local ownership of MFI by offering attractive interests on savings, which promotes local fund capitalization. These and other sound practices[1] taken from a review of international examples are examined in detail in this study and are taken as benchmarks for operating efficient MFIs. The characteristics of an "enabling regulatory environment" are then defined in relation to those characteristics; an "enabling environment" being that which allows MFIs to operate in the most efficient manner.

For local MFIs to be successful and beneficial to the largest group, sound practices thus call for a regulatory environment that enables MFIs to adapt their services to local needs, gives them the ability and freedom to operate under sustainable financial conditions, and facilitates the transfer of skills learnt locally so that they can be replicated and adapted to reach out others. This requires the ability to charge the full costs of providing financial services, and calls for the removal of unfair competition which provides financial services at rates below costs, and prevents non-subsidized initiatives from developing services adapted to local needs [Fallavier, 1997].

An important element of an enabling environment for MFIs to sustainably serve their goals is thus the freedom to adapt to local requirements and charge the actual costs of providing services. This freedom must be directed by appropriate laws and regulatory devices to guarantee that only sound and honest institutions take the saving from, and provide financial services to those in need. Other aspects of a necessary enabling environment from a regulatory perspective are (i) factors that build trust in the banking system (the existence of appropriate banking and corporate laws and their effective enforcement, a transparency in accounting practices, and the removal of hidden costs and corruption); (ii) tools that give a certain insurance that investments will not lead into bankruptcy and a debt spiral (appropriate insurance products); (iii) and the potential to create adapted new financial products (such as leasing) through regulations that allow MFIs to offer more than a simple credit and/or saving service.

Yet, as the provision of financial services is not a sufficient condition to achieve human development and truly empower the poor over his/her own life, an enabling environment for human development is not limited to mechanisms allowing needed funds to be better distributed. A larger enabling environment must also provide the entrepreneurial poor with potentials to make the best productive use of funds by insuring them fair access to life-supporting services (so that loans can be used for productive investment rather than survival needs), and to appropriate vocational/business training and extension services. This environment must act in a way to

[1] The literature often refers to 'International Best Practices'. From my research though, it seems that there is not one set of 'best' practices that can directly be transposed from one situation to another. I thus prefer to use the less often quoted phrase of 'Sound Practices', suggested by H.D. Seibel [Seibel, 1996].

reduce the main causes of poverty other than that of lack of access to capital and training (i.e., reduce isolation and risks, and improve participation and ecological sustainability of livelihoods).

The Vietnamese government recognizes the necessity to develop the access of financial services to the poorest while reducing the other causes of poverty. It is indeed part of the thrust of the Government's Hunger and Poverty Eradication Program (HEPR) to provide the structure for human development efforts by giving the poor access to the required basic services (access to land, health and education, technology transfer, micro-finance and rural infrastructure) so that they can expand their array of options in life and grasp the opportunities offered by *Doi Moi,* the current reform process of administrative decentralization and adoption of a market economy in Vietnam [HEPR, 1995]. On the macro scale, this implies promoting growth, stability and equity to rural and isolated areas through legal reforms, the reduction of rural isolation and risks, increased access to available resources, environmental sustainability, and increased participation [UNDP, 1996a]. Improving access to financial resource through developing access to micro-financing services is thus directly in line with governmental directions.

Linking the effectiveness of micro-financing services in Vietnam to the characteristics of their regulatory and supervisory environment will give valuable insight for Vietnamese policy makers to direct some aspects of the *Doi Moi* liberalization process based on an analysis of local Vietnamese conditions as compared to international examples.

1.5 Relevance of the Research

The main research question is: *What are the factors in Vietnam that most strongly promote or hinder the effectiveness of MFIs to advance human development in a financially viable way?*

Field research and an analysis of the Vietnamese industry and of the literature show that most research efforts until now have focused on understanding the characteristics and needs of micro-finance schemes at the local level (i.e., what determines the success and failure of micro-finance programs) and the definition of best practices at the project scale in Vietnam. Little has been written on the characteristics of the necessary macro-environment conducive to the successful dissemination of those best practices, especially in terms of regulatory needs for MFIs.

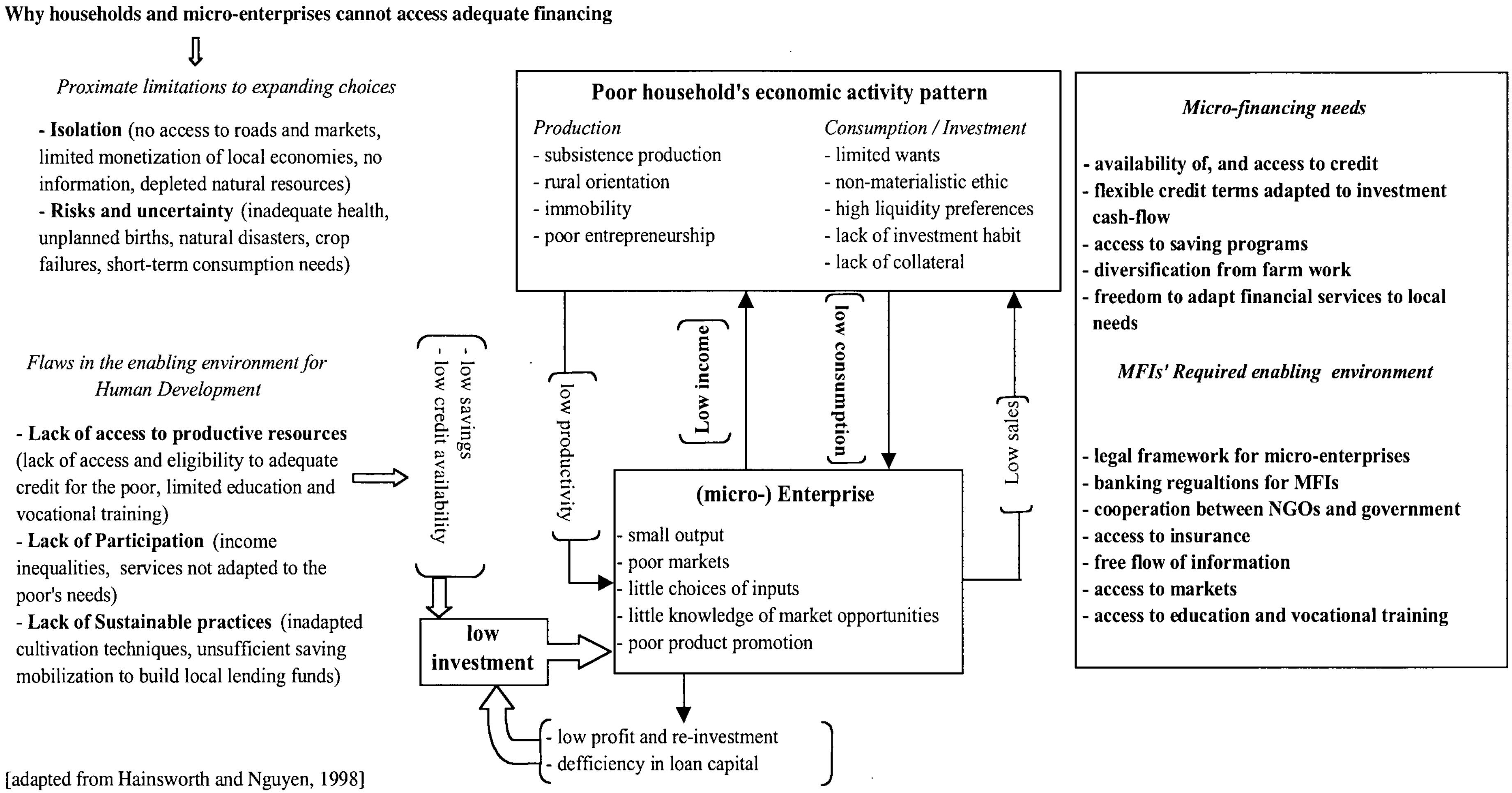
The main contribution of this research is thus to analyze and present how the current institutional and regulatory settings in Vietnam affect the possibility to offer widespread access to sustainable micro-finance, and how those settings could be improved to contribute to the coordinated efforts of poverty eradication. Policies that positively influence those relationships can be used both by governmental authorities to provide a facilitating environment to integrate micro- and macro-scale efforts, and by the MFIs to expand their operations and adapt their activities to reach and empower a more significant portion of the extreme poor in Vietnam.

The study takes an approach in three points : First, a literature review of international examples defines the concepts and characteristics of successful micro-finance programs and articulates a relationship between their efficiency and their operating and regulatory environment (chapter 3). Second, the results of field research present current micro-financing practices in Vietnam and analyze the regulatory environment in which MFIs evolve (chapter 4). Then, a third part derives policy implications aimed at the government for regulatory purposes and at the industry players for a more efficient division of roles and cooperation (chapter 5).

1.6 Causal Model of the Research Question

Based on the definition of poverty as "a lack of ability to participate in national life, most especially in the economic sphere" [UNDP, 1996a], Figure 1 outlines the inter-relations that this study clarifies between poverty situations, lack of access to financial resources for households and micro-enterprises, and some main elements of the environment needed for micro-financing institutions to deliver appropriate services on a sustainable basis in Vietnam.

Figure 1 : Vicious circle of poverty and financial services needed for the development of micro-enterprises



2. RESEARCH METHODOLOGY

This thesis was elaborated in three phases: the first covered background research on the poverty situation in Vietnam, on the needs of a multi-disciplinary approach to understand this situation, and on the role of micro-financing in human development. The second phase consisted of a three-month field research trip to appreciate the realities of Vietnamese localized poverty alleviation efforts and understand some of their inter-relations. The third phase of analysis and writing started with the editing of research papers for UNDP's first *Report on Human Development in Vietnam* and was pursued with the study of the material brought back, further secondary research on micro-finance, and the organization and writing of the findings.

This section details each phase, presenting its goals, process, and the kind of data collected (2.1), analyses the approach in terms of validity of the findings and how those issues were tackled (2.2), and sets some limitations to the findings (2.3).

2.1 Research Process

Research started with a year-long series of weekly seminars on interdisciplinary issues of development and poverty alleviation in Vietnam (e.g., defining poverty and human development, understanding *Doi Moi* and its impacts upon rural livelihoods, understanding participatory research and planning methods, reviewing research approaches relevant to field work in Vietnam). They required thorough reading and occasional presentations of literature reviews on the subjects presented, and were instrumental in later giving theoretical foundation to our field observations. The seminars were supplemented by Vietnamese language classes and cultural events. During the same time, I studied the characteristics and roles of micro-finance in poverty alleviation and developed a theoretical understanding of the role of micro-finance in empowering the poorest to enter the economic circles of their communities.

The primary findings used in this study are based on interviews, field visits and literature conducted and collected between April and June 1997 during a study tour with UBC's Centre for South East Asia Research (CSEAR). This multi-disciplinary research trip aimed at gaining a well-rounded understanding of why part of Vietnam's population did not profit from the positive effects of *Doi Moi* which had led to a dramatic reduction of poverty since 1986 nationwide. Precisely, we wanted to understand (i) the roots of different poverty situations; (ii) the limitations to escaping these situations from a poor person's perspective; (iii) the impacts of existing poverty reduction programs; and (iv) the potentials for community-based improvements based on other successful local initiatives both from Vietnam and other countries.

Table 1 : Major cross-cutting issues explored by the CSEAR's workshops and field trip

- Alternative definitions, causes, perceptions, explanations, and criteria of poverty
- Impacts of *Doi Moi* on rural livelihoods
- Hunger eradication as a separable vs. an integral problem in poverty alleviation
- Poverty as a gender issue
- Effects of institutional arrangements, public policies and outside interventions on poverty
- Ways to mobilize and direct local resources in the anti-poverty campaign
- Needs to create an enabling environment supporting local initiatives and self-help
- Current, likely, and appropriate roles for NGOs, mass organizations, or cooperatives, in poverty eradication
- Macro vs. micro issues and tackling policies

We recognized that poverty cannot be understood by separating its different causes and reflected this in a multi-disciplinary and collaborative team-approach to research. Our group of five included economists, geographers and planners with over-arching interests in community development and poverty alleviation, each with a specific focus (eco-tourism, land reforms, gender and development, natural resource management, and rural finance). We were led by Dr. Hainsworth, an expert on poverty issues in Vietnam, and we were joined by local experts and key informants along our way. As a team, even though we were all pursuing our own agendas, we acted as much as possible in a way to learn from each other, listening to each others' questions during the interviews, building knowledge on different subjects, and sharing notes and findings.

We conducted research in very poor areas, that gave examples of many diverse livelihood patterns (e.g., mountainous ethnic minorities, or resettled boat dwellers on coastal areas) and reasons for poverty (e.g., lack of access to market, or dependency on depleted natural resources). We used a variety of participatory techniques (based on participatory rural appraisal tools - PRA) to empathize with the people and understand the local realities of poverty while minimizing our intrusion in people's lives: We conducted household surveys, listened to daily life stories, shared some of people's activities, and met with numerous local key informants (farmers, officials, aid workers, scholars) for triangulated assessments of such aspects of rural livelihoods as land use, tenure, control over resources, cropping systems, labor utilization, sources of income and expenditure patterns, household assets, access to saving and credit, or educational and health issues.

Given the exploratory content of our approach and the diversity of the realities we encountered, we did not keep track of findings in an easily quantifiable and 'codable' manner. Therefore, the field observations are used for qualitative analysis and illustration of documented points rather than to prove new ones. Interviews with experts and key informants gave direction regarding when findings were representative as opposed to when they were merely anecdotal.

The last phase analyzed the field findings in the light of relevant theory. The theoretical literature on international experience (which is presented in Chapter 3) sets up a conceptual framework to analyze the data on micro-finance collected during the field research. The analysis of those data consisted of appreciating the case studies and interviews brought back from Vietnam, and other international examples analyzed by experts, to figure out a relationship between the MFIs' operating environment and their success in reducing poverty while being commercially viable. From this review of international experience and a sound appreciation of the Vietnamese cases, I drew directions for policy implications. The theoretical and practical data in this phase were gathered from recent scholarly and professional literature covering a large range of involvement from academic interests to practitioners' toolboxes. Most literature is drawn from the experience of a vast array of practitioners, and shows that if some rules apply across borders, micro-financing systems must remain flexible and adapted to the needs of the local communities.

2.2 Validity of the Findings

The validity of data measures how truly they reflect reality [Creswell, 1994]. In this study, insuring validity required a sound understanding of documented methods of research on poverty, which was obtained from a careful literature review on the economic, social and environmental aspects of poverty alleviation and of sustainable human development and on the methods and application of PRA, and from expert advice during the preparatory workshops. It also demanded an in-depth knowledge of the Vietnamese realities (socio-cultural, economic, and political) which was obtained from Dr. Hainsworth's experience and by (i) gathering primary and secondary data prior to designing surveys from similar or related projects; (ii) refining the survey tools along the actual field work to adapt to un-forecasted situations; and (iii) keeping open minds to interpret results and describe the observed livelihoods with a local insight.

We chose to partly use participatory research and to triangulate to cross-check the data and improve accuracy. We did so (i) through the application of various PRA methods (e.g., semi-structured interviews supplemented by farm maps, livelihood analysis and flow charts) and (ii) by employing different sources to validate information (interdisciplinary research team to generate analysis from diverse perspectives; different sizes of observation units - for several levels of probing if necessary; numerous interviews - for significance; and use of secondary data).

During our field experience, we were aware that, as outsiders, we were likely to influence the respondents (and thus the validity of their answers), and we tried our best to bridge the cultural distance with the villagers so that answers could be valid. To do so, we had to gain the trust of the villagers before we could intrude on their privacy. In this logic, we conducted surveys, semi-structured interviews and focus groups in a very informal manner, often around a cup of tea or local alcohol, or walking in the fields with villagers, experiencing first hand local realities, taking notes and asking questions during the conduct of a normal day. Doing so greatly reduced cultural gaps and hopefully avoided some of the biases in answers that would result from a more detached, outside approach while increasing the validity of data.

To insure access to most relevant household members of the community surveyed, and obtain valid and representative answers to our questions, we :

1. worked with local co-interviewers to bridge cultural gaps during interviews and meetings;
2. kept many questions open-ended to account for our incomplete knowledge of local realities, and kept research content and design open to modifications;
3. had good briefings on the cultural aspects of doing research in Vietnam;

4. remained aware that, despite all efforts we were viewed as foreigners, and that answers had to be 'filtered' (through triangulation and judgment) to remove components that may distort reality (e.g., answers from a first day in a community are not as ingenuous as those collected after several days spent among villagers once we became more socially accepted).

Table 2 : Potential sources of invalidity and approaches taken to minimize their impacts during the field trip

SOURCE OF INVALIDITY:	⇒ **"Unwillingness to respond, and Researcher bias"**
Reason	*In a poor village, educated outsiders are figures of knowledge and authority and respondents may answer questions in a way to give face to the researcher instead of presenting their own thoughts.*
Actions taken	- need to be culturally aware and 'integrated' to offset the bias. We showed willingness to learn from people and personal interest in the actions resulting from the research. - let people express themselves, asked practical rather than theoretical questions, participated in daily activities and shared genuine interest in the ways they live. - used proper aids : self-drawn diagrams or maps.
SOURCE OF INVALIDITY:	⇒ **"Ignorance of answer"**
Reason	*Asking a question to someone who does not know may not yield a "don't know" answer; rather, some respondents answer anyway (to save face, to repeat the Communist Party's lines in front of an official, or just to oblige the interviewer).*
Actions taken	- investigated who held the specific information. Used local key respondents
SOURCE OF INVALIDITY:	⇒ **"Respondents may be restricted by social desirability of answer"**
Reason	Answers can be affected by social pressure in front of a group (fellow villagers, family members) - e.g., one may admit the extent of one's poverty in private settings, but not admit in front of others that s/he is the poorest in the village.
Actions taken	- tried to minimize our impact by being un-obtrusive and transparent. Let every one know who we were and what we were doing to avoid misconceptions. - Were aware of what to discuss in front of whom: many questions were asked on a one to one basis, when anonymity was insured and pride not a major issue.
SOURCE OF INVALIDITY:	⇒ **"Respondents may not be used to give their opinion"**
Reason	*In households, the husband most likely answers questions. He speaks up for the family, including children, women and elders, but it is likely that his answers differ from what other members of the household would have answered if given voice.*
Actions taken	- under-voiced members of a community might have invaluable input in the research if adequately interviewed in their natural, informal surroundings. - tried to show respect for people's privacy and own schedule and arranged times accordingly for respondents to be interviewed, alone, in family or in groups.

The issue of validity is also important in the literature review. There exist different schools of thoughts among international development practitioners regarding the sound practices of micro-financing (e.g., the extent of financing services necessary for MFIs to help empower the poor, or the degree of direct vs. indirect subsidies). These differing approaches are indeed in accord with the many diverse influences that can affect the success of micro-finance programs in different parts of the world. Despite trying to achieve the same goals of empowering the poor entrepreneurs upon their fates, those programs must consider very local cultural, political and social realities (e.g., should men or women receive the financing services, should the program be run by state banks, who is eligible for services,...?) and thus adapt to them. This explains why there is not one single set of 'best practices' regarding the conception and operation of micro-finance programs, but rather, sets of 'sound practices' that must be adapted to the local realities. To analyze the Vietnamese situation and arrive to policy implications, I selected the variables and indicators out of sound practices used in other country studies that seemed to best fit the Vietnamese circumstances and thus to be the most valid.

2.3 Reliability and Limitations of the Findings and Implications

As mentioned, our first approach in the field was very exploratory. We had research directions and specific interests but did not carry sets of standardized questions to ask in each locality we visited. Rather, we used semi-structured interviews and participatory approaches, so that respondents could direct us toward what they thought were the most critical issues related to poverty in their communities. By not simply applying preconceived models, we tried to avoid overlooking important local realities. Even though this approach gave a very good base to further research some of the specific issues raised during those interviews (which later, when compared to answers in other communities, may emerge as recurring themes), it made it difficult to obtain standardized answers that could be quantified. For those of our group who stayed in Vietnam for longer research, this laid out sound foundations for deeper specific probing, but in my case, it raised questions relative to the replicability of my findings and to their relevance to serve as a basis for policy implications on a national scale.

One main limitation of my field approach is thus that I did not stay in Vietnam after our intensive tour of all the poorest provinces to systematically collect primary data in a specific area. Hence, I had a good understanding of different situations related to the needs of micro-financing services and to the existing efforts deployed in many localities, but I did not have in depth case studies based on primary data collected in one sample locality.

This absence of a specified sampling frame may cast doubts on the grounding of my findings and on their aptitude to be extended to what I broadly describe as the 'Vietnamese enabling environment for MFIs'. Actually, during the analysis and writing, a recurring question was to decide whether it was better to generalize findings from (i) *anecdotal local evidence backed up by secondary data* coming from many localities, and thus encompassing a larger vision of all different poverty situations and their needs in terms of micro-financing, or from (ii) *an in-depth collection of data in a specific area* which might more accurately reflect one given situation, but might be limited in its replicability to other poverty situations and needs.

Based on my purpose to draw directions to improve the operating environment of MFIs in general, I opted for the first solution which, by trying to understand different micro-financing needs and constraints in a rather large geographical area, is more representative of the national reality than the study of a single case would be. I thus decided to use the field data I had collected in many communities and try to match those situations with similar or approaching cases from other countries documented in the international literature. From those international cases which have been studied in depth, I assessed whether my field observations were relevant (and "generalizable"), and produced policy implications based on sound practices tested in similar environments elsewhere.

Note: *Observations, figures and analysis that are not referenced come from the findings of our field trip and discussions with experts and key informants.*

3. FRAMEWORK - DEFINING AN ENABLING ENVIRONMENT FOR MFIs

This chapter analyses the literature related (i) to the international experience of micro-finance as a tool to contribute to human development in a financially sustainable way; and (ii) to the enabling environment required for MFIs to succeed in this endeavor. It defines the key concepts of the study and proposes a causal relationship between the effectiveness of micro-finance in promoting human development and the environment in which MFIs operate. It thus lays out a framework in which to analyze MFIs' operating environment in Vietnam.

It starts by presenting the concepts and measurement of poverty and human development and defining the major elements required to create an enabling environment for human development (3.1). It then explores the effectiveness of micro-finance in promoting human development, determines relevant indicators, tallies a set of sound practices used to attain effectiveness, and derives the conductive attributes of an operating environment that allows MFIs to serve their goals efficiently (3.2). Lastly, it presents the main policy and planning tools that can modify the operating environment to enable MFIs to reach their goals (3.3).

3.1 Poverty as Exclusion, Human Development as Expanding the Availability of Choices

This section presents the concepts of *poverty, human development and enabling environment for human development,* and introduces indicators that measure progress (3.1.1). It then proposes a policy framework to create an enabling environment for human development (3.1.2), and sets the role of micro-finance within such a framework (3.1.3).

3.1.1 Poverty : a Limitation of Choices - Concepts and Indicators

Until the early 1990's, the level of a country's poverty had long been mainly associated with measures of its *economic* development. Little regard was given either to the social redistribution of the benefits of growth, or to the side effects of economic growth onto the quality of human and natural resources (e.g., empowerment vs. alienation of people, sustainable use vs. depletion of the environment). Economies with high GNP growth rates were thus considered on the road to poverty reduction. This vision emphasized the acquisition of wealth and technology as a path to development and assumed that improved lives for all would result [Todaro, 1993]. Yet, poverty cannot solely be defined or measured by an aggregate level of consumption or production capacity which ignores any component of higher-level human development.

The definitions of poverty which rely solely on the distance between one's total production or consumption level expressed in monetary terms and a production or income poverty-line (as measured by *purchasing power parity* or *GDP per capita),* are not reliable in informal or un-monetized economies where exchanges often rely more on barter than on formal payment and thus escape accounting records. Besides, if economic growth does enhance many lives, it often leaves behind those unable to derive profit from the use of the free-market mechanisms, because of gender, lack of skills, or insufficient access to capital, and the aggregate GDP measures do not reflect disparities of achievement between people [Solomon, 1990]. Some more qualitative definitions (such as the *rice-equivalency* or the *cost-of-basic-needs* methods) consider the level of basic needs required to survive and help draw a line between the *relative* and the *absolute* poor[2]. Under these definitions, the *relative* poor have access to *inadequate* (albeit sufficient) intake of food and access to the most basic needs, while the *absolute* poor cannot even obtain food and basic necessities on a year-long basis [RPMM, 1995]. This distinction is important to understand where the first amount of disposable income may be directed, and suggests what use might be made of new capital under the pressure to fulfill basic needs[3].

Yet, what these quantitative baselines fail to measure is that poverty is not simply the lack of access to material wealth, but also the deprivation of access to the higher-level needs of human development of living long, healthy and creative lives. Such factors of well-being which cannot be measured in monetary terms [UNDP, 1995a].

[2] The rice-equivalency method converts all household monetary and non-monetary income into rice quantity (i.e., it measures how much rice they can purchase with their income). The cost-of-basic-needs method evaluates needs for basic food expenditure and for other basic non food spendings. Both approaches generate a minimum-need poverty-line against which a population can be rated [RPMM, 1995].

[3] A poverty pyramid is also used to separate the poor into five strata. It distinguishes between poor based on people's potential to survive economically : at the bottom, the *ultra poor* depend on the earning of others : then the *laboring poor* is employed full-time as unskilled labor; the *self-employed poor* work for their own account, possibly employing others; the *entrepreneurial poor* employ five or more people, and the *near poor* have stable wage employment but low earning power [Gallardo, 1997].

Seeking a more universal definition, the common characteristic that identifies poverty across frontiers, levels of national economic development and cultures is a situation of *exclusion from access to basic survival needs* (such as food, shelter and medical care), due to insufficient income - *a poverty of income,* and *from access to the tools necessary to improve economic productivity* (such as access to training and capital*)* and *fulfill higher needs* - a *poverty of choices.* By not having access to enabling factors for human development the poor are excluded from normal economic and social activities and live in the margin of their own communities.

The core concept of poverty is then the *lack of choices and opportunities that one is given for life when born and raised poor.* This lack of choice is often due to isolation (geographic, linguistic or social), high risks of losing one's few assets (due to natural disasters, sickness, or unplanned births), and a lack of access to productive resources (skills, information, land or credit) [UNDP, 1996b][4]. Those factors compound to create a high level of vulnerability for the poor, closing the loop of a vicious circle in which difficult access to resources brings low economic productivity, itself calling for low income which does not allow to break out of dependence and perpetuates the situation among the next generations as Figure 1 showed.

It is thus important to realize that poverty is not the lack of material property *per se.* Rather, the lack of material wealth is *one result* of poverty, itself defined as *a situation of exclusion from society and from its social and productive systems.*

But within a poor population itself, inequalities are often marked and some groups suffer more than others from social and economic exclusion. Notably, women, elders, children, ethnic minorities and the disabled are more likely to be stricken by multi-faceted deprivations. Women's workload for instance is more often than not heavier than men's, and less rewarding. In many societies, women's roles are to look after their children and husband and maintain the home. When they are given the opportunity of (or are forced into) working for an income, the new workload only adds onto the existing one. Women hence work longer hours than men and less of

[4] By the words of rural poor themselves, ill-being is stigmatized in their daily lives by situations of disability, lack of land or livestock, inability to bury the dead, inability to send children to school, bad housing, low status job, food insecurity several months in a year, or single parenthood [UNDP, 1997b].

their work is rewarded by monetary income, most of it remaining unpaid, unrecognized and under-valued (in 1995, the UN estimated at $11 trillion a year the unvalued or undervalued contribution of women through their economic activity). Despite their prevalent economic importance, they are given little opportunity to improve their conditions; they do not have access to land ownership and, as a consequence to credit (for lack of collateral); they are given little power of decision on how to use household incomes; and are often not kept in school or offered the vocational training that could enhance their economic potentials. On top of this, they often suffer from a lower social status than men, encounter legal discrimination (e.g., they are left with nothing in case of divorce, repudiation or spouse's death), and are subject to domestic violence and abuse. Lastly, they are generally politically under-represented, which prevents their voices and concerns from being heard [UNDP, 1995a].

Disabled persons (i.e., 10% of the world population) are also likely to be at the bottom of the poverty pyramid. Owing to their lack of mobility, education and training and to discrimination, they are confined to the lowest level positions. Elders often share similar exclusion from access to the economic and social lives of their communities. Lastly, facing all obstacles, the indigenous or ethnic minorities are in many cases marginalized and live in dire lack of access to the factors that would enable them to fulfill their basic needs and achieve higher goals of human development (from access to markets, to language skills or political representation) [UNDP, 1996b].

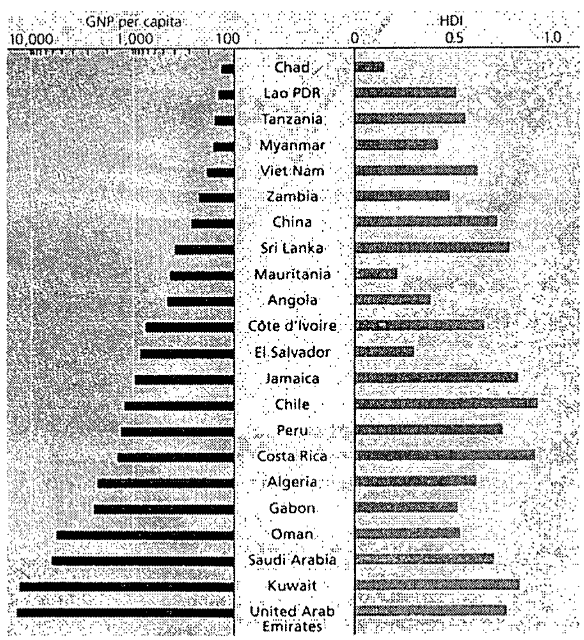
For a long term approach to poverty *eradication* (and not only temporary *alleviation),* it is therefore more relevant to focus on the poverty of *choices and opportunities* (or *human poverty*) to improve one's future than on the poverty of *income* alone. Defining the lack of choices and opportunities focuses on the causes of poverty and suggests strategies and actions to enhance people's opportunities [UNDP, 1997b]. Assessing poverty must thus consider comprehensive socio-economic indicators of human development rather than income or production levels alone.

Eradicating human poverty thus means improving human development, defined as:

> "a process of enlarging people's choices [...] the three essential choices are for people to lead a long and healthy life, to acquire knowledge and to have access to resources needed for a decent standard of living. [...] Additional choices range from political, economic and social freedom to opportunities for being creative and productive, and enjoying personal self-respect and guaranteed human rights" [UNDP, 1990a]

Since the early 1990s, comprehensive indicators of human development are being developed. Along the years, the UNDP has refined measuring tools that are used in this study to measure the impact of poverty in Vietnam and assess the potentials for MFIs to sustainably improve the poverty situation in the long term. The base indicator now used is the Human Development Index (HDI), which measures the level of attainment of human development through a composite of *longevity, knowledge,* and *standard of living,* and thus gives an appreciation both of people's choices in life and of the level of their well-being. Its baseline is the highest standards that can be reached on a national average[5]. Figure 2 shows that ranking poverty by GNP per capita and by HDI gives very different appreciation of poverty ratings : some countries with high income poverty (i.e., low GNP per capita) may rank much better on human development. Hence, despite limited richness, the populations of countries as Sri Lanka or Vietnam enjoy more rewarding lives than measured by GNP alone [UNDP, 1990].

Figure 2 : Comparison of poverty as measured by GNP per capita and the HDI [UNDP, 1990]



The Human Poverty Index (HPI) builds on the HDI to indicate levels of basic deprivations which poverty-eradication programs should aim at removing. The HPI measures deprivation by *chances of survival* (the percentage of a population expected to die before 40), *level of exclusion from the reach of knowledge* (the percentage of adult illiteracy) and *decency of living standard* (a composite of the percentages of people with access to health service and safe water, and of malnourished children under five) [UNDP, 1997b]. The major advantage of indicators such as the HDI and the HPI is that, unlike the solely monetized approaches, they measure different attributes of poverty and thus suggest directions for intervention.

[5] The highest average life expectancy is 78 years, which represents an index of 1, the highest literacy rate is 100% and the level of income poverty is measured against an average income line (PPP adjusted) measured in richer countries.

Assessing progress must also consider the evolution of disparities between rich and poor, male and female, rural and urban, and ethnic groups in income, access to social services and to productive resources [UNDP, 1997b]. To measure progress in reducing disparities, the UNDP proposes a Gender-related Development Index (GDI) similar in measurements to the HDI but which notes inequalities in achievement between women and men. A Gender Empowerment Measure (GEM) also indicates the extent to which women are given chances to take advantage of the opportunities of life by holding economic or political decision-making positions [UNDP, 1995a].

3.1.2 The Needed Enabling Environment for Human Development

The goal of poverty eradication efforts are therefore to promote human development by bringing choices and opportunities to the excluded poor to live healthier, longer and more creative lives. For expanded choices to contribute to improved well-being, people must be able to increase their productivity, have equal access to opportunities and be empowered to govern their development process [UNDP, 1997b]. Poverty eradication efforts will achieve their goals by first setting up an enabling macro-environment characterized by a sustainable economic growth, a stable society, fair access to productive resources for all, and an equitable redistribution of the outcomes of growth and people's efforts [Hainsworth and Nguyen, 1998]. Such an environment should give everyone more choices and ability to participate in the life of their communities, and most especially in the economic sphere by (i) ensuring that the working poor can better help themselves in the long term; (ii) providing social assistance for the destitute poor; and (iii) supporting the non-poor [UNDP, 1996a; Fforde, 1995].

Table 3 reviews the characteristics of *human poverty* and presents the main attributes of an enabling environment for *human development*. Table 4 presents specific policies aimed at empowering the poor over their own lives. They set up the main framework for human development into which part 3.1.3 integrates the need for an adapted operating environment for the development of micro-entrepreneurship and of its required micro-financial services.

Table 3 : Gaps in Human Development - Framework for Directions and policies

DEPRIVATION EXPERIENCED IN HUMAN DEVELOPMENT		CHARACTERISTICS OF AN ENABLING ENVIRONMENT
Life Expectancy and Life Quality		
average life expectancy in South-East Asia was 12 years shorter than in industrial countries in 1992.		
food insecurity affects daily a sixth of the people in developing nations **serious malnutrition** touches one in every three children under five	⇒	**Risks and uncertainty must be reduced** (people with inadequate health cannot be productive, unplanned births add to fatigue and costs, natural disasters, crop failures, short-term consumption needs prevent from developing better livelihoods)
health care does not reach 1.5 billion people. 14 million children under five die each year, among which nearly 3 million from immunisable diseases. **rural access to safe water** (47%) and to **basic sanitation** (38%) are grossly inadequate in South-East Asia and the Pacific	⇒	**Access to sanitation, safe water, family planning and health education** are prerequisite for a healthy and productive work force
Access to Knowledge		
Literacy rate is only 41% in South Asia. The poor are often unable to send their children to school because of isolation, cost, and the lack of appropriate programs	⇒	The poor must be able to increase their productivity, they **need equal access to education and skills**
Income Generation/access to productive resources		
More than a billion people live in absolute poverty. They suffer from a lack of access to productive resources (lack of access and eligibility to land and adequate credit, limited vocational training) and a lack of participation in managing their own development process	⇒ ⇒ ⇒	Stable, pro-growth policies must **help the poor find or create employment** **Isolation must be reduced** (road access to markets, better information **Access to productive resources must be enhanced** (land, funding, adapted extension services)
Women and minorities		
Female literacy rate in developing countries is still only two-thirds that of male literacy The South's maternal mortality rate is 12 times that of the North's	⇒	**All should be empowered to develop** for and by themselves regardless of age, gender, ethnic or religious belonging
Political Representation		
The poor, women and minorities are **not proportionally represented** at decision-making positions	⇒	Empower the poor and under-represented by **ensuring their participation** in the governance of their communities
Environment		
During 1981-90, over 3 million hectares of tropical forest were lost in South East Asia and the Pacific.	⇒	**Lack of environmentally Sustainable practices** (in-adapted cultivation techniques)

[UNDP, 1996a; 1996b; 1997b]

Table 4 : Policy directions to reduce the impact of the main causes of poverty

(i) Reduce Isolation

- Geographic isolation: provide feeder roads for better access to markets, services and utilities
- Intellectual isolation: develop functional literacy, locally appropriate schooling and technical training
- Economic isolation: provide land, capital, information, and technical skills to potential entrepreneurs.

(ii) Improve risk management

- At the macro scale, provide sanitation, health care services and family planning choices. Provide a safety net for the destitute poor who cannot integrate the market economy
- At the local level, reduce health risks by building local dispensaries and training local health practitioners, and promote the use of traditional medicine and family planning
- Reduce dependence from weather, crop risks and food shortages by building sea dikes and irrigation systems, providing access to required inputs for farming (seeds, fertilizers), and to insurance services.

(iii) Increase access to available resources

- Employment creation programs : involve local labor in infrastructure work (road building, irrigation); develop activity diversification form farm work.
- Set up national and local legal business framework and institute a rule of law to secure investment
- Develop the stability and legal framework for the creation of financial institutions specialized in rural and micro finance.
- Ensure more widespread access to locally-adapted credit and saving programs (both for production and consumption) by reviewing credit eligibility, extending outreach to remote communities and promoting the development of financially sustainable rural finance programs.
- Put in place the necessary systems of insurance for productive capital, develop proper communication and information flows for better market price transparency.
- Distribute land more equally in the rural areas.

(iv) Increase participation of all

- Develop research and planning cooperation between local mass organizations, NGOs and governmental agencies to empower the poor and minorities by ensuring their participation in identifying local priority needs and developing solutions
- Value women's unpaid work by tax and social security incentives
- Promote equal access to opportunities and gender equality, especially in rural areas through affirmative action, female education, improved reproductive health and more credit for women and minorities

(v) Increase ecological sustainability of livelihood patterns and economic practices

- Integrate human consumption/production needs with the carrying capacity of natural environment in development policies (e.g., improve land management and reforestation, develop agro-forestry)

[Fforde, 1995; HEPR, 1995; UNDP, 1994; 1996a; 1996b]

3.1.3 Role of Access to Micro-Finance in the Framework of Human Development

On the macro scale, the most important policy for rapid poverty alleviation is employment creation, which implies for each individual to have access to education and skills, productive assets and financing [Fforde, 1995]. For government, this means creating an environment conductive to the development of the private sector, and especially of micro-enterprises, which have shown to be the main driving forces that develop employment opportunities. This enabling environment includes stability (regular growth, low inflation, limited external debt and balanced budget), an equitable legal framework (rule of law, separation of powers, suppression of corruption and rent-seeking, better accountability and transparency), adequate physical infrastructure (power, communication, irrigation) and incentives for private investment (access to credit, free flow of information, freedom to operate profitably) [UNDP, 1994].

On the micro-scale, growth must be community-centered. Households must gain access to education, training and locally adequate saving and credit services while being ensured food and health security. This demands building safety nets for the destitute poor (who, for reasons of disabilities or age, cannot produce enough food or income to sustain themselves), and providing mechanism to enable the entrepreneurial poor to realize his or her own economic potential, either through wage employment or self-employment.

Self-employment implies the development of micro-enterprises[6], and micro-entrepreneurs can be at the core of their community's economic development, provided they have access to the adequate factors to operate profitably. Of those factors, access to relevant vocational training and to life sustaining services are all essential, but access to financing is a *sine qua non* condition to start a business, and providing credit and saving capacity through specialized MFIs targeting poor families is one way to achieve more equitable access to the required financial services [UNDP, 1996a].

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[6] Micro-enterprises can generally be defined as 'the businesses of the self-employed' and their total number of paid and un-paid employees do not exceed five [CGAP, 1995].

3.2 Micro-finance : Basics, Sound Practices, Efficiency and Enabling Environment

In the last ten years, assisting micro-enterprises with the provision of micro-credit and saving services has proved a successful strategy for job creation and income generation among the very poor, and the participation of the poor in credit and saving systems has been correlated positively with betterment of family welfare and human development [CGAP, 1995]. Meanwhile, some of the most successful MFIs have established that micro-finance can also be a profitable, attractive commercial enterprise, showing that poverty alleviation strategies can reconcile humanitarian with business drives [Berenbach and Churchill, 1997].

This section presents the notions of micro-finance strategies (3.2.1) and of their effectiveness in sustainably promoting human development (3.2.2); it derives a set of sound practices from the experience of successful MFIs (3.2.3); defines the needs of MFIs and the characteristics of an enabling environment for them to efficiently reach their goals (3.2.4); and proposes policy and planning tools to create this enabling environment (3.2.5).

3.2.1 Micro-finance : Offering Lending and Saving to the "Unbankable" Poor

Small and micro-enterprises comprise nearly 90% of the business activities in a developing economy [Churchill, 1997b]. Micro-enterprises are generally owned by the landless poor and include street vendors, farmers and traders, and entrepreneurs who engage in a variety of manufacturing, service and repair functions (potters, weavers, blacksmiths, seamstresses...). They operate in the informal sector which is easy to enter, unregulated, small-scale and labor-intensive, and permits adaptability of resources from one use to another. Such activities employ 30 to 70% of a developing nation's labor force among which many women, as they often lack access to formal employment, and home-based activities are their only means of earning a livelihood. Businesses keep operating costs low by operating from within the home and using handmade or second-hand equipment and family labor [Strassman, 1988; Churchill, 1997b].

Table 5 : Characteristics of micro-enterprises

- Employ one to five persons, including unpaid family
- Labor intensive work with few assets
- Home-based, located on market stalls, or mobile vendors
- Local sourcing, supplies, and marketing outlets
- Rudimentary management techniques, mostly unwritten
- Often not legally registered, do not adhere to regulations

[Berenbach and Churchill, 1997]

Part of promoting human development relies on developing support for the vitality of the informal entrepreneurs through enabling micro-enterprises to develop. Yet, the development of self-employment requires investment in small working capital and the low incomes of the poorest do not allow them to save and invest to expand their work beyond the barest means of survival. Obtaining credits is their only option as a substitute for saving and many could build substantial enterprises if they had access to financing, but they often have no access to capital beyond limited sources from family, friends, or professional moneylenders.

Table 6 : Why micro-enterprise programs are effective in poverty reduction

- Micro-enterprises are simple to operate;
- They use locally available skills;
- They are labor intensive and create significant employment;
- They improve the income of the working poor, especially poor women;
- They can serve as a basis for community participation and empowerment of clients;
- They can pay market interest rates on loans, helping MFIs cover costs and reach more people

[UNDP, 1997c]

Yet, historically micro-enterprise loans have not attracted commercial banks because of the high risks and low return banks associate with micro-operations, namely : (i) high administrative costs relative to interest and fees received from the small loans (similar paperwork is required to originate and service a loan, regardless of its amount); (ii) small-scale informal operations are often perceived as risky and not deemed credit-worthy; (iii) poor entrepreneurs typically have few assets that can serve as collateral; and (iv) legal and regulatory constraints may prevent financial institutions from servicing informal businesses [SGPB, 1990; Churchill, 1997b]. Besides, the vision that financing services to the poor should be subsidized often deters commercial banking institutions from lending to the poor.

However, the conception that the poor are not credit-worthy and that their financial needs should be treated as welfare transactions has been proven false by the successful experience of viable commercial lending to the poor that resulted in improving their standards of living and in launching thriving micro-enterprises. Table 7 presents empirical evidence that the poor should indeed be trusted with credit and be given access to other necessary financial services.

Table 7 : Myths and Realities about micro-finance to the poor

MYTH	REALITY
"Micro-entrepreneurs need to be cared for because they are poor"	Micro-entrepreneurs are knowledgeable about doing business in their communities, what they need is capital
"Micro-enterprises are too small-scaled to have a real impact on community development"	Micro-enterprises are viable and earnings are spent locally; they are important to their communities.
"Interest rates to the poor must be subsidized"	Micro-finance rates must reflect operating costs to achieve sustainability. Despite the relatively high costs of micro services, rates are significantly lower than those charged by informal sources
"Credit alone is useless. It must be packaged with training, marketing, technology, and other services"	Programs which package credit with other services require large subsidies. Those services should be managed separately. Approaches that offer credit alone have proven successful to start/improve profitable micro-enterprises.
"The poor are not credit worthy as dire consumption needs prevent them from investing in productive activities"	Well-managed MFIs achieve repayment rates of 95-100% while lending to the poorest.
"The poor are unable to save"	The BRI Unit Desa in Indonesia, largest MFI in the world, has 15.7 million depositors (for US$2.8 bn) and 2.5 million borrowers (for $1.7 bn) showing that the poor value saving at least as much as credit.
"Poor women are unskilled; it is useless to target them with micro-finance programs"	Women are often the survivor in the household; most MFIs loans (often over 95%) go to women as they show best repayment behaviors.
"Poverty has a crippling effect rendering the poor unable to improve their condition"	The success of MFIs lending to over 10 million of poor clients around the world proves the ability of the poor to improve their lives with their own ingenuity and drive.

[UNDP, 1997c; Yunus, 1997; Churchill, 1997b]

Recognizing the poor's need for access to credit and their solvency, the Grameen Bank of Bangladesh pioneered techniques to issue loans to the entrepreneurial poor in the late 1970s. Since then, MFIs in some of the poorest countries of Africa, Latin America, and Asia have demonstrated very positive results (for the clients as well as for the MFIs) in adapting those techniques: clients borrow, invest in their activities, repay their loans, and borrow again, all with an average repayment rate above 95% [UNDP, 1997a]. Simultaneously, the borrowing households show improved measurements of well-being with higher income levels, better living conditions and increased levels of participation in their communities' economic and social activities.

More recently, the evolution of some MFIs into profitable commercial operations has shown the commercial viability of lending to the poor and has opened new windows in linking private efforts to public goals of poverty eradication and human development [Gallardo, 1997a].

3.2.2 Effectiveness/Efficiency of MFIs: Human Development on a Commercial Basis

The *Effectiveness* of micro-finance efforts is related to two apparently conflicting objectives : on one hand helping the poor reach out of their predicament by lending them dearly needed capital, and on the other hand operating a viable financial business. Although debates divide scholars and practitioners on how to reconcile the humanitarian and business drives needed to bring access to banking services to the poorest in a sustainable manner[7], this study poses that a financial institution must be able to generate profit to survive and serve its clients in the most appropriate fashion. Providing standardized services at subsidized prices does not serve the community, and it undermines the potential of the MFI to be viable in the long term. Simply put, a commercially run MFI will stay and grow in a community and offer appropriate services while a subsidized approach will last the length of its subsidies and will not integrate in the long term development of the community.

Effectiveness in an approach based upon an intrinsic goal of institutional viability for MFIs thus relates to the ability to achieve three major goals: (i) *outreach* (providing services to the largest poor population possible); (ii) *financial sustainability* of the MFI (ability to cover all costs with revenue from operations and to mobilize deposits for self-financing); and (iii) impact in *eradicating poverty and promoting human development* in the communities reached - *Efficiency* of operations is related to attaining the highest possible ratio of output for input, i.e. achieving outreach and human development, while reaching sustainability.

There is not one single model of MFIs: they can be branches of NGOs not primarily focused on delivering financial services, of government banks or of development organizations, addenda to privately-owned banks, or specially created financial intermediaries. All successful MFIs though share common institutional elements among which: a clear objective and well-defined basis for motivation, institutional commitment, operating autonomy and a management environment conductive to responsive business decisions [Gallardo, 1997a].

[7] For instance, two recurring topics of discussion are : (1) subsidized lending vs. institutional viability, or (2) saving requirements to build up locally owned funds vs. risks of saving due to inflation and instability.

3.2.3 How Micro-finance and MFIs Work - Sound practices

A credit program designed and implemented in a way that the loan and the interest are recovered in small installments over a relatively long period of time can make borrowers save small amounts on a regular basis of what would otherwise be consumed due to the pressure of poverty. On this basis, successful projects devised credit systems of collateral-free lending subject to recovery typically over a year (yet adapted to the expected return from business operations) with a built-in *peer monitoring* mechanism that ensure timely credit repayments and use group liability in place of collateral. Many lessons have been learned from the traditional informal finance activities in extending credit to poor entrepreneurs[8] and despite the diversity of the informal sector, the "laws" of effective micro-financing projects are very similar. They include:

- Working directly in the community through regular and frequent visits of villages and poor neighborhoods to meet existing clients and secure new ones;
- Keeping application procedures simple, relying on peers to choose credit-worthy clients;
- Quickly extending credit (often within a week);
- Not requiring records and complex business plans;
- Not asking for guarantees that eliminate most potential candidates (such as collateral), rather, rely on the effectiveness of the group dynamics;
- Working initially with existing local economic activities, to reduce un-necessary risks and costs associated with developing new enterprises and markets;
- Extending small, short-term loans primarily for working capital on simplified terms (equal and frequent repayments) to test the clients' commitment to repay, and the viability of businesses;
- Providing larger loans based on successful repayment (incremental lending);
- Charging a rate of interest that covers all costs (financial, administrative and operational)
- Involving participation of the clients who take a major role in promoting the project within the community by forming groups and providing one another with advice and assistance, reducing costs significantly and developing commitment to the project and to each other;
- Developing projects in coordination with local banks to help increase outreach;
- Addressing the needs of poor clients (e.g., flexible hours, field visits) [UNDP, 1997c].

[8] Such as rotating saving and credit associations (ROSCAs) which pool members' deposits, and extend loans to members after a given period, pawners who provide instant small loans for short periods against physical collateral, or village money lenders who provide small unsecured loans to people they know well.

Before presenting a detailed review of sound practices in micro-finance, two important concepts must be clearly laid out that are at the core of the operations of a successful MFI: (i) the use of cost-recovery interest rates on loans; and (ii) the necessity to promote saving mobilization.

(i) To be successful in the long term, MFIs must base their operations on the understanding that they need to become financially independent from the agency which initially advanced the first lending fund (until now, such funds come essentially from government or development agencies, and commercial funds are still the exception). Accordingly, they must lend with positive real interest rates which cover the full cost of lending (operating costs, financial costs, and potentially a profit to motivate loan officers and to expand capitalization to finance further loans).

Such interest rates are typically higher than those of the banks who are not carrying micro-services, as managing small loans is costly compared to the size of the loan. Annual real effective interest rates typically fall into the 20 to 60% range [9][Berenbach and Churchill, 1997].

(ii) Requesting the poor to save before they can receive credit also seems to go against the conventional wisdom that if the poor cannot feed themselves all year long, there is little chance that they have any saving potential. Yet, saving among the poor is needed both by the clients and by the MFIs. For the clients, saving allows to set up a contingency fund to secure disposable income away from risks of theft or from the temptation to spend, and help build a safety net for the lean months. For the MFIs, requiring saving before a loan allows to accumulate some collateral, demonstrates the ability to save, and is the first stone in building up local ownership of the MFIs.

In terms of process, MFIs mobilize saving either prior to the loan (members must save for several months - to build accountability and ownership), during loan repayment (levies on loans, to capitalize more lending funds - Grameen-type approach), or once the loan has helped generate surplus income (used mainly when clients' confidence in banking system is low).

[9] The need to cover costs must not yet justify usury practices. Allowing competition ensures availability of financial services at the best prices, while prudential regulations guarantee the soundness of the MFIs.

Table 8 : Characteristics of successful MFIs - International Sound practices in Micro-finance - a benchmark for effective operations and policies

	Sound Practice	Impact of practice upon : **O**utreach, financial **S**ustainability, **P**overty
Concepts		
Borrower Selection	⇒ Provide loans to all poor based on business potential, regardless of their poverty level. ⇒ The majority of borrowers are landless women. ⇒ Self-selecting credit groups meet to approve loans, to ensure that loans are repaid on time, and to offer advice and support to members in the group.	**S :** High repayment as the poor know it is their only access to credit. Self-selection is an effective low-cost mechanism for character screening, credit checking and feasibility study . **P :** Loans are provided to those most likely to repay it (historically women in Asia), not placing in a debt-situation the destitute poor. Empowers women by giving them the support and reassurance to take business risks they might not have undertaken.
Adapted instruments	⇒ Financial services and requirements are tailored to the needs of the poor, not simply down-sized from the commercial version: no collateral, financial statements, letters of reference, or bylaws of the enterprise.	**S :** Adapted loans are most likely to lead to successful businesses, which insures loan repayment.
Loan purpose, term and amount	⇒ Credits are priced and structured to fit revenue and cash-flow generation patterns. The amount of loan depends on the needs of each enterprise (as opposed to lending a similar amount to all borrowers). ⇒ Repayments are small and regular (e.g. weekly). ⇒ Loans are not tied to a specific purpose.	**S :** Simplicity of operations and reduced costs. **P :** Poor are trusted and not told what to invest in - belief in their intelligence and business knowledge - gives them confidence. Terms match the expected cash-flow generated by the business.
Interest rate structure	⇒ Spread between interest rates on loans and deposits are sufficient to cover costs of the MFI (financial, operational costs, risk and inflation) to enable program sustainability. ⇒ All services offered are charged for. ⇒ Using local market rate means offering attractive yields on saving.	**O :** Permits to afford outreach activities (more and better services) as MFIs can develop a commercially viable basket of diverse services to serve the different needs of the local community. **S :** No hidden costs and better accountability - MFIs can be run as independent profit centers. Promotes the creation of a locally-owned credit fund, which supplements and gradually replaces the external seed capital and makes more local capital available for lending. **P :** Sets a precedent against rent-seeking, bribe and corruption.
Practices		
Participatory banking	⇒ Branches are in small communities, loan officers are sent into villages to disseminate information about activities, promote formation of borrower groups, and collect repayments. ⇒ Borrower groups meet weekly with a loan officer.	**O :** Best to reach those who cannot travel to obtain financial service. **S :** Close and regular monitoring of funds prevents potential repayment problems - keep in touch with the field. **P :** Decreases borrowers' hidden transaction cost (e.g., transportation), gives access to timely capital and information. Promotes collaborative spirit and efficiency of business ventures.
Role of credit officer	⇒ Credit officers assess loan eligibility, advise on the loan, help through a simple application procedure and collect the repayments - they do not tell the borrower how to run his or her business. ⇒ Once bank approves a loan, group monitors how money is used.	**S :** Create peer-pressure to fulfill loan repayment schedules and other obligations to the bank and the group. Bank can forego close analysis of each loan application, lower its transaction costs (staff can service more loans with fewer contacts). **P :** Peer support insures that borrowers operate their business properly; it fosters a sense of community.

Loan eligibility	⇒ To qualify for loans, borrowers form groups from the same community & learn bank's rules/procedures. ⇒ Groups review loan requests and business proposals. ⇒ Group members sign each loan application.	**S :** Before a group agrees to guarantee a loan, they discuss the business idea with individual applicant to test the soundness of the project. Groups guarantee loans, create solidarity, promote problem-solving & help develop leadership and management skills in the community.
Sequence of loans	⇒ A first member of the group must demonstrate repayment ability before other members become eligible for a loan. ⇒ Second loans are not approved for any member until accounts of all members are settled.	**S :** Incentive to encourage a delinquent member to make payments, or group is responsible to honor late payments.
Incremental lending	⇒ Timely repayments & regular monitoring by MFI officers are important to access larger amounts. ⇒ Initial loan is small; once it is repaid, subsequent loans are larger with longer repayment periods.	**S :** Incremental lending provides incentives to the borrower and minimizes the risk to the bank. **P :** Members graduate, build credit history and asset base, and apply to regular loans for the non-poor.
Saving mobilization	⇒ Saving and loans are offered simultaneously from the beginning of the program (saving should not be forced). ⇒ Borrowers buy bank shares.	**O :** Locally-generated funds are re-loaned. **S & P :** Saving rates and investment capacity rise and MFIs become people-owned and operated - building local capacity, members' sense of ownership and commitment towards the fund. **P :** At household level, saving secure disposable income from theft or temptation to spend and help build a safety net.
Innovative products	⇒ Creation of emergency insurance funds and life insurance as a percentage of each loan that covers outstanding loan obligations in case of death, or natural disasters. ⇒ Creation of leasing schemes.	**P :** Insurance pool partly guarantees that in case of harsh event, the borrowers' family will not be run into a debt spiral. **S & P :** Leasing is a good compromise both for the lender (who keeps ownership of the good until it is bought off) and the borrower (who can build up an asset base with no initial collateral).
Governance and Management		
Organizational management	⇒ Local staff responsibility for financial decision is coupled with special training and incentives for good performance. ⇒ Groups of borrowers may federate into centers; several centers in turn form a branch.	**O :** Promotes maximum outreach **P :** Groups select their own officers and rules of conduct, building local capacity for MFI replication and other participative projects. Group members become interested and involved in each other's businesses over time and offer guidance and support to fellow members laying a foundation for larger business ventures (collective enterprises) too risky for individuals to undertake alone
Operations	⇒ Simplified accounting procedures and loan processing guidelines for more time spent in outreach. ⇒ Credit administration is conducted quickly. MFIs extend repeat loans on the spot or within a few days.	**S :** Repeat lending allows MFIs to screen clients and to direct larger loans to proven borrowers. Operations can be delegated to local trustee/group officer.
Incentive scheme for loan officers	⇒ Incentive schemes are used for field agents based on a mix of target for portfolio values, number of new and repeat loans and on-time repayment record.	**S :** Incentive pay based on efficiency motivates agents to reach out more potential borrowers and insures that loans are sound and repaid.
Self-regulation	⇒ An expert board of directors, well formulated and implemented internal and external control and risk management policies insure the soundness of the MFI	**S & P :** Sound self-regulation practices reduce external controlling costs, increase safety of members' deposits, and help build local capacity to managing funds and investment practices.

[Churchill, 1997b; Gallardo, 1997a; UNDP, 1997c; Robinson, 1996; Yunus,1997]

In many countries, the financial infrastructure is formed by a variety of financial institutions of national and local outreach, each with its own comparative advantages for micro-financial services at the local level [Seibel, 1998]. Generally, MFIs can thus be categorized into:

(i) **formal institutions** which fall under the banking law, including agricultural banks, development banks, commercial banks, private shareholding banks, finance companies, leasing companies, and sometimes village or rural banks;

(ii) **semiformal institutions** authorized by some government agency, including saving and credit cooperatives, NGOs and various projects and programs; and

(iii) **informal institutions** beyond government control, including ROSCAs, community-owned fund-raising/credit arrangements and other types of self-help groups.

To fit the financial requirements of the micro-economy, existing financial institutions must adapt their cultures and processes to the sound practices described in Table 8 in a "*down-scaling strategy*", by adjusting their policies and processes in the following manner [Seibel, 1998]:

- **A delivery system which brings the bank to the people** by: developing branches and sub-branches; establishing part-time offices in villages and markets; offering mobile services through cars, motorcycles, bicycles, or on foot; and employing full-time or part-time agents to provide doorstep or other decentralized services;
- **A corporate culture that shows closeness and attention to the poor's needs** by: adapting the bank's material culture (appearance of buildings and offices, types of vehicles), and its social culture (dress code, language and quality of staff-customer relations);
- **Adapted and sustainable business and product policy** by developing customer-oriented banking (timely delivery and collection services, doorstep services, daily saving collection), seeking cost coverage (improving the efficiency of operations), and aiming at self-reliance (through the mobilization of their own funds);
- **Bank procedures to easily communicate with customers** by: simplifying forms and procedures, maintaining convenient facilities and banking hours, developing customer-oriented services, adjusting collateral requirements to the needs of small customers;
- **Terms and conditions adapted to local needs**: small sizes of saving, loans and installments with different terms according to business risk, cost structures and repeat loans;
- **Risk management and crisis prevention** can be achieved by: adapting loan terms to investments, using non-formal collateral practices and relying on a borrower's track record

based on saving and previous loan repayment; insisting on timely (re-) payment, keeping a solid equity capital base and a conservative capital equity ratio, relying on internal resources rather than government or donor funds, adhering to obligations, including legal action against defaulters, monitoring portfolio quality and the value of collateral;

- **Human resource development and training system** must be based on selecting staff with particular language and social skills, and including customer-oriented social behavior, micro-loan appraisal and arrears prevention in the training curriculum.
- **Status:** National development banks' small farmer and microenterprise lending operations can be privatized into member-owned or community-owned local banks or semiformal financial institutions, or private shareholding banks [Seibel, 1998].

Box 1 : Bank Rakyat Indonesia (BRI) Unit Desa: an agricultural development bank with sustainable microfinance operations

With the 1983 requirement that rural banks charge cost-recovery rates, the Unit Desa (village units) of the BRI - the largest formal provider of rural credit in Indonesia - evolved from being a conduit providing subsidized rural credit in the 1970s, to becoming a network of full-services rural banks in the mid 1980s. As of 1984, all of the village units were turned into autonomous profit centers, offering positive margins on deposits that allowed them to offer incentives to mobilize resources from depositors, and laid the ground work for the creation of a viable rural banking system [Churchill, 1997a].

With this model, BRI became one of the most successful rural-mandate banks in Asia-Pacific. With liquidity first provided by the World Bank, BRI broke even in 1990: fully mobilizing its loanable funds through village-level saving and generating excess resources thereafter. Since then, BRI's Unit Desa network has been completely self-reliant (mobilizing its own resources) and viable (covering its costs from the margin and making a profit). Between 1984 and 1996, 18.5 million loans were made, with repayment rates over 96%, and consolidated profits amounting to US$177million in 1996, or 10.4% of loans outstanding [Seibel, 1998].

BRI, with 3,482 village units at end 1995, outperformed the totality of 1,948 formal and 7,413 semiformal MFIs, mobilizing Rp6.02trillion (tr) from 14.48m savers compared to Rp1.45tr mobilized by 9,361 MFIs from 4.60m savers; and providing Rp 3.19tr to 2.26m borrowers, compared to Rp1.88tr provided by MFIs to 2.45m borrowers. As of 31 Dec. 1996, BRI served 2.49m borrowers with a total amount of loans outstanding of US$1.71billion (b.); and 16.17m depositors with saving balances of US$2.97b. The ratio of borrowers to savers of 1:6.5 is an indication of the strong demand of rural people for deposit facilities, far in excess of the demand for credit.

BRI has demonstrated that in a deregulated policy environment, a government-owned agricultural development bank is capable of serving vast numbers of micro-savers and micro-borrowers at market rates, mobilizing its resources internally, covering its costs, and financing its own expansion. It has proven that institutional viability, sustainability and outreach are compatible [Seibel, 1998].

BRI's success can be traced to a number of factors:

- Developing financial instruments designed/priced specifically to meet local demand/return profits;
- Simple, transparent accounting and reporting procedures;
- Treatment of each village unit as a profit center, with its own profit/loss statement and balance sheet;
- Attention to the appropriate timing and sequencing in building the village unit system;
- Creation of specialized staff training and incentive systems that emphasize responsibility at unit level;
- Decentralized management structure;
- Knowledge of local markets;
- Respect for and close relations with the units' predominantly rural, lower-income clients;
- A well-designed and implemented supervision process.
- BRI Supervision of the Unit Desas [Churchill, 1997a].

3.2.4 Needs and Strategies to create an Enabling Operating Environment for MFIs

The actions of MFIs have proven to be instrumental in long term poverty alleviation. Yet, those institutions do not operate in a vacuum; their operations are facilitated or hindered by an operating environment that affects their ability to deliver appropriate services in a financially sustainable manner. This environment is made of the rules and mechanisms that facilitate the allocation of funds where they are needed and secure the investments of the depositors. On the micro-entrepreneurs' side, the environment might (not) be conductive to taking loans for productive micro-investment because of (in)security of investment or (dis)trust in the banking system.

This section exposes the needs and constraints faced by MFIs to operate sustainably and provide micro-entrepreneurs with adapted financial services, and introduces examples of government interventions which can facilitate their operations. Although there is not a single model of enabling environment, the selection of international examples presented forms a sound benchmark to analyze the Vietnamese environment and derive policy implications.

a. Basis for Regulation: Needs and Risks of MFIs - Is regulation worth its cost?

To ensure outreach, sustainability, and effectiveness in promoting human development, MFIs need to cover their operating costs, while being able to develop loans and services adapted to their clients, and to insure access to financial resources at the best cost.

The basis to fulfill those needs is the flexibility to charge for the true costs of the services offered (covering fixed and variables costs and including an adequate profit margin to motivate the bank to serve customers who differ widely in terms of service costs and risks), as well as to remunerate deposits at an attractive rate to mobilize local financing. This rate cannot be fixed by a central authority, irrelevantly of local costs and availability of capital [Seibel, 1998].

On the clients' side, the pre-requisites to entrusting any financing institutions with deposits are that saving incur minimum risks and can easily be withdrawn, and that the institutions be perceived as part of the local community (hence the importance of local ownership).

Box 2 : Needs and constraints of micro-entrepreneurs to operate & access adapted financing

From the poor's perspective, there are three main requirements to micro-financial services:

(i) *availability* - proximity of banking institution, quick extension of credit and possibility to withdraw saving immediately;

(ii) *adequacy* - services must be adapted to local business needs, e.g. loan amounts and terms must fit with capital requirements and investment payback period; and

(iii) *safety* - one must be sure that saving will not 'disappear' from the saving fund.

All aspects are important and linked: for instance, without trust in the banking institution, no saving will be mobilized (hence a shortage of funds to lend on); if services are not customized to local needs (e.g., if everyone receives the same credit amount and terms) some businesses will fail, thus undermining the stability of the local MFI; if the MFI is not closely associated with the community (e.g., not using locals as loan officers) it cannot build the needed trust and extend services adapted to the local needs.

An important constraint though to applying for 'formal' micro-lending is the legal status of micro-enterprise and the potential administrative burden attached to running a formal business.

While most micro-enterprises operate in the informal sector, developing access to micro-financing services means that the informal sector is somehow 'formalized'. Thus enterprises might have to comply with business licensing requirements, zoning rules and regular tax reporting to be eligible for financial services. Yet, such requirements create disincentives for many of the illiterate poor to invest.

Combining the poor's requirements for financial services with an enabling business environment for the development of micro-enterprises suggests that, along with allowing MFIs to deliver appropriate services on a financially sustainable basis, the government should consider specific sets of business laws and regulations (associative structures, tax, responsibilities) adapted to the size and requirements of very small enterprise which can evolve over time with the size of the business (e.g., a micro-business could be legally recognized at its creation, but exempted from licensing and tax reporting for a given number of years, until it 'graduates' to become a small to medium size business, at which point it may fall under more formal requirements). These business rules of conducts must be simple and clear and not leave room for corruption in understanding their implications. They must be accompanied by an effective (i.e., enforced) rule of law so that claims and disputes can be settled in a predictable fashion [Fforde, 1995].

The objective of regulating MFIs is thus to let only the most trust-worthy institutions operate while leaving them enough flexibility for adapted operations. While sound practices of micro-finance call for interest rate deregulation and a freedom for MFIs to adapt to local conditions, regulators must ensure that barriers to entry in the micro-finance sector are not so low that unviable (or even dishonest) financial institutions flood the market.

Yet, traditional regulating and controlling mechanisms are not always adapted to the needs and requirements of micro-enterprises and MFIs[10]. To develop an enabling operating environment, it is therefore important to understand the specific risks associated with MFIs that the framework must regulate and which may differ from those of mainstream banking.

[10] For instance, the loan portfolio of MFIs is made of numerous small accounts, which naturally diversifies portfolio risk (while it is not the case for regular banks with larger loans).

Table 9 : Specific Risks associated with MFIs that regulatory systems must deal with

***Ownership and Governance risk** - donors are often from a non-profit, socially-oriented sector*
⇒ **Management may not have the capacity to oversee micro-financial operations** or may be pressured by social goals - e.g., in case of NGOs not dedicated to the provision of micro-financial services - either due to the nature of their main action, or from influence from politicians or funding agency.
⇒ **Ownership and organizational structure may be unclear** between the social and financial activities of a given development organization, thus mixing accountability for results. Questions arise such as "if managers are paid by an NGO both for social work and for heading a saving and credit scheme, what is the transfer price to charge to each activity to keep it accountable for results?"
⇒ **Sufficient financial depth may not be available**. While MFIs may need to raise capital quickly - e.g., in case of currency devaluation - the process of obtaining funds from the initial funding agency may be time consuming and may jeopardize the financial health of the institution.
***Management risk** - MFIs have decentralized operations, high volumes, and low returns per loan*
⇒ **Decentralization of important responsibilities can lead to fraudulent practices** if internal control are not sufficient - e.g., charging extra costs, un-accounted for in the price of the loan.
⇒ **Management must be able to promptly re-lend funds** to generate profits, as MFIs operate on services that have low return per operation - this requires professional financial management.
⇒ **Effective Management Information System is primordial** to timely and reliably keep track of portfolio information essential for effective MFI management - e.g. to know when a payment is due and act immediately upon delinquent loans.
***Portfolio risk** - risks are different from these encountered by regular commercial lending institutions*
⇒ **Most micro-lending is unsecured** by a regular collateral. It relies on social pressure from group members and thus particular attention must be paid to the unity and efficiency of the groups.
⇒ Management should be particularly aware of the **risk associated with delinquency**. Delinquent payment can quickly dry up funds available to loan and should be tackled quickly.
⇒ There is a potential **sector or geographic concentration risk** if an MFI lends to a market segment particularly vulnerable to a common threat - e.g., a flood which may ruin all crops in a community.
***New industry risk** - due to relatively new industry and new services for the clients*
⇒ Difficulties to **attract knowledgeable and competent managers** in small-scale lending activity.
⇒ MFIs typically witness **very high growth rates** - they must manage growth by quickly training staff and developing standard policies and procedures while maintaining portfolio quality.
⇒ **Development of new, adapted product is always risky** - failure may be especially costly for MFIs.
⇒ **Lack of empirical knowledge about the performance of new markets** makes projection difficult - when no financial service has ever been extended and people are not used to personal financial planning.

[Berenbach and Churchill, 1997]

Most MFIs though are small and informal and operate as voluntary associations at the local level, and it might not be necessary to regulate them[11]. Besides, regulating an existing MFI sector is complicated by significant differences in institutional types, scales of operations, and level of professionalism between all MFIs (they may be ROSCAs, village banks, national or regional NGOs, credit cooperatives or national banks, and may be private or government-owned). The number and diversity of such institutions makes it neither feasible, nor desirable to regulate them all (costs of on-site audits and regular monitoring of activities would be prohibitive, and too rigid regulations may prevent small MFIs from using locally-adapted methods). Therefore, regulators should direct their attention to large-scale MFIs that offer deposit-taking services to the general public (for the purpose of on-lending). Hence, at the infant stage of the micro-finance industry, regulation may only apply to a few major players [Churchill, 1996].

Although most regulatory and supervisory agencies do not have the capacity or the resources to monitor small institutions that do not pose a threat to the integrity of the financial system, it does not mean they should ignore developing an appropriate set of regulatory devices for the micro finance industry. Developing a country's appropriate set of financial laws and regulatory institutions is an incremental process and adapted rules must exist when more of the small-scale MFIs graduate from the infant stage, start to expand their outreach and lines of services, and need to mobilize local saving. Initial steps should thus at least be taken to research the most locally-adapted regulatory devices, independently from the development stage of the micro-financial market of a country [Berenbach and Churchill, 1997].

[11] Small local MFIs based on common bond (such as ROSCAs and village banks) are small enough so that all members know each other and that no regulation concerning deposit mobilization be needed.

b. Developing micro-financial strategies - the *Regulatory Reform Approach*

Improving the effectiveness of a micro-financing system goes through three inter-related approaches: (i) improving the policy and regulatory environment framework in which MFIs operate (*the regulatory reform approach*); (ii) improving the financial infrastructure and the micro-economy's access to it (*the institutional transformation approach*); and (iii) improving the efficiency of existing MFIs (*the sound practices approach*) [Seibel, 1998].

The characteristics of sound institutions and of sound practices have been presented in part 3.2.3. This sub-section reviews the regulatory reform approach of MFIs' environment, supported with examples that give a basis for comparison with the Vietnam case.

Three main components of a necessary regulatory environment are: (a) deregulated interest rates to allow MFIs to structure their interest rates to cover the high costs associated with serving marginal clients in remote areas, collecting micro-saving and micro-installments, and offering doorstep services; (b) a banking law adapted to the needs of MFIs to establish a wide network of branches of different sizes (thus a variety of legal forms for financial institutions with different capital requirements); and (c) an appropriate supervision system for MFIs, in the interest both of the institutions and their customers [Seibel, 1998].

The extent to which the micro-finance sector ought to be regulated depends mainly on the risks associated with the deposits taken by the MFIs. Obviously, the "moral hazard" (i.e., the risk that management misuses depositors' funds for its own benefit) increases with the size of deposits, and so does the need for external regulation [Churchill, 1997a]. Accordingly, the four main options for regulation by a central bank or its agent have ranged from *a complete lack of external MFI regulation* (at infant stage of the formal micro-financial market) to *the creation of a specialized regulatory framework for MFIs* (when the micro-financial market turns "commercial" and attracts large deposits), as presented in the four following points:

(i) No external regulation: Historically, as micro-finance has evolved outside of a regulatory framework, it has been free to develop non-traditional approaches to providing financial services. This approach has allowed the Grameen Bank of Bangladesh to pioneer most of the techniques used by formal MFIs worldwide. Yet, as the microfinance industry matures and mobilizes more saving, some regulatory oversight becomes necessary to guarantee members' saving and, in some countries, MFIs have established associations to initiate a formalization process (e.g. through defining sound practices and industry standards) of MFI practices [Churchill, 1997a].

Box 3 : The absence of MFI-specific regulation allows flexible approaches but limits market entry

1. Pioneer work: the "light hand" of regulation allows the Grameen Bank to innovate

The Grameen Bank has evolved from a university initiative - designed to grant the unbankable poor access to financial services - to a Chartered Institution pioneering many of the sound practices replicated by MFIs around the world.

Given Grameen's need to raise capital and collect deposits to finance its lending activities, it needed a formal and legal bank status. In 1983, the Bangladesh Parliament adopted an ordinance that described the formation of the institution, its management and governance structures, supervision, ownership structure, and functions, effectively serving as Grameen's articles of incorporation and major policies.

The requirements of this ordinance followed the standard prudential and supervisory requirements needed to grant a banking license - including restrictions on permitted business activities and limitations on certain risks, capital adequacy requirements, limits on ownership by any one party, liquidity and cash reserve requirements, information disclosure through periodic reporting to the central bank, and strict limits on insider and related lending that might put the bank at undue risk.

Once granted the right to operate as a conventional bank despite its unconventional profile (i.e., lending to the poor with all the - real and fancied - risks associated to this activity), Grameen enjoyed the "light hand" of the central bank of Bangladesh which did not intervene in the operation of the Bank and has allowed Grameen to operate with minimal restrictions and to continue its innovations and growth: no regular reports on portfolio quality, costs or profitability are required, and Grameen only submits a brief annual report with audited financial information. The main government oversight occurs through its participation to the board of directors - for it owns shares of Grameen - and the power given to the Bangladesh Bank to revoke Grameen's charter (which motivates Grameen to develop adequate internal prudential and regulatory systems to avoid financial disaster).

This one-time approach to regulation has allowed an efficient and strong-willed bank to develop, but has not set up a system for regulating other MFIs. By now, the only way an MFI can become a formal regulated institution in Bangladesh is by meeting the standard requirements of a commercial bank in terms of minimal capital, capital adequacy, and liquidity standards. The system does not consider the specific risks and needs of MFIs, and MFI managers and donors are specifically concerned with the issues of: (i) creating financial reporting guidelines for consistent, accurate and transparent reporting from MFIs so outsiders can make meaningful comparisons and informed decisions; (ii) establishing minimum standards for financial condition and financial performance to prevent MFIs from putting depositor funds at undue risk; and (iii) developing appropriate regulation and effective supervision mechanisms.

2. Learning from the grassroots to develop adapted regulatory devices in the Philippines

Evolving from a similar situation of absent regulatory device, the Central Bank of the Philippines has started a participatory process of surveying the existing (mostly informal) micro-financial practices and institutions, to understand their specific needs and the requirements for an adapted regulation of their activities. Along with the increased dissemination of sound practices for the design and management of sustainable MFIs, this process should form the basis to develop a regulatory framework more adapted to the needs and constraints of MFIs than that used for mainstream commercial banking [Churchill, 1997a]

(ii) Hybrid Approach between self-regulation and external supervision: An hybrid approach occurs when the main financial regulatory body (often the central bank) contracts a third party (e.g., an accounting or consulting firm) to perform some or all of the supervisory functions, i.e. to ensure - through regular audits - that MFIs meet self-imposed standards of financial reporting and performance analysis. This approach assumes that financial results are fully published and that clients can make a rational choice of financial service provider [Churchill, 1997a].

Box 4 : Case of MFI supervision in Indonesia: BRI, hybrid approach and limitations of lax regulations

During the 1980s and 1990s, Indonesia enjoyed all factors that facilitated the development of a wide network of sustainable MFIs: high growth of output and of rural incomes (micro-investment opportunities emerged with the deregulation of domestic markets and the lowering of international trade barriers), a stable macro-economic environment (limited inflation and political stability), a high degree of social cohesion (particularly beneficial to group-lending mechanisms), and the promotion by the government of financial institutions offering services to the poor at market prices.

In 1988, the establishment of new banks and the opening of branches was eased by a new rural banking law permitting the establishment of rural banks with capital requirements lower than that of regular banks (equivalent to US$24,100 vs. US$4.82m).

Thanks to this enabling environment, from 1983 and 1990, BRI Unit Desa's saving mobilization increased 6.7-fold and bank loans outstanding 6.4-fold, and between 1990 and 1995, saving increased 2.5-fold and bank loans outstanding 2.4-fold (Box 1 presents BRI Unit Desa) [Seibel, 1998].

To supervise the 16,000 MFIs created under this environment, Bank Indonesia (BI - the central bank) entered into a third-party arrangement with various agencies for the direct supervision of MFIs (for on-site audits), while MFIs were responsible for their own indirect supervision (through operation reports to BI):

- By end 1996, BRI- supervised 3,581 of its own Unit Desa and 5,435 Village-Owned Banks in which officers conducted weekly unit visits to review the reports submitted, and to ensure their veracity
- Provincial Development Banks supervised the 6,131 units of Provincial Village Banking Networks
- BI supervised 1,000 Private Village Banks

Supervisory actions include simplified procedures to report on elements of prudential control, standard management, and financial controls[12] as well as regular achievement contest between units (e.g., on meeting targets for profitability, client growth, loan portfolio and deposits increases. Procedures to avert potential fraud comprise dual controls when handling loan disbursement checks, limited cash retained in village units, and the dismissal of staff involved in collusion or fraudulent practices [Churchill, 1997a]..

Important lessons learnt from the Indonesian supervision of MFIs are: (i) the viability of third party prudential supervision to verify accuracy of data, monitor financial controls, and ensure adherence to bank regulations for institutions that provide saving services to the low-income market; (ii) the possibility for saving facilities to meet their cost of supervision, even with average deposit sizes under US$5; and (iii) the importance of simplifying and standardizing the supervision process [Churchill, 1997a].

During the Asian financial crisis of 1997 which led to a bank run, the collapse of the Rupiah, soaring inflation, massive unemployment, and political instability, weaknesses appeared in Indonesia's supervision of regular commercial banks, when the extent of politically instigated lending became public. Yet, microfinance was least affected, indicating that at the local level, MFIs were more successful in sound banking and the avoidance of political influence [Seibel, 1998].

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[12] E.g., performance indicators are ranked by color-coding: on-time repayment is ranked positive (green) if less than 2% of the portfolio is in arrears; poor (red) status is assigned for those with delinquency of greater than 4.5%; and satisfactory (yellow) rating is provided for delinquency in between [Churchill, 1997a].

(iii) Regulation through the existing legal and regulatory framework: Some countries regulate MFIs with the existing framework used for formal financial institutions, adapting required ratios and practices to address MFIs' unique risk profile. MFIs can apply for a standard banking license if they meet all the requirements for a commercial bank. Stringent requirements ensure the viability of the MFI, but place high barriers to the formalization of small-scale incumbents (such as NGOs). Yet, some development financial institutions in Bolivia have thrived under the regulatory oversight imposed by commercial bank status [Berenbach and Churchill, 1997].

Box 5 : The creation of BancoSol under the Bolivia Law on Commercial Banks

In 1992, Banco Solidario, (BancoSol) entered the Bolivian regulated financial sector as the first private commercial bank exclusively dedicated to providing micro-financial services to the poor.

In meeting the requirements to become a commercial bank, it confronted an array of regulatory issues and was a test-case in the applicability of banking regulations to MFIs:

- 1988: PRODEM is a joint-venture between Bolivian businessmen (contributing seed capital and leadership) and ACCION International (an NGO bringing technology and methodology). PRODEM is an NGO providing micro-financial services to the poor.
- 1991: PRODEM has accomplished many characteristics of a successful MFI — visionary leadership and clarity of purpose provided by its board of directors, rapid growth, achievement of operational and financial self-sufficiency, and high portfolio quality. However, it reaches less than 3% of the potential market. Access to funds is its limiting factor. Donor funds cannot keep pace with PRODEM's ability to expand and PRODEM's local commercial capital supply of US$710,000 in 1991 cannot support the US$2 million per month lending pattern. As an unregulated NGO, it cannot rely on the potentially much larger voluntary saving of its clients and the public [Churchill, 1997a].

The process of formalizing PRODEM into BancoSol started in 1989 when local businessmen created a committee to manage the planning and transition process. They had to fulfill the requirements for entering the formal sector as a regular banking corporation would, by (i) raising the minimum capital; (ii) fulfilling legal and technical requirements; (iii) detailing financial information about the owners and experience of the managers; and (iv) demonstrating operational capability to the Superintendency.

- 1991: the committee has raised US$5 m. of equity financing, US$1.8 m. over the required minimum (35% from PRODEM's portfolio, 19% from Bolivian investors, and 46% from external foundations)
- 1996: BancoSol is a financial intermediary that operates profitably and funds approximately 25% of its loan portfolio by saving mobilization (the rest is funded through inter-bank loans and equity). Its clients represented 40% of the banking customers in Bolivia [Churchill, 1997b].

The supervisory structure requires all Bolivian financial institutions to submit reports for off-site monitoring of bank's operations which serve as an early warning system in case of problem:

- *Daily*: funds captured; average interest rates
- *Weekly*: inter-bank operations; reserve requirement; total deposits by contractual maturity
- *Every 10 Days*: liquidity levels
- *Monthly*: Credit bureau; financial statements; fluctuations in share price; risk-weighted asset report
- *Quarterly*: Changes in financial situation; changes in equity; notes to financial statements; statement of institutional compliance (regarding labor laws, taxes, etc.); quarterly financial information
- *3 Times / Year*: loan portfolio classification; board meeting minutes; breakdown of deposits by size; liquidity management policies
- *Yearly*: external auditing report; published audited financial statements; annual report; published list of shareholders [Churchill, 1997a].

(iv) Regulation through MFI-specific regulations: Some countries have created a distinct legal status and regulation for non-bank MFIs, which has evolved through the adaptation of an existing mainstream banking law to the specific requirements of MFIs. In some cases, these institutions are supervised through a separate unit within the central bank or delegated supervisory authority [Churchill, 1997a].

Box 6 : Characteristics of the new Bolivian regulatory framework for MFIs

After the creation of BancoSol, Bolivia has been particularly innovative in the regulation and supervision of microfinance and its regulatory environment has encouraged significant competition of the financing market.

In 1995, a decree was enacted as part of an overall policy to strengthen the private banking system which regulates the incorporation and operation of the Private Financial Funds (PFFs), non-bank financial intermediaries designed to serve the small business and microenterprise sector, which only PRODEM and Banco Sol were then serving, but with limited outreach [Churchill, 1997a].

PFFs are corporations with a minimum of US$1 m. of equity (vs. US$3.2 m. for a regular bank) who can provide most financial services of regular banks (lending, saving, leasing, drafts payment orders, and foreign exchange operations). They are subject to the Law on Banks and Financial Institution and must have professional managers with extensive experience serving the small business and microenterprise sectors [Churchill, 1997a]. Although no figure is available on the total outreach of the PFFs, the Bolivian operating environment for financial institution is given as an example of sound practices that gathers all elements necessary for the development of an efficient environment for MFIs to serve the poor.

A liberal banking law...

- No interest rate ceilings
- No directed credit mechanisms
- Legal reserves set at minimal percentages above which central bank remunerates funds so set aside
- The scope of banking supervision includes all non-bank financial intermediaries and companies that provide services to the financial system
- Minimal capital requirements denominated in bolivianos equivalent to a constant international unit of value, the Special Drawing Rights of the IMF
- The minimum operating equity of financial intermediaries is determined by international standards.

... which limits risk exposure through restrictions

- Market entry criteria based on a rigorous review of the solvency and capabilities of the founding shareholders
- Loans to a borrower or borrower group may not exceed 20% of the intermediary's net worth
- Loans to a borrower or borrower group may not exceed 5% of the intermediary's net worth, if these loans are not guaranteed
- A total loan portfolio without guarantees may not exceed twice the net worth of the financial institution
- Loans cannot be made to borrowers or borrower groups related to the lending institution.

Banks are required to publish periodic income statements and balance sheets according to the bookkeeping system and asset valuation determined by the central bank[13] [Churchill, 1997a].

[13] Auditing is based on past performance and uses Generally Accepted Accounting Principles (GAAP).

c. Other elements relevant to developing appropriate regulation:

(i) Self-regulation: External regulation must be completed by an efficient self-regulation of MFIs who must strengthen their institutions to develop their own supervisory and governance bodies and share financial information on a consistent basis. Effective self-regulation is guaranteed by (i) an independent board with the technical expertise and authority to hold management accountable; (ii) well-formulated and properly implemented internal control and risk management policies; and (iii) external auditors knowledgeable and competent in microfinance as an objective check on internal systems to protect against fraud and mismanagement. Self-regulation is only possible if these elements are combined with transparent disclosure [Churchill, 1997a].

Box 7 : A Kenyan example of sound internal practices that promote efficient self-regulation

In Kenya, K-Rep, a micro-enterprise development NGO created in 1984, was successful in becoming a private commercial bank in June 1997 with a capital of nearly US$6 m. To prepare its transition process from an NGO status, it learnt from international experience and was careful in developing strong internal skills along with "educating" external decision-makers about the needs and requirements of MFIs, which were new institutions in a country in which the regulatory system was conceived for regular banks.

K-Rep managed its self-regulation by developing:

- **Strong management skills:** K-Rep has attracted and cultivated an experienced management team and a capable group of directors that complement management and has implemented internal policies. procedures, and controls that will make compliance with bank financial and performance reporting requirements less onerous. Management was able to use outside expertise effectively (when specialized assistance was needed) and to communicate with and mobilize staff support (to manage the "cultural evolution" during the transition from an NGO to a for-profit bank [Churchill, 1997a].
- **Education of key decision-makers about microfinance:** K-Rep brought its own management and representatives of the Kenyan central bank to Bolivia to meet with Bolivian bank regulators and see BancoSol. This visit helped the Superintendent understand how micro-finance is similar to traditional banking, it unique risks, practical approaches to mitigate those risks, and how micro-finance could fit within the existing bank regulatory structure [Churchill, 1997a].
- **A pool of experienced investors committed to establishing a sound institution:** Each investor has a long-term commitment to the organization, and brings a particular area of expertise that complements the skills of K-Rep's management. The cooperation between its investors has helped K-Rep design an appropriate legal structure and ownership arrangement to achieve its long-term goals.

The transition to a formal financial institution had many benefits for K-Rep and few costs. It benefits from introducing investors/owners into the governance and oversight structure who bring a new focus on cost-effectiveness. Besides, it created a clear separation between the social side of the NGO and the new formal bank, each focused on its own activities and with its own performance measures and accountability, yet with some coordination through the linked boards of directors. [Churchill, 1997a]

This, and other international experience suggest that the most effective forms of financial regulation are those that create incentives for institutions to develop strong risk management policies and internal controls [Churchill, 1997a].

(ii) Transparency : Aside from the need for efficient information flow, transparency can be only achieved meaningfully by using a rating agency for MFIs to consistently monitor and publish their performance indicators, thus showing the MFIs credit-worthiness to potential commercial investors. The creation of such a rating agency would enhance access to commercial sources of capital for the MFIs, establish the legitimacy of the microfinance industry and serve as an important link to investors in the capital market [Churchill, 1997b]

Box 8 : Developing a rating system for MFIs and making relevant comparisons

To assess the quality of MFIs despite their wide range of services, reporting and management practices, a pilot system in Latin America (*Sistema Calificador por Microcredito* - SCM) has developed a rating system summarizing in three reports the quality of an MFI. The reports consist in :

- a set of comparative financial statements with adjusted numbers to produce peer group comparisons;
- a fact sheet that supplements the financial statements, including details such as the number of borrowers, the average loan size, and the incentive scheme;
- a narrative profile of the institution.

The rating agency will publish the reports on these MFIs to insure transparency of the industry and develop more complete rating procedures as they obtain a critical mass of data by surveying more MFIs.

The C.A.M.E.L. scoring system,
a simple tool to produce comparable qualitative assessments of financial institutions:

- **Capital adequacy:** measures the extent to which an institution's capital base can absorb unexpected losses and the risks inherent in its business activities with three parameters: (i) an absolute minimum amount for new institutions; (ii) a minimum ratio between capital base and deposit liabilities; and (iii) a minimum ratio between capital and risk-adjusted assets.
- **Asset quality:** loans are classified according to risk (e.g., into *satisfactory*, *watch*, *sub-standard*, *doubtful*, and *loss*), with higher risk categories assigned minimum reserve levels to anticipate loan losses properly. Measured by ratios on loan loss provision, portfolio in arrears, loan loss and reserve.
- **Management:** Senior executives and the board of directors are assessed in terms of their ability to set policy and ensure that they are being followed. Indicators are: # of active borrowers per credit officer or management staff, # of portfolios per officer, cost per loan, or cost per unit of money loaned.
- **Earnings strength:** Earnings must be sufficient and reliable for an organization to absorb loan losses without eroding capital, and to finance capital growth to support increase in assets. Earnings are measured by ratios on return per assets, on financial/administrative costs, and on self-sufficiency.
- **Liquidity.:** A minimum level of liquidity is needed to ensure that the institution can honor maturing obligations and withdrawals, and to ensure that sufficient funds are available to make new loans. Liquidity is measured by current ratio.
- **(Social Impact :** A non-conventional criteria that may be specific to micro-finance and measures the impact of the provision of the financial services upon borrowers' level of human development. It can be measured in terms of the proportions of poor/women/landless borrowers and of the evolution over time of these proportions) [Churchill, 1997a; Srivinas, 1997].

CAMEL systems are used for all sizes of banking institutions and, as was discussed in the previous pages, the minimum requirements and ratios for evaluating the quality of an MFI must be adapted to the specific needs and risks of MFIs. Definitions of ratios are presented in Appendices.

(iii) Regulation must be developed in cooperation with existing service providers

The best knowledge of a community's needs and constraints regarding micro-financial services comes from those in direct touch with the situation: informal money lenders, self-help groups, or NGO running micro-financial schemes. Both in researching the most adapted practices to deliver micro-financial services and in regulating the operations of formalized institutions, those actors should be integrated with external efforts to insure the relevance of the concepts and rules developed and work in synergy with a system with broad outreach to lower costs.

Box 9 : Local informal lenders as partners for research on and implementation of adapted policies

In opposition to a common belief, money lenders are not all loan-sharks who live off the poor and maintain them in a dependency circle by controlling access to all productive needs and developing a system of clienteles. Many informal lenders are successful farmers in the local community and self-help groups (SHGs - such as ROSCAs) who lend at affordable rates to the otherwise unbankable poor.

Thus, when developing rural financial systems, there is much to learn from the traditional (informal) money lending practices. All lending circles have unwritten rules of conduct, and respond to particular community needs and constraints that may easily be overlooked if an MFI simply tries to apply imported "best practices", without adapting them to the local customs. For instance, in terms of delivering the micro-financial services, in many remote community where there is little hope of ever installing a profitable branch of an MFI, or where agents from branches would not be able to travel, informal money lenders and SHGs can very well be the most appropriate delivery agents.

Linkage strategies can thus be thought of between banks and farmers/micro-entrepreneurs. They can use local money-lenders and self-help groups as grassroots financial intermediaries to cut down on transaction costs for both banks and customers. Learning from the field, they can help local communities strengthen their practices by adopting international sound practices to build a sustainable local MFI. In the long term, those strategies can also help the local informal MFI upscale into formal institutions, with the advantages of obtaining access to larger financing capacities [Seibel, 1998].

The case of India in successfully linking banks and self-helpgroups

Along the 1980s NABARD, the National Bank for Agriculture and Rural Development in India provided US$2b in subsidized credit through 150,000 lending institutions for 49 million rural households. It experienced dismal repayment rates, was out of reach for many poor and profited otherwise bankable borrowers. The subsidized approach undermined MFIs' saving mobilization and institutional self-reliance.

Starting in 1987, NABARD adopted principles of (i) working through existing institutions - banks, SHGs and NGOs; (ii) institutional autonomy - participating institutions working out their own terms and conditions; (iii) institutional viability - through cost coverage from the interest rate margin; and (iv) self-reliance - through local saving mobilization. From 1992 to1997, the number of participating SHGs grew from 255 to 8,598: 13% of them linked directly with banks without facilitation by NGOs, 45% linked with banks with NGOs as facilitators, and 42% linked with NGOs as financial intermediaries.

The Reserve Bank of India (RBI) has declared linkage banking a regular banking program in India, authorizing banks to lend to unregistered SHGs, and SHGs to accept saving deposits from their members. RBI has also moved away from interest rate regulation. The interest spread of participating banks and NGOs averages 5.5% p.a. - SHGs charge around 2% per month to end-users (vs. standard moneylender interest rate of 10% per month) and re-invest the interest earnings into the SHG loan fund, thus increasing access to credit from their own internal resources on an augmenting scale.

Despite its still limited size, the program has shown remarkably successful features worth emulating: a considerable increase in rural saving; a reduction in bank transaction costs by 40%; a substantial reduction in borrower transaction costs; and a near-100% repayment rate [Seibel, 1998].

3.3 Policies and Planning Tools to Create an Enabling Environment

The essence of the lessons learnt from international experience is to consider the risk profile of MFIs and rigorously apply prudential guidelines where MFIs are vulnerable while recognizing the risk control measures that do not apply to the micro-finance sector. Effective regulation can be accomplished through exemptions and modifications to existing financial sector guidelines or through the establishment of specialized regulatory regimes. Regulation must be based on a careful consultation with existing (formal or informal) providers of micro-financial services so that regulations do not box MFIs into replicating traditional banking practices, thereby losing their ability to reach their target markets [Berenbach and Churchill, 1997]. Table 10 presents some specific regulatory measures that can be implemented to insure a prudent external and internal regulation of the risks associated with MFIs.

Box 10 : Elements that define the local operating environment

Providing adapted financial services to local communities requires a sound understanding of the existing practices and framework for (informal) financial activities. It is only by first understanding the way the local operating environment works that formal MFI can develop useful services that are well-integrated in the local economy [UNDP, 1997c].

- **Informal sector practices :** traditional sources and methods used by the community to access credit and accumulate saving - ROSCAs, moneylenders, suppliers, and other providers of financial services - must be well researched and understood;
- **transportation and communications Infrastructure :** the condition of roadways, transport, and rural phones impact the easiness of service delivery and timely information transfer;
- **geographic profile :** if communities are far from headquarters, efficiency is reduced;
- **regulations :** banking laws, interest rate regulations, or business registration may restrict ability to lend or take saving;
- **macro-indicators :** level/evolution of inflation/economic conditions must be stable & predictable;
- **language and literacy :** illiteracy or multiple languages within a community or region may impede effective communication and loan delivery system;
- **gender issues :** concerns on gender roles and needs of women and men, right for women to own property or sign for loans, level of resources controlled by women, and other main constraints facing women in terms of improving their lives must be well integrated in MFIs policies;
- **cultural norms :** Some social norms may discourage borrowing, or group formation. Customs must be used at best by MFIs;
- **financial sector involvement :** Local banks/government may be involved with MFI for strategic alliances to provide capital to on lend to borrowers;
- **other collaborative Institutions** - other NGOs, credit unions, governmental, cultural, social or religious institutions may help promote MFI services.

Table 10 : External and internal regulatory measures to address MFIs' risk profile

Ownership and Governance risk *- donors are often from the non-profit, socially-oriented sector*

Management may not have the capacity to oversee micro-financial operations

⇒ **Regulators should encourage the participation of local private investors** who can provide sound business directions and be a good source of local governance if their capital is at stake in the MFI.

⇒ **MFIs benefit from the participation of several significant shareholders who bring diverse background and perspectives to the governance process.** Diverse experiences in development-related and/or micro-finance bring a balance of experiences and qualifications among shareholders.

Ownership and organizational structure unclear between social (NGO) and financial activities (MFI)

⇒ **Financial operations must be separated from non financial activities** and relations between activities must respect transparency, arm-length transactions, honest transfer pricing and operational independence. Thus, the NGO can maintain clear identity and mission and the MFI can maintain an independent management of financial services and clearly account for its costs, revenues and profits. Business dealings between the NGO and the MFI must be included in required reports.

⇒ **MFI directors must be held legally responsible for providing transparent and sound supervision.** This requires developing standards in what constitute sound practices and manager's responsibilities.

Sufficient financial depth may not be available.

⇒ **Regulators can introduce measures to anticipate the limited availability of owners' resources to respond to additional calls for capital** by (i) increasing capital adequacy requirements; (ii) establishing additional reserve funds; (iii) limiting dividend distribution until capital benchmarks are reached; and (iv) requiring standby financial commitments by MFI owners.

Management risk *- MFIs have decentralized operations, high volumes, and low returns per loan*

Decentralized operations can lead to fraudulent practices

⇒ **Regulators should ensure that well-trained internal and external auditors are performing their responsibilities accordingly.** MFIs must maintain strong internal auditing capabilities to prevent and detect fraud and guidelines must establish the performance requirements of external auditors.

Management must be professional and maintain effective information systems

⇒ **MFIs should apply consistent financial service methodologies.** Supervisors can require MFIs to document their operating methods and to hold the organization accountable to their operating procedures. MFIs must maintain well-trained and supervised staff, keep appropriate reporting systems and communication systems so that uniform procedures and policies are adopted.

Portfolio risk *- different from that encountered by regular commercial lending institutions*

Most micro-lending is unsecured

⇒ **Regulators should accept flexible definitions for loan security that enhance repayment incentives** (such as guarantee of access to repeat loans and peer pressure).They should not require lengthy or costly application procedures and documentation for loans from clients.

Management should be aware of the risk associated with delinquency and sector concentration risk

⇒ **Adequate Management Information System must be developed and used** (e.g., portfolio risk can be evaluated by using statistical analysis and verifying results with random portfolio checks).

⇒ **Regulators should adopt standards to weigh the risks of MFIs' portfolios** . Encouraging the adoption of standard loan provisioning policies and loan classification procedures limits management discretion and allows to obtain an accurate and consistent assessment of portfolio quality.

New industry risk *- due to relatively new industry and new services for the clients*

MFIs typically witness very high growth rates

⇒ **Regulators should closely monitor MFIs that dramatically surpass the growth projections presented in the license application.** Experience has shown that rapid growth can lead to a deterioration in loan portfolio quality.

Development of new products and markets is risky

⇒ To profitably offer a large number of very small transaction, **MFIs should be limited to offering a limited number of products and services**, yet being allowed to offer new services adapted to local needs once profitability is demonstrated on the other products and services.

[Berenbach and Churchill, 1997]

4. FINDINGS - THE VIETNAMESE ENVIRONMENT FOR MFIs

This chapter presents the needs for developing micro-financing services in Vietnam through : a review of human poverty in the country and how micro-finance fits in a poverty eradication strategy centered on the people (4.1); and an analysis of the historical and current practices of MFIs and of their operating environment that points out some inadequacies of micro-financing practices and links them to inadequate characteristics of their environment (4.2). This analysis uses the framework for human development and sound practices presented earlier and leads toward the policy implications to develop an enabling environment presented in chapter 5.

4.1 Poverty and Micro-Finance : Assessment and Strategies for Human Development

4.1.1 Positive Impacts of *Doi Moi* on Human Poverty, and Remaining Disparities

Since the launch of the *Doi Moi* policy of decentralization of power and shift from a centrally-planned economy to a market-ruled system in 1985, there has been an estimated 35% reduction of poverty in Vietnam. The country has achieved a GDP growth of 9 to 10% in recent years, with budget deficits of around 1% of GDP and a single-digit inflation rate (down from triple digit). Yet, despite impressive macro-economic progress, poverty still affected between 20% and 51% of the population in 1996[14], placing Vietnam in the 84th percentile of the poorest countries in terms of *income poverty.* It has since then estimatedly decreased by a 3% annual average.

More qualitatively, Vietnam's Human Development Index (HDI) indicates a higher international ranking (69th percentile), based on longevity, knowledge and standards of living. This good qualitative ranking shows that, despite an enduring income poverty (1997 GDP of $240 per capita), Vietnam has made much progress in enlarging the range of options and opportunities the poor face. It has achieved a life expectancy of 66 years, an adult literacy rate of 95% and access to health service for 90% of its population, meaning that people can lead longer and healthier

[14] According to the Vietnamese General Statistical Office (GSO)'s interpretation of the figures collected during the 1992/93 Vietnam Living Standard Survey (VLSS), 20% of Vietnam's population was poor (using an income-based poverty-line equivalent to a per capita daily consumption of 2,100 calories - i.e., a yearly income of VND 600,000 in rural areas and VND 840,000 in urban areas). With a national average poverty line of VND 1,090,000 yearly per capita income, the World Bank for its part rated poverty at 51% of the population [Patten, 1996].

lives and obtain some of the basic means to thrive on their own. To break this measurement further down, the Human Poverty Index (HPI) ranks even higher than the HDI (42nd percentile), showing that *Doi Moi's* growth-oriented human development efforts are truly pro-poor. Hence, as measured by Vietnam's 1997 HPI, human poverty strikes 26.2% of the population [UNDP, 1997].

Table 11 : Comparing different measures of poverty in Vietnam : the HDI, HPI and GDP methods

Human Development Indicators			
Longevity	Life expectancy at birth (years)		66
Knowledge	Adult literacy rate (%)		95
	Combined 1st,2nd &3rd level gross enrolment ratio (%)		55
Standard of Living	(GNP per capita ($)		240)
	Real GDP per Capita (PPP$)		1,208
1997 Human Development Index (HDI) value			**0.557**
Human Poverty Indicators			
Survival	People not expected to survive to age 40 (% of total population) 1990		12.1
	Population without access to health services (%) 1990-1995		10
	Population without access to safe water (%) 1990-1996		57
Education	Adult illiteracy rate (%) 1995		5
Personal Security	People killed and affected by disasters (year average in thousands) 1969-93		1,579
Sustainability	Forested area (% change) 1980-93		-19.3
Income	Real GDP per capita (PPP$) 1980-94	Poorest 20%	406
		Richest 20%	2,288
	Population in poverty (%)	National poverty line	20
		World Bank poverty line	51
1997 Human Poverty Index (HDI) (%)			**26.2**
HDI rank	***121 out of 175 countries ranked***		***69th percentile***
GDP rank	***147 out of 175***		***84th percentile***
HPI rank	***33 out of 78***		***42nd percentile***
GDI rank	***101 out of 146***		***69th percentile***

Source [UNDP, 1995b; 1997b; WB, 1997]

As well, measures of equality in how the development of minority groups is affected by the overall improvement show that women benefit of an improved human development and are getting more involved socially and economically. The rank of Vietnam's Gender Development Index (GDI) is similar to that of its HDI (both at the 69th percentile of the number of countries rated), showing that human development for women equals that of men, a positive indicator when for many developing nations, women human development still lags far behind this of men. Despite improvements though, there remain marked disparities and if *Doi Moi* improved women's living conditions, they stay very much under-represented among politicians, planners and decision makers at all levels. As a proxy for a Gender Empowerment Measure (GEM, which focuses on actual woman economic and political participation and decision making and has not yet been calculated for Vietnam), a political participation rate of 19% (in terms of parliamentary seats held by women) remains modest for a female economic activity rate of 94% that of males.

Even more affected by disparities are Vietnam's ethnic minorities, who represent 20% of the population (i.e., about 15 million) and suffer the most both from *income* and *human* poverty. Table 12 points out some indicators of the inequalities that remain and which causes must be understood to define macro- and micro-policies that can improve the conditions of those who need the most from a more enabling environment [UNDP, 1997b].

Table 12 : Advancement of efforts against poverty and remaining disparities in Vietnam

PROGRESS	DEPRIVATION
Income and Poverty	
Income poverty decreased from 70% of the population in 1985 to a current level just below 50%	37 million people still suffer from income poverty. Average annual income p.c. is approximately US$240
Food	
From 1978 to 1994, Vietnam's food crop output rose from 238 kg to 361 kg p.c.	52% of children suffer from chronic malnutrition
Education	
Functional literacy is more than 83%	Illiteracy is un-equally spread : 88.8% of the illiterate live in rural areas, 47% in mountainous areas, and 70% are female. Only 57% of children complete a primary education
Urban Environment	
Urban family income is twice that of rural families	53% of the urban population live in non-permanent housing
Children	
Infant Mortality Rate (IMR) is about 36‰ live births, rather low for a developing country	In mountainous areas, the IMR can reach 75 ‰ live births
Women	
Recently married women want an average of only 2.3 children. Maternal Mortality Rate in 1993 was 66/100,000 down from 260/100,000 in 1989	90% of maternal deaths are preventable through improved prenatal care, risk factor screening, a referral system, availability of essential drugs and equipment, improved diagnosis and treatment
Health	
Real government spending p.c. in health tripled from 1986 to 1995.	57% of the population has no access to safe water; and an estimated 95% of the country's northern population is infected with intestinal parasites As many as 60K people may be infected with HIV
Natural Environment	
Vietnam is home to two recently identified large mammal species	Extinction rates are higher than the worldwide average. From 1943 to 1993, forest cover declined from 43% to 28% of the country.

[UNDP, 1997d]

Independently of the particulars, much of the remaining poverty in Vietnam is linked to five broad underlying and inter-related causes : (i) isolation; (ii) risk; (iii) lack of access to resources; (iv) lack of sustainability; and (v) inadequate participation. Isolation can be geographic (living off-road, without access to goods, services or information), or socio-cultural (ethnic minorities may not speak Vietnamese, nor accept Vietnamese rules). Risk can come from illnesses, unwanted births, poor crops, livestock deaths or natural calamities. Lack of access to adequate productive resources is the need for adapted labor, land, and capital. Unsustainable financial and environmental conditions come from the pressure of subsistence needs and the depletion of natural resources. Lastly, inadequate participation refers to a low involvement of the poor in planning and implementing decisions that affect their livelihoods [UNDP, 1995; UNDP, 1996a].

4.1.2 National Poverty Eradication and Human Development Strategies

The Vietnamese government aims at suppressing chronic hunger by 1999, eradicating income poverty (as measured by the GSO) by 2010, and catching up with Vietnam's more prosperous neighbors by increasing real incomes p.c. by eight to ten fold between 1996 and 2020. These objectives imply an annual 10% growth rate of real GNP over the next two decades.

To achieve these goals, a major aim of *Doi Moi* has been to create an enabling macro-environment characterized by a sustainable economic growth, a stable society and an equitable redistribution of the outcomes of growth. Conceptually, the overall strategy for poverty eradication in Vietnam is thus based upon developing an enabling environment to give everyone more options and ability to participate in the national life, and most especially in the economic sphere, by building the systems' capacity to thrive on their own. This environment should (i) ensure that the working poor can better help themselves in the long term; (ii) provide social assistance for the destitute poor (the handicapped, chronically ill, elderly or disabled, unable to become economically independent); and (iii) support the non-poor (who generate employment for the poor and a tax base to finance social programs for the destitute) [UNDP, 1996a; Fforde, 1995].

This strategy must be sustained by reducing the impact of the five main causes of poverty. The Government's program for Hunger Eradication and Poverty Reduction (HEPR) addresses directly these causes by various measures aimed at the poor, including : (i) reducing isolation (by building roads to markets, developing functional literacy, language training in ethnic areas, information flows and communication systems); (ii) improving risk management (by building sea dikes and irrigation systems, and increasing preventive health care services and family planning choices); (iii) increasing access to resources (land, micro-credit, extension services, skills, and technology); (iv) ensuring environmental sustainability (through improved land management and reforestation); and (v) increasing participation in identifying priority needs and developing solutions (through fiscal decentralization and participatory planning), especially in the rural areas where 80% of the population and 90% of Vietnam's poor live [UNDP, 1996a].

Cutting across all these efforts is a need to insure decent minimum living standards for all (through increasing access of the poor to basic health and education, and special support for the disabled poor), to promote equal opportunity to succeed for all – including women and minorities – and develop transparent, corruption-free systems. Broadly, this can be achieved through continuing macro reforms, good governance, macro-economic stability and the rule of law.

As mentioned above, a lack of access to resources is one of the main causes of human poverty in Vietnam. Access to adequate financing needs for rural enterprises is a major concern, and if the people are truly to be at the center of their own development process, they need access to financial services for their local (micro-) enterprises to thrive. Increasing the availability of, and access to financial services for the poor is thus needed for them to expand their range of choices and develop better livelihoods. The main services needed are access to credit and saving, and to services that reduce risks (insurance, leasing). To develop access to such micro-financial services in Vietnam means, as a starting point, to improve the environment in which the MFIs operate.

The following pages summarize the need for credit and the limitations to accessing adequate financing from the viewpoints of the people themselves who need access to financing.

4.1.3 Credit-Related Explanations to Poverty in Vietnam

This section assesses the major poverty/lack of choice situations we encountered in our field work as perceived by the affected households. The evaluation focuses on the role of credit as a factor relating causes and effects of poverty, and as a key element of an enabling environment for human development. It reviews the needs for credit and the limitations for accessing adequate financing from the viewpoints of the people in need of financing services to show the connection between people's needs, the services currently available, and the required enabling environment for MFIs to deliver more adapted services (presented in the second part of this chapter).

To approach the situations and the needs of the poor systematically, we defined a taxonomy of poverty that broadly characterized the livelihoods we encountered into : (i) farmers of rain-fed midlands or uplands and remote mountainous areas; (ii) agricultural laborers and rural non-farming households; and (iii) low income farmers of coastal zones and fishing households)[15].

a. Farmers of Rain-fed Midlands/Uplands & Remote Uplands/Mountainous Areas

The most striking characteristics of the upland mountainous areas, home of the poorest Vietnamese are their isolation and the lack of access to enabling factors (financial resources and productive capital, extension and education services, infrastructure improvements) that would ease the population's daily struggle to survive on non-irrigated, steep and impoverished lands in the harshest conditions of deprivation. In many cases, people lack access to basic life supporting services, such as health care or clean water, and are given very little chances to change their fates with no road access to markets, or outreach of extension and credit services. Yet, despite extreme living conditions, their high resilience and intense work suggests that, with the provision of agricultural extension services, adequate access to capital and production skills and the necessary programs of activity diversification to move away from dependency on their austere natural environment, they can gain the means to improve their livelihood in the long term.

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[15] 'Farmer' is taken here in a large sense. Most rural poor are farmers, even if they have other activities, for at least they try to feed their families out of what they grow and raise on their lands.

A team visit we conducted in the Northern province of Ha Giang to communes in the districts of Dong Van and Meo Vac (100,000 inhabitants live in those districts, almost all from ethnic minorities) showed the following findings in terms of credit:

Many programs in the communes visited provide interest-free credit as part of the HEPR, Women Union's action, or other anti-poverty schemes. Poor families are included in the dispersal of funds but many of the poorest are excluded as "not credit-worthy", and many are excluded by illiteracy in face of the cumbersome paper work. One commune leader justified excluding the very poor by his understanding that the commune might be liable for repayment if a loan was defaulted, but other commune leaders said that repayment dates would generally be extended for poor families who could not pay on time, or obligations might even be canceled if misfortune justified default. This showed great uncertainty over the terms and conditions that apply to the schemes.

As an example of loan utilization, data made available for Xa Phin Commune indicated two main sources of interest-free loans: (i) a HEPR program had extended VND 300 million in loans of VND 0.5 - 1.5 million each to 360 families (i.e., 80% of the commune); (ii) the Women's Union had disbursed VND 45 million in VND 300,000 loans to 150 families selected from a UNICEF poverty assessment. Most households favored investment in livestock (pigs, cattle, or goats) as the most secure and profitable source of income to tide families over the lean months.

Women's Union loans allow a household to buy one or two pigs per year (at a cost of VND 250-300,000 each). After a year, an adult pig will be sold for a million VND. Alternatively, a couple of pigs bought can be used for breeding to generate a longer term, annual source of income through the sale of the offsprings. A calf also costs around a million VND, and can double its selling price in three years (with lower feeding costs than pigs).

Officials in both districts said that capital was available to those who could make good use of it from loans from the Bank for the Poor and the Bank for Agriculture. At the commune level, however, farmers would know most about Women's Union credit schemes and knowledge of Plan 327 ("Re-greening the Hills") had not reached the commune leaders interviewed, in contrast to comparable communities in Nghe Anh Province, where ethnic minorities are encouraged to shift from subsistence crops to cash crops, and free fruit tree seedlings are distributed to increase household living standards and to help reforest barren lands.

Although many households in Meo Vac District expressed interest in borrowing to buy fruit tree seedlings, most loans issued to poor farmers have 12 to 18 month limits (a relatively safe time frame for micro-credit schemes). Most fruit trees, however, do not yield fruit before *5* to *7* years, generating no income to repay a short-term loan.

The adequate provision of credit in such surroundings thus faces severe constraints : (i) the lack of knowledge from the local inhabitants (mostly ethnic minorities) in existing formal micro-finance (such as program 327); (ii) the inadequacy of loan terms to be used for locally adapted investments; and (iii) the pressure of basic consumption needs which is likely to divert production-oriented credit into buying food or repaying loan sharks. Moreover, the lack of trust in governmental authorities, from which some minorities purposely live disconnected, increases the difficulty to develop and provide adapted micro finance services and practices [CSEAR, 1997].

Box 11 : The need for better rural infrastructure to promote economic opportunities in remote areas

Poor Rural infrastructure remains an important impediment to developing rural economy in Vietnam and some of the populations the most in need of credit (remote populations and ethnic minorities) still cannot access micro-financial services because of isolation.

Especially in the upland areas, there is a strong need for supporting rural infrastructure development, mainly with the improvement of roads, irrigation systems, and telecommunication. Roads can permit rural communities to break their isolation and obtain access to markets where they can buy and sell goods, be put in contact with people who use other technologies and cultivation methods (and with potential for innovation in general), have easier access to education, and social and health services. Irrigation systems provide drinking water and field irrigation on a regular basis over the year and thus diminish water dependency for survival and for the success of crops. Telecommunication infrastructure, significantly reduces the risks (e.g., health risks) of very isolated communities and the costs of administrative (and bank-related) exchange of information for MFIs.

Further developing rural infrastructure would help decrease the isolation of remote communities, their lack of access to capital resources and their exposure to high risks, which are among the more important causes of the remaining rural poverty in Vietnam.

b. Agricultural Laborers and Rural Non-Farm Households

Poor agricultural laborers and rural non-farmers share similar characteristics of "exclusion" from the productive rural society. In a country where 80% of the population is involved in farming activities, they are too poor to own productive land (for food production or income generation) or the inputs needed to cultivate the soil and subsist from it (tools, seeds, or fertilizers). Despite the redistribution of communal land that grants each household a plot of cultivable land, some may be out of land because of debt, or because, as widowed or divorced women, they may not be able to claim the plot that was under their husband's name. Inheritance of land also divides plots into smaller and smaller lots which cannot produce enough to sustain a family and which are often left to an elder brother. Having little chances to increase their allocation of productive land, laborers and non-farmers may have to turn to non farming activities to earn a living, and many are pushed to migrate to the cities.

Non-farming rural poor may find employment as migrant/day-laborers, wood-cutters or construction workers, or offer petty services such as bicycle transportation or repair-activities. Non-farm work can also take place in traditionally farming households as a complement to the work in the field. In areas where land cultivation activity is limited by the quality of soil, natural elements or lack of inputs, activities such as handicrafts making can help make ends meet when the field cannot be cultivated. For the destitute poor, such non-farming activities alone must support one's living and the creation of micro-enterprises.

As an example, and even though it is located in a traditionally urban environment, the population living in floating villages in the city of Hue (4,700 people) represents an interesting case of a community living essentially off rural labor and non-farm work:

Those "sampaniers" live a semi-nomadic existence on their boats, which they use altogether for fishing, freight traffic, and for shelter. Their income generating activities can be classified into four major areas: (i) fish catching; (ii) collection of building material (for men) and of weeds to be sold as animal fodder (for women and children); (iii) provision of transport services (either along the river in the boat, or on land for the few who own a bicycle); and (iv) other services (such as tailoring for those who have a sewing machine and work for local textile industries). Monetary income from those activities averages VND 80,000 to VND 90,000 (US$ 8.1) per month for a family of fishermen. All get advantages of being located on the river for they have access to free fish and abundant water supply, and can move along the river for odd contract jobs

The economic activity generated on the boat allows for basic subsistence needs, but does not permit families to either send all their children to school or have access to basic health services. Family sizes are often larger on the boats than on-land (between 6 and 12 people live on the same 5-6 meter boat), and with recent increase in public education costs (one woman told us the cost of a year of school for her daughter had jumped from VND 17,000 to VND 180,000 over a year) and high cost of attending NGO-built schools (VND 90,000 per month), families generally cannot afford to send more than one of their children to school. Besides, existing health clinic are reportedly under-equipped and financially out-of-reach.

In terms of eligibility to credit, the absence of land ownership or of formally recognized productive capital (in the case of sampaniers, boats are considered as dwellings only and too risky to be taken as collateral) is a major impediment to receiving any financial help to invest in income generating activities (because of the absence of collateral and little chance to form long-lasting solidarity groups for Grameen-type lending activities).

In all the provinces visited, we have witnessed very little help to the non-farming household to either enhance their non-farm productive capacities or secure access to arable land and farming activities. Yet, the population of laborers and non-farming rural households is growing, and care must be taken to develop an adapted environment for them to find a solid place in the productive fabric of their communities and to prevent them from falling into destitution. Special micro-finance products and practices must be sought for those living on the edge between productive poverty and destitution (for instance, leasing can be used as a form of productive loan when no collateral is available, so that lenders' risks can be limited).

c. Low Income Farmers of Coastal Zones and Fishing Households

Poor households living in coastal areas must derive their subsistence from a natural environment that is no longer productive, because of desertification or saltification of the land, or depletion of fish stocks. They are ill-equipped to utilize this environment with sustainable fishing techniques or soil-regenerating cultivation processes, or to diversify their income-generating activities due to a lack of knowledge and a lack of access to adequate credit and extension sources. Besides, day-to-day survival needs leave them no time to plan for long term, sustainable approaches that might only bear fruit in years to come.

Table 13 : An explanation of coastal dwellers and fishermen's lack of opportunities for income-generation

	Immediate Cause	***Key inter-relations***	**Deeper Cause**
LACK OF OPPORTUNITIES FOR INCOME GENERATING ACTIVITIES	• No value-adding activities • Don't know how to diversify activities	*Production sold to middlemen for processing or export*	⇒ Limited local processing capacities and market outlets ⇒ Limited local knowledge of non-traditional activities
	• Coastal waters have been fished out • Non-sustainable fishing techniques	*Boats are too small to go in deep seas* *Need for day-to-day survival*	⇒ Loans for larger boats are too risky for VBA, too large for VBP ⇒ Lack of research in adapted fishing techniques
	• Traditional crops do not grow because of land saltification and inland desertification.	*Poor knowledge of appropriate cultivation techniques* *Vegetation has been exploited at unsustainable rate*	⇒ Floods and droughts due to upstream deforestation ⇒ No outreach from agricultural extension schemes ⇒ Need for fuel-wood and little incentive to protect/cultivate trees

At the local level, an enabling environment needs to provide (i) production and diversification training (e.g., to process primary production into value-added goods - such as sea foods into canned/frozen products - or to develop shrimp and crab farming or silk production and weaving activities); (ii) financial assistance for a better productive use of existing resources (e.g., offering adapted credit, leasing and insurance products to purchase larger boats to go off-shore); and (iii) infrastructure and incentives that can render coastal dwellers' livelihoods less dependent on their pressing natural surroundings (e.g., better irrigation, locks and dikes on rivers during high tides, or agro-forestry programs that benefit farmers and regenerate soil).

As Table 14 shows, poor coastal households do not have access to adequate financial services due to (i) a lack of outreach of financial programs; (ii) practices mis-adapted to local needs and constraints; and (iii) limited enabling factors to invest in sound business ventures.

Table 14: An explanation of coastal dwellers and fishermen's lack of access to formal, adequate credit

	Immediate Cause	***Key inter-relations***	**Deeper Cause**
LACK OF ACCESS TO ADEQUATE FORMAL CREDIT	• Unable to generate viable production plan	*Loans are available against sound production plans*	⇒ Unskilled labor and lack of managerial skills
	• Limited cooperation between farmers / fishermen	*Voluntary cooperative too risky in case of bankruptcy*	⇒ No adequate insurance or incentives
	• Ineligibility to credit	*Very few projects to take part in*	⇒ Loan availability limited to government-sponsored projects
		No collateral	⇒ Land certificates not allocated
			⇒ Land has very little value
	• Ignorance of credit availability	*Recourse to informal sector and loan sharks — indebtedness*	⇒ Illiteracy, fear of paperwork
	• High transaction costs for formal sector loans		⇒ Credit terms/lending mechanism not adapted to local needs
	• Insufficient loan sizes to purchase productive capital	*Necessary rural credit is not always micro-credit*	⇒ No lending mechanism adapted to fishermen's needs (boats)

In terms of improving access to adequate financial services this situation suggests that:

- Loan eligibility be contingent upon business potential rather than upon formal collateral for micro-financial needs and that non-conventional forms of collateral be used (e.g., group lending, or demonstrated ability to save);
- basic production management skills be better disseminated and efforts between mass organizations, financial institutions and extension services be better integrated in offering services that work in synergy (e.g., financial management and production training);
- sound practices adapted to local market needs be used by MFIs (e.g., offering saving facilities, raising local funds, dissociating social & financial services and aiming at self-sufficiency while simplifying procedures);
- the formation of voluntary cooperatives be facilitated (by providing adequate legal structures and insuring the enforcement of a rule of law), to underwrite larger loans (e.g., boats).

d. Common features of all poverty situations in terms of micro-financial needs

Despite the local natures of the poverty-related problems encountered, many circumstances are shared between the different areas we visited. Some situations cross "geographically deterministic" environmental factors that are the partial causes of poverty (e.g., non-farming rural households and agricultural laborers face relatively similar situations of lack of access to production inputs, either in remote uplands or in coastal areas, independently from the irrigation problems or the desertification which strike the region. As well, deterministic factors related to each category vary : there exist "rain-fed agricultural lands" in "low lands" that share characteristics with "remote mountainous areas" (e.g., they have access to inadequate and insufficient financial services). Thus, economic development programs successfully implemented in some localities can be appropriately used (albeit customized) in other relatively similar environments.

One of the main problems for many rural poor is the dependence on a volatile and risky work dependent on their natural environment. When harvests are good, markets can be reached, and selling prices are high enough, they can sustain a basic livelihood. But in the lean months before harvest times, or in case of crop failure or natural catastrophe, many cannot even feed their families. Illness and/or debt often ensues, with the poor losing most of their meager assets (e.g., their land may return to the commune when they fail to pay taxes).

Developing non-farm activities during the time when fields do not need to be tended would permit to diversify risks, raise average incomes, and make better use of under-employed human capacities. While this often requires basic welfare services (health, sanitation, education) and infrastructure improvements (better irrigation, roads to markets and information flow), it may start with small, self-help, home-based operations (i.e., micro-enterprises) that necessitate little but a small startup capital (to process crops into value added products, or into storable/ transportable foods, or to produce clothes and handicrafts).

Yet, our research showed that many poor households in Vietnam are not given the chance to access adequate credit to finance such start-up capitals. These households are either unaware of existing credit schemes, unsure about their eligibility for funds, or simply do not think they have the potential to turn the funds into a profitable activity. Often though, they simply are out of the reach of existing credit schemes, as MFIs are located too far from their communities, or do not offer services that fit with the needs and constraints of the households. Of the many micro-financial programs we were put in touch with, few were able to have a significant outreach while offering adapted services and adopting sustainable practices.

These findings suggest that most of the potentially "productive" poor in Vietnam would directly benefit from an improved environment to develop micro-enterprises and increase their prospects of better livelihoods. This environment must offer micro-financial services (in both saving and credit) adapted to the needs of the would-be entrepreneurs, and special attention should be given to develop micro-financing services adapted to the poorest of the productive poor (migrant workers, day laborers, and landless women) who cannot bring forward assets or stable lending groups as collateral for loans so that they do not fall into destitution[16].

Box 12 : Gender inequalities in addressing micro-financial services

At the household level, the limiting environment that prevents from or allows the poor to have access to micro-financing services is not similar for both spouses.

- Task sharing is not equal and women traditionally end up bearing more responsibility and work than men in insuring the survival of the family; with yet even further limitation to accessing enabling factors. While women must produce food, look after the children and possibly generate income, they often have limited access to education and vocational training, and are socially and economically kept in dependence from their husband's family (land ownership is under the husband's name and women have no right onto the land if they divorce, lose their spouse or are abandoned).
- Having no access to land ownership, they often cannot secure credit (for lack of collateral).
- Lastly, they are not easily recognized as the head of the household (even if they are widowed/single mothers) and hold relatively little actual decision power in a man-oriented society (Vietnam Woman Unions exist at all levels, but they are often acting arms of the Vietnamese Communist Party, with little effective local decisional role).

The rest of this chapter analyzes in detail the delivery of rural financial services in Vietnam and the environment in which micro-finance institutions evolve.

[16] The approaches to develop the economic capacity of the "productive poor" are based upon building people's capacity to lift themselves out of their predicaments. They do not preclude from continuing to directly help the disabled and destitute poor who cannot be "economically empowered" to escape poverty on their own and should be cared for by adapted programs of direct assistance (welfare).

4.2 Micro-finance and the Enabling Environment for Human Development in Vietnam

This section starts with a presentation of the factors that influence the delivery of micro-financing services, and of the current MFIs in Vietnam (4.2.1). Then it analyzes the services provided by the major MFIs in the light of the sound practices presented in Chapter 3 (4.2.2). Linking the analysis of practices to an understanding of their operating environment allows to distinguish ways to improve this environment to enable the development of adapted MFIs and the promotion of human development via the creation of people-centered micro-enterprises (4.2.3).

4.2.1 Historical review of rural banking in Vietnam

a. Evolution of the Financial Sector and its Operating Environment

Before 1988, Vietnam's banking system consisted of the State Bank of Vietnam (which was the central bank but also carried out commercial banking functions), the Bank for Foreign Trade, and the Construction and Investment Bank (charged with implementing the government's capital budget). In 1988, the State Bank's delegated its commercial banking role to two new banks : the Agricultural Development Bank (ADB), aimed at the agricultural sector, and the Bank for Commerce and Industry (BCI), aimed at the industrial and commercial sectors.

After 1988, the inability of commercial banks to lend funds to growing non-state enterprises led to the creation of numerous credit-and-saving cooperatives (300 by March 1990) who attracted saving by offering high rates on deposits (as much as four times those offered by the banks). In 1989, despite the government's commitment to keep positive real interest rates and to stop offering advantageous credit terms to State-Owned Enterprises (SOEs), most of the credit extended by the ADB and the BCI was to SOEs (respectively 80% and 90%). In March 1990 the revelation that numerous credit cooperatives were operating pyramid schemes lead to a collapse of the credit cooperative system, and an estimated 2,000 small firms' bankruptcy.

As a result, banking decrees were passed in 1990 to govern commercial banks, credit cooperatives and other financial institutions. They insured a stricter control of the operations of credit cooperatives by the State Bank (cooperatives now had to be licensed by the State Bank rather than by local Peoples' Committees), and in a greater autonomy given to state commercial banks to compete with each other and seek non-governmental sources of capital. New instruments were introduced to render the market more competitive (open-market operations, varying reserve requirements) while providing the State Bank with control over the banking sector.

Until 1992 though, credit to SOEs remained subsidized (inflation fluctuated but interest rates for SOEs remained constant) while non-SOEs continued to lack funds. By 1993, interest rates became more unified and the banks started to lend to non SOEs but by 1995, still only 6% of the population used formal banking institutions. Informal, unregulated financial institutions remained prevalent, showing the lack of confidence in the formal financial system [Fforde, 1995].

Meanwhile, important reforms and restructurations allowed private enterprises to operate in a more adapted environment with (i) measures to control monetary growth and stabilize the VND, an the increased availability of products (which drastically curbed inflation); (ii) the closing of non-strategic, loss-making SOEs; (iii) a new constitution supporting the shift to a market system in 1992; and (iv) important legal reforms : 1990's Law on Private Enterprises and Law on Companies – establishing three types of private companies, 1993's Land Law – giving farmers titles to long leases on their lands, 1994's Labor Code – protecting employer and employee rights and obligations and regulating labor contracts and social insurance, a Bankruptcy Law – establishing a legal framework for restructuring and liquidating insolvent enterprises, and 1995's new Civil Code – laying the legal foundation for a market economy [Fforde, 1995].

Under *Doi Moi,* these adjustments and reform programs have restored a good degree of macroeconomic stability, accelerated growth to 8-9% over the last 7 years, and attracted public and private foreign capital. The fiscal deficit has been curbed (from 10.4% of GDP in 1989 to 0.5% in 1995) and inflation decreased from 331% in 1988 to 34.7% in 1989 (and stayed under 15% since 1993). For the banking sector, this meant that security over long term investments increased and interest rates on saving could be positive. Thus, both domestic saving and investment picked up : saving rose to from 7.4% of GDP in 1990 to 16.5% in 1994 and 17.3% in 1995, and investment rose from 25.5% of GDP in 1994 to 27.1% in 1995. These increases were led by a growth in private sector investment (an average growth of 13.8% a year since 1992, and an increase in employment of 4.7 million people between 1989 and 1993, absorbing new job-market entrants and former military and SOE personnel) [Fforde, 1995].

The government recognizes that industrialization and growth will come primarily from the private sector, and plans further reforms in its policy framework to encourage its growth and diversification. Yet, since the state sector continues to play the dominant role in resource allocation (directly through the state budget, and indirectly through policies, SOEs, and joint ventures between SOEs and foreign investors), sustainable and rapid socio-economic progress and poverty reduction still heavily depend on the quality of public sector resource allocation and investment.

b. Delivery of Rural Credit

Historically, until the late 1980s, the rule of the central planning model did not recognize private investment and its need for capital; it ignored the informal market economy which developed in the margin of the collective system of production and needed financing. While official credit was delivered by the State Bank to communes, cooperatives and state farms, a long-existing informal financial market nevertheless permitted to finance private enterprises. In 1988, the creation of the ADB (later transformed into the Vietnam Bank for Agriculture -VBA) and the development of NGOs were the first official steps to lending to private enterprises in rural areas (mostly for farming activities). By 1993, the VLSS estimated that 59% of the population had taken loans, stressing the significance of credit needs. Yet, due to the limited outreach of formal financial institutions in remote communities, and to the inadequate products or services they offered, only an estimated 30% of those loans were provided by formal financial institutions (banks and cooperatives). The remaining 70% of the demand was fulfilled by local informal sources (relatives, money lenders, ROSCAs) who insured fast, paperless access to funds, replacing the need for collateral by a personal (often long-lasting) relationship with clients [UNDP, 1996a; 1996c].

Yet, there are major limitations when only limited informal markets are used to answer the bulk of the expressed financial needs : (i) the availability of funds is limited and services offered remain relatively simple (thus money lenders' scarce funds go to the highest bidders and services are often confined to loans); (ii) they do not encourage the formation of local saving funds (even if systems like ROSCAs can be assimilated to saving schemes, they are short-term oriented; money lenders for their part do not facilitate saving, as this would go against their own interest); and (iii) by limiting competition, they keep the poor at best in a system of patron-client relationship (with no alternate choice to obtain funds), thus developing dependency toward loan sharks.

This study recognizes the importance of the informal micro-financing sector, for it developed over the ages mechanisms adapted to local financing needs. The aim of setting up an enabling environment for MFIs to thrive is to bring the most appropriate micro-finance services (with practices often adapted from the informal sectors) at a large scale, and to suppress the limitative effects of solely relying upon the informal micro-financing sector. Yet, given the limited amount of data collected on informal financial operations, those informal practices cannot be detailed and only the practices of the main formal MFIs can be presented and analyzed here. The following pages characterize the operations of those formal MFIs, and their results and needs, to later derive the changes required in their operating environment.

The first formal attempt at decentralized, people-oriented micro-financing schemes in Vietnam was through setting up credit-and-saving cooperatives in the 1980's. The program failed as the cooperatives quickly degenerated in pyramid schemes, partly due to a lack of legal control through an adapted supervisory body. In 1990, the VBA was then set up by the Central bank to become the main provider of rural credit. By 1996, it had a substantial nationwide outreach with over 1,800 branches spread over the provinces, districts and villages and 21,000 employees. It provides credit to approximately 7 million farming and non-farming families, for an average loan size of VND 1.3 million (US$118), with funds coming from the Central Bank and from international loans. Most of its lending is done directly, but some is channeled through mass organizations[17]. Due to the low interest the VBA charges (1.25% per month by end 1996, substantially less than rates offered by informal moneylenders), demand for its loans is high and funds are rationed and tend to go to the least risky applicants (farmers with good credit history, collateral, and high income potential), rather than to the poor farmers. To provide financial services more specifically aimed at the poor, the government thus created two main institutions : (i) the People's Credit Funds (PCFs), and (ii) the Vietnam Bank for the Poor (VBP) :

(i) PCFs started in 1994 as Grameen-type credit-and-saving cooperatives with each credit fund autonomous and responsible for its own operations under the control of the Central Bank. By end-July 1996, PCFs seemed to fare particularly well in the majority of the communes where they had been set up. 674 PCFs gathered about 275,000 members, with total deposits of VND 530 billion (US$48 million) and outstanding loans of VND 735 billion (US$67 million). National and regional credit unions were set up to advise the local unions while a central level credit union was given charge to improve the organization, use and regulation of the capital (this control is to avoid the irregularities that brought the collapse of the credit cooperatives). In South of Vietnam, Rural Shareholding Banks are the equivalent of PCFs; they typically have 50-60 shareholders, and derive most of their funds from the VBA, which they on-lend at higher interest rates.

(ii) The VBP, created in 1995, is a non-profit branch of the VBA that distributes subsidized credit to the poorest. It mainly offers collateral-free credit services to finance productive activities (credit-worthiness is checked through "poverty committees"). The credit period is in accordance with the production cycle but not over 36 months long. The maximum credit per family is VND 2.5 million at a rate of 14.4% per year (end 1996). By 1996, it had disbursed VND 1,320 billion (US$120 million) in loans (averaging VND one million or US$96) to approximately 1.3 million families, with an initial capital coming essentially from the VBA.

[17] Mass organizations are important links between the Communist Party of Vietnam (CPVN) and major socio-economic groups such as women, farmers, peasants, youth or war veterans. They are organized in parallel to the CPVN structure at the national, provincial, district and communal levels and help implement Party or governmental decisions at different levels right down to the grassroots [UNDP, 1996c].

Box 13 : The VBP as a major player / policy maker in Vietnam's approach to credit to the poor

The VBP started its operations on Jan 1, 1996 with the stated objectives of (i) alleviating poverty through the provision of credit to the poor and (ii) improving the credit system.

Underlying the foundation of the VBP, the government's policy in terms of credit to the poor is based upon the following principles:

- the concentration of credit resources into a focal point [the VBP];
- the focusing of credit resources on the poor
- the need for differing credit policies for the differing regions
- the moral obligation to help the poor;
- retaining credit services to the poor within the public rather than private sector
- making best use of existing infrastructure (e.g. the existing banking network); and
- independence of VBP (own legal status and ability to cover its own costs) [Johnson, 1996].

Accordingly, the VBP was established to carry out the following operations:

- Mobilize funds from internal and external resources of various organizations (issuing promissory note, borrowing discounted and rediscounted loan from the State Bank of Vietnam and other domestic and foreign institutions for lending to the poor);
- Receive funds on a non-repayment basis from international, national and other organizations to extend fund for poverty alleviation;
- Develop the saving mobilization capacity of the poor communities;
- Act as trust agency for providing loan from international and national organizations as well as from domestic and foreign individuals to the poor.
- Provide short-term and medium-term loans for production, trading and services;
- Cooperate with internal & external economic organizations and mass unions to co-finance production and trading projects [VBP, 1995].

Credit services are aimed at the potentially productive poor households (i.e., with labor force) who cannot have access to regular production loans, since they lack of collateral. Eligibility is contingent upon being qualified as "poor" by a local poverty alleviation committee at the commune or village level[18], and upon being free of any outstanding loan from other banks.

VBP's lending methodology is to provide funds directly to the poor (i.e., not using intermediaries), and to cooperate with mass organizations (such as the Farmer Association or Vietnam Women Union) to establish saving and credit groups in the communities to mobilize funds and directly extend loans to the poor [VBP, 1995]. In doing so, it utilizes the VBA's outreach and organizational capacities.

Mass organizations are also active in microfinance either directly such as the VWU which runs an estimated 50,000 women's saving and credit groups nationwide, or indirectly by assisting in the disbursement of loans under specific programs [UNDP, 1996c].

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[18] The selection of eligible households is made according to criteria defined by the Ministry of Labor, War Invalid and Social Affairs, or the Ministry of Agriculture & Rural Development, and must be approved by the local people's committee before being sent to the VBP branches. In 1995-96, the main criteria to define eligibility for a VBP loan were either (i) access to less than 200 sq. m of land for agricultural production; (ii) annual production under 200 kg of paddy per capita; or (iii) income under VND 100K (US$9) per capita per month [VBP, 1995; Johnson, 1996].

Other government actions provide credit for punctual intervention : The *120 program* provides capital at preferential interest rates to local governments and mass organizations who can re-loan it to families of their choice, provided that they finance activities that directly create employment. Those loans are not micro-loans, they are capped at VND 150 million (US$13,600), and, when underwritten by local organizations can go up to VND 500 million (US$45,450). The *program 327* ('re-greening the hills') lends for the purchase of seedlings and agricultural inputs for projects aiming at regenerating forest cover while generating income.

Alongside the state-run financial systems, a network of NGOs has developed to provide rural credit, mostly to the poor who cannot access funds from the VBA, the VBP or other government schemes. Given the size of NGOs though, they cannot pretend to a wide outreach, and most schemes involve less than 10,000 persons. Thus, their efforts have been mostly research-oriented, testing what practices work best in different surroundings.

There are 10 major NGO-sponsored saving and credit (S&C) schemes, experimenting local approaches to rural credit and credit for the poor. According to a 1996 UNDP survey of those scheme s, they pursued a variety of objectives, policies, and mechanisms as table 15 shows.

Table 15 : Objectives and Practices of Major NGO-sponsored Saving and Credit schemes

Scheme	Startup year	Scheme objective	Avg group size	% women	Intra-group mechanism	Max loan size (VND)	Loan term (mth)	Forced savings	Monthly interest spread
AAV	1993	*Mostly S&C*	19	100%	**Individual saving and loan**	1,000K	24	yes	.5%
MCC	1992	*S&C as part of a package*	20	60%		600K	6	yes	.5%
PCFs	1993	*Mostly S&C*	290	>50%		10% of PCF share capital	12	yes (share buying)	-
GRET	1992	*Mostly S&C*	5	-	**Joint**	500K	12	yes	.3-.8%
Oxfam UK/I	1990	*Mostly S&C*	30	100%	**Access to revolving fund is contingent on other members'**	500K	12	yes	.5%
SCF (UK)	1993	*S&C as part of a package*	5-6	100%		1,000K	12	yes	.5%
UNICEF	1993	*S&C as entry point for other activities*	5-15	100%		500K	12	yes	.0-2.0%
CARE	-	*S&C as part of a package*	10-153	100%	-	1,000K	3-6	yes	.0%
SIDA	1992	*S&C as part of a package*	10-15	40%	-	2,000K	12	yes	-
UNFPA	1992	*S&C as entry point for other activities*	37	100%	-	1,000K	6-12	yes	.7%

Source: UNDP, 1996c. Note: '-' is used when data are not available

The variety of practices encountered in running NGO-sponsored micro-finance programs reinforces the need to acknowledge that many diverse situations in terms of credit needs call for locally adapted solutions, and that standardized loans, procedures and services (such as those offered by the VBA and VBP) cannot properly answer the need for rural financial services. It calls for an opening of the micro and rural financing sector to more competition, and for the creation of banking regulations adapted to the needs of the clients and of the financial institutions.

Box 14 : GRET's experience of self-managed loan funds

GRET is one of the major foreign NGOs providing micro-finance services in Vietnam. It is a French organization which started in 1989 a cooperation project on agronomic development and research on family livelihoods along the Red River and initiated a rural-credit scheme in 1992, then filling a gap in VBA's activities. It set up 29 self-managed loan funds aimed at providing collateral-free, micro-credit to solidarity groups at the village level with the aim to assess whether self-managed credit funds were sustainable in the villages. Funds were set up in Hai Hung (a delta province), Bac Thai (a mountainous province), and Vinh Phu (a delta & hilly province) in villages typically composed of 600 households, among which 60 to 70 were poor (according to the official rice poverty line of 15 kg of rice per head per month).

Funds are Grameen replications with an initial fund financed externally and then managed by the village, and a single type of loan delivered to all households with a one year term, maximum initial loan of VND 200,000 (increasing by VND 100,000 yearly.). There is no limitation as to the use of the loan (most funds are used to purchase pigs and seeds).

There is a credit committee for each commune fund, which comprise 3 representatives in charge of selecting the borrowers and one secretary (a farmer trained to accounting) who manages the loans. The staff are elected by the commune members and 1/5 of interests received from the loans serve to finance their salaries. Above the commune committee is a credit agent in charge of 4 credit funds. His/her duty is to oversee local representatives' handling of the credit operations and train commune representatives; they do so by visiting each fund weekly. The credit agents are employed by GRET. Six of them are credit agents temporary detached from VBA and four are farming technicians.

In terms of eligibility, the scheme does not only target the poorest. The wealth distribution of borrowers is closely related to the official poverty ranking (based on rice equivalent production). In most of the pilot communes, this translate in a proportion of starving poor between 15% and 17% and program organizers estimate that they reach 50-60% of total poor .

Repayment rates are high and the scheme has proven able to cover direct operation costs

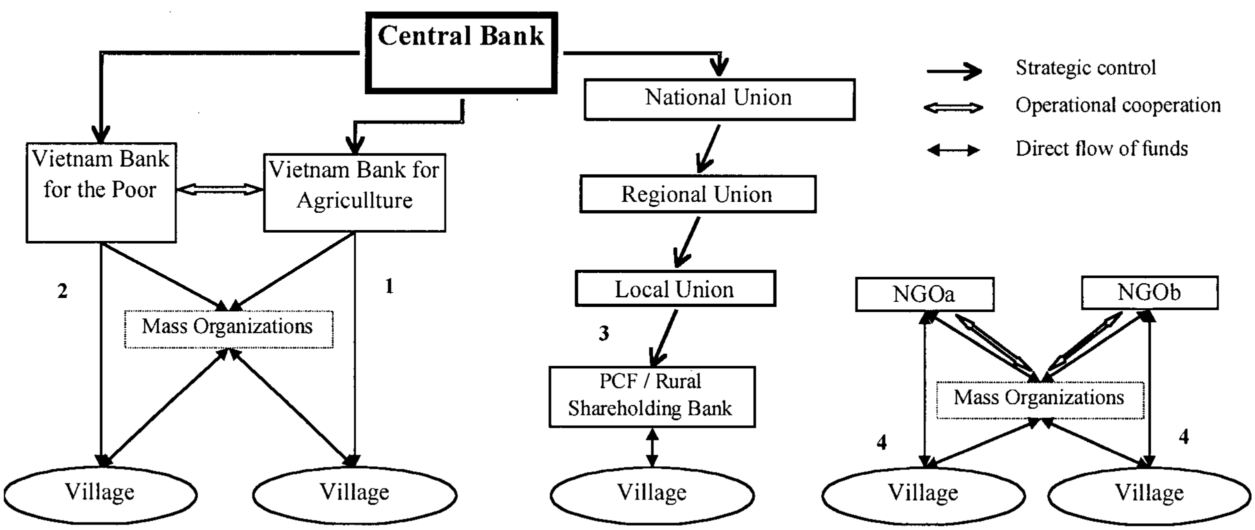
Despite localized differences, most NGO programs operate with the following features :

- Short-loan term (usually less than 12 months)
- Lending done through local groups and mass organizations (such as the Women's Union)
- Small initial loan size (VND150K-500K) and ceiling on maximum amount (VND500K to 2m)
- Interest rates higher than that of VBA or VBP (usually NGOs' short term loans scheme rates are in the range of 2.0 - 2.5% per month while VBA rate are 1.75%)
- Use of collateral substitutes (peer pressure)
- Freedom of use (no restrictions on loan use)
- Regular repayment of principal and interest (usually monthly)
- Loans available after some saving period (usually three months) [UNDP, 1996c]

Figure 3 summarizes the interactions between the major Micro-financing Institutions in Vietnam. Briefly, it shows a rather centralized governmental approach to providing rural credit, with a top down control of most operations by the Central Bank. The promising PCF/Rural Shareholding Bank approach is a proof of partial localization of the responsibilities, but, as other government-run programs, it still fails to attract much saving and build up a local financial base. Cooperation between NGOs, mass organizations and the grassroots is more present, but at a small scale, and the lack of clear relationship between the Central Bank and NGO-sponsored MFIs limit the potential synergies between the governmental and non-governmental actions.

The practices and relations between all actors are detailed in section 4.2.2.

Figure 3 : Organization of rural finance in Vietnam



Adapted from Daubert, 1995

The Central Bank plays a very important role in allocating and facilitating rural financing needs :

1. Through the VBA, it extends loans to farmers (poor and non poor).
2. Through the specialized VBP (connected by its capital and operations to the VBA), it extends credit specifically to the poor.
3. It delegates the organization of the PCFs and Rural Shareholding Banks to national, regional and local unions (legal and autonomous entities which operate independently), while 'guiding and controlling' the system.
4. The NGO-sponsored system of MFIs is a more bottom-up approach in which farmers participate and which the Central Bank is supposed to unite. NGOs yet operate with limited autonomy due to a lack of adapted regulations.

4.2.2 Analyzing MFIs' Operations in Terms of Sound Practices

a. Review by Major Player

The main assets of the VBA are its large network of branches and its high capacity to handle many small loans. It is thus very well placed to expand on its position in the future. One of its main weaknesses though is an incentive structure that does not promote a reduction in transaction costs and a too low spread between borrowing and lending rates (fixed at 0.35%) which is not adequate to cover costs. The VBP for its part also benefits from the outreach capacity of the VBA, as it uses its wide network of branch at the district and commune level and is mainly staffed by VBA personnel. Yet, despite remarkable geographical coverage, its services do not always reach the bottom poor. Besides, it encounters similar incentive problems as the VBA since VBP agents are mostly VBA officers who take on their supplementary VBP duty without specific training, time, incentives and accountability for efficiency[19]. This calls for a better training on micro financing needs and techniques; and a clear absorption of costs in interest rates (no hidden transaction costs). Lastly, neither the VBA nor the VBP can sustainably keep offering credit to a substantial amount of clients if they are only to rely on public funds obtained at preferential rates. They need to support credit by mobilizing deposits through local, appropriate, positive-interest-bearing saving schemes.

Both Rural Shareholding Banks and PCFs seem to be sound basis upon which to build commune-based rural credit institutions. The incentive structure where borrowers buy shares (and build local ownership) seems appropriate to make this an effective and sustainable micro-financing system. The control from the Central Bank authority may imply that the pyramidal schemes of the rural credit cooperatives will not be reproduced as it puts a strong emphasis on

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[19] For instance, while traveling to remote communities and building long term trust with the population is time consuming and costly, VBP officers lack the time and funds to reach the poor villages (many officers travel on their own motorcycles, at their costs, outside from regular hours). This tends to add hidden transaction costs to the extension of loans as villagers know they have to pay for the officer's travel expenses as a compensation for the time spent. Accordingly, this practice discourages loan seekers from applying to formal sources of credit and encourages loan officers to extend credit to those who can afford the added costs (hence some low-rate loans *for the poor* are made to villages' well-off figures who then re-loan the funds on an informal basis).

the security of the members' deposits. Lending at 2.2 to 2.5% per month and an interest rate spread of about 0.7% are closer to cost recovery rates than other governmental programs. Yet, deposits continue to remain limited, for people who can lend through the informal market still obtain higher rates, and since the shareholding banks are still viewed as fairly risky ventures.

The punctual programs of subsidized credit rarely reach their goals and often do not contribute to actually alleviating poverty. The jobs created are often short-term (borrowers use loans for livestock raising) and the lack of clarity in the rules for loan eligibility make many potential borrowers hesitant. Those programs mostly contribute to extend loans at preferential rates to non-poor borrowers who could have accessed the funds at regular market rates from other lending programs, and thus, they decrease the availability of funds to the poorest.

NGOs efforts achieve positive results : they are very popular in most communities reached, they have developed innovative and practical ways to identify the poor within rural communities and to include them in saving and credit schemes, and have been able to substantially build the capacity of the localities reached to take over and manage their own schemes. Many lessons can be drawn from the NGO-sponsored local S&C schemes. Most experiences confirm the rationale of the sound practices presented in chapter 3 and illustrate them in the context of Vietnam. The most important lessons to draw from the NGO experiments are the following:

- there is a large unmet demand for financial services adapted to the needs of the poor;
- the poor will actively participate in well-designed and managed schemes;
- S&C groups are an effective means of involving the poor in their communities;
- the poor are capable of taking and repaying loans at sustainable interest rates;
- the poor value access to credit more than the low cost of credit;
- the poor are capable managers of their own investments and enterprises;
- microfinance schemes have shown high repayment rates;
- the poor value access to saving facilities providing that the schemes are trustworthy and that the saving are easily accessible;
- increasing the supply of loan funds in an area leads to decreasing interest rates in the informal credit market.

An important indication from these is that the poor in Vietnam are able to take and repay loans at interest rates higher than those offered by the BVA or the VBP [UNDP, 1996a; 1996c].

Nevertheless, several NGO programs face operational inadequacies that call both for an adaptation of their practices, and for the modification of the environment they operate in :

(i) Firstly, one of the main problems faced by many schemes is that the size of loans is often barely enough to allow poor households to maintain a subsistence production level, let alone to leapfrog out of a situation of absolute poverty. In this sense, those loans are more used as interim financing for "subsistence" needs to the poor than as real seed capital for the economic takeoff of a household. As an example, if most loans are taken to purchase pigs (a seemingly attractive investment that can be sold during the lean months), the maximum loan size is often too low to buy pigs and cover medical risks, or even food provision[20]. Such loans do not contribute to building people's productive capacity or asset-base in the long-term.

(ii) Secondly, another important problem is linked to a weak cooperation with local mass organizations or formal MFIs. Many programs started their lending activities in parallel to governmental lending institutions and, learning from the difficulties of holding such a position, are now directing their efforts towards more cooperation with the local mass organizations. While working with local authorities is necessary to build local capacity to manage the schemes, many NGOs nevertheless feel that this diverts the impacts of their initial efforts to reach the neediest. For instance, the selection process of most mass organizations is often biased by the need to satisfy personal networks' needs and hence grants preferential treatments to friends and relatives of the decision-makers before allocating fund to the poorest. Helping develop a sense of true participation, transparency and fairness in allocating funds and running the scheme is part of the challenges that any capacity building program (NGO-sponsored or not) must face.

[20] This results in poor farmers buying the cheapest piglets (4 to 5 kg, still mother-fed, too weak and prone to ailments), being unable to feed and cure them appropriately, and being forced to sell them before maturity to better-off farmers who will raise them to full value and reap the benefits of their sale. Here, the impact of the loan is mainly to transfer risks onto the poor farmer and only profit the richer.

Structurally, NGOs also face a few major problems that will have to be dealt with :

(i) Conceptually, NGOs are not financial institutions *per se*; their S&C schemes are often part of a larger project which includes the access to micro-funding (e.g., integrated rural livelihood improvement programs). This situation raises two important issues : the first is that NGO-run MFIs are not recognized as formal banks, thus not regulated by the banking laws, and not allowed to offer all the services that sustainability of operations calls for (e.g., legally non-banks are not supposed to take deposit, which precludes local saving mobilization, an integral part of a sustainable micro-financing scheme, besides, they do not have access to inter-bank loans for short-term refinancing needs - Many NGOs still run saving schemes, but they do so in a "gray" area of legality, which keeps them in a very unsecured situation). The second issue is that not all NGOs are truly adapted to offer banking services (NGOs may not have well-trained staff - financial managers or bank officers - or may tend to operate as grant-funded operations, which undermines their search for sustainable practices);

(ii) In places where both governmental and non-governmental loans are provided, the presence of VBP's subsidized loans undermines the efforts of NGOs to develop a sustainable, independent S&C system with interest rates on lending high enough to cover costs. While the VBP allows some people to access cheap credit (and not always the most adapted kind of credit), it does not contribute to building the capacity of a community to finance its own development, while it artificially limits the competition that would allow the poor to obtain adequate services;

(iii) There is an atomization of lending efforts and a lack of coordination and exchange between the micro-lenders (within NGOs and between NGOs and governmental institutions) that prevent the dissemination of experiences necessary to strengthen the rural and micro lending activities at a national scale. As a result, many schemes become limited by a "project culture" where efforts focus more on projects than on building local institutional capacity. Regrettably a micro-credit forum created in 1992 to disseminate findings and sound practices, was discontinued in 1995 because of competition between projects for funding.

For the time being, the landscape of micro-finance in Vietnam is thus made up of disparate players, operating rather independently from each other. Many operate successfully in some respect, but do not achieve the overall level of efficiency that they would if they were to evolve in a more adapted environment on the one hand, and if they were to better cooperate with other players on the other hand. Basically, government institutions and programs have an impressive outreach and the potential to reach most communities nationwide at strategic levels (for the dissemination not only of financial products, but also of corollaries of economic development such as health and sanitation practices or management training). Yet, they witness difficulties to reach their goals in a sustainable manner due to a loan management not always adapted to the conditions of the poorest and to inadequate reporting and controlling structures. They thus end up subsidizing loans to some who could otherwise have access to regular commercial lending. Several micro-finance schemes run by NGOs are successful and partially sustainable but their efforts lack of coordination to have a real national impact on poverty. Lastly, the majority of players rely on subsidized loans (for the VBP, financed by the VBA, for NGOs financed by external funds) which makes them unsustainable institutions in the long term and does not contribute to empower local communities by providing them with locally-owned credit funds. The remaining subdivisions of this section extract the major problems commonly faced by all MFIs.

Box 15 : Main choices and limitations of the poor in accessing micro-credit

In Vietnam, the poor who have access to credit face the following choices and limitations in terms of financing sources (interest rates are estimates as at end 1996):

- Friends or relatives (at no interest): capital is insufficient and source is unreliable for long term needs.
- Preferential credit funds, through governmental punctual programs (0.5-1.0% p.m.): High demand makes capital scarce. Funds are allocated to better-offs because of political interference and bribery.
- VBP (1% p.m.): Limited loan size, heavy administrative burden and transaction costs, once-off loans.
- Mass organizations (varying rates): Lending is only extended to members, capital is limited, and there is no sustained financing in the long term.
- VBA (1,45% p.m.): Collateral is required. There are heavy administrative paperwork and hidden costs.
- ROSCAs (varying rates): members must be able to contribute regularly. Not liquid. Limited capital.
- NGOs (1,5-2,2% p.m.): Simple paperwork. Saving required or encouraged. Repeat loans are available.
- PCFs (1,8% p.m.): Only lend to members who must have shares. Not targeted at the poor.
- Private moneylenders (3-10% p.m.): Lot of capital, but high interest which contributes to debt trap. Poorest may be deemed credit unworthy [Nguyen and Nachuk, 1996]

b. Capped Interest Rates Prevent from Delivering Adequate Services

Since the end of 1995, the State Bank has set interest rate ceilings and maximum interest rate spreads between deposit and lending to give the poor access to funding at 'affordable' cost and fight against the high rates charged by usurers[21]. Although the motivation was commendable, this decision prevented financial institutions from building the real cost of money into their interest rates and forced them to operate out of subsidies.

With a standard lending rates of 1.0% per month, or 12% p.a. (sometime as low as 0.5% p.m. - or even free when local People's Committees pay the interests), the VBP effectively fixed a cap on interest rates and forced other local formal MFIs to align their rates. Yet, with a 10% inflation, there is no way that any institution can cover its costs at such a rate without external subsidies (especially as MFIs' costs of managing many small accounts are typically higher than these of regular banks). Those interest rate ceilings prevent MFIs from setting prices that cover costs (direct and indirect costs of managing the organization and its portfolio), from operating sustainably in the long term, and from better adapting their services to local needs. This forces MFIs to rely on concessionary loans or plainly on grants from external agencies. Operationally, the very low rates (sometime negative in real terms) discourage the timely repayment of loans as borrowers are actually making money out of their debt.

Because of the limited interest rates they can charge, often local institutions cannot deliver more than a single type of production loan package. Yet there is a need for diversified (and not always financial) services linked to the extension of production loans, such as organizing training sessions in management or production skills or extending advising services in vocational training or health education. The current interest rate structure prevent the MFIs from offering those services. Yet, often, there is no existing governmental structure that already offer them.

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[21] Starting Jan. 1, 1996, the ceiling interest rate on short-term lending went from 2.1% per month to 1.75% while that on middle-term remained at 1.7%. Gradually, by October 1, 1996, the maximum interest rates allowed where 1.25% p.m. on short-term lending and 1.35% for middle-term. Meanwhile, for credit cooperatives and PCFs, rates went down from 2.5% to 1.8%. VBP rates decreased from 1.2% to 1% [VET, 1996].

VBP loans for their parts are often not specifically adapted to the local conditions of the poor, they are simply scaled-down versions of the loans extended by the VBA and do not specifically address the needs of the poorest (for instance, poor coastal dwellers may need a loan for a boat that exceeds the maximum offered by the VBP; as they have no collateral, they cannot go to the VBA - they could need a leasing system, or insurance for the boat, which no institution can afford to offer if it cannot charge the real cost of the services). For all players, the un-sustainable low rates of interest defeat efforts to make affordable credit available by encouraging hidden costs and a lack of incentives and accountability for results. Those capped rates are thus a serious impediment to the financial independence and sustainability of any MFI and dramatically so - several localized schemes we visited reported that the artificially low interest rates may force them to discontinue their activities if the VBP where to reach out more at their community level.

Then, as the Central Bank has fixed a maximum interest rate spread between deposit and lending of 0.35% per month, MFIs cannot either offer attractive return on saving to mobilize deposits and capitalize on saving that could then be lent on. The non-poor, whose saving could have helped build a local fund, prefer to lend their disposable capital on the informal financial market, often financing the activities of usurers and rationing the liquidity otherwise available to the poor on the more open (and cheaper) basis of the local MFI[22]. As for the MFIs, they can either attract some local capitalization through forced saving (i.e., before one is eligible for a loan s/he must save for a few months - which tends to prevent access to credit to the very poor who cannot generate the necessary disposable funds), or turn to external funding[23]. There is no way that, under such conditions, any formal MFI can become financially independent or even develop a "commercial" approach to micro-financing, proving that lending to the poor can be profitable. Capped rates and fixed spread hence not only ration funds, but also deter saving, prevent competition, and promote a status quo that benefits loan sharks.

[22] The lack of deposit growth has significant implications for both growth and equity. In spite of increases in short-term credit, farmers face acute shortages of medium-term credit and inadequate short-term credit. Available information suggests that six to eight out of every ten rural borrowers who are commercially viable fail to get loans from the VBA, in spite of its rapid growth [Fforde, 1995].

c. Confusion in Goals and Accountability : Social objectives vs. Financial Autonomy

Along with recognizing the relevance of building costs into the interest rate charged, lending institutions should dissociate the accounting of the costs related to extending financial services from this of costs related to social programs, as MFIs cannot become financially sustainable if their costs are burdened by social welfare objectives. Banks must be accountable for financial results, while organizations providing social programs cannot be limited by a need for return on investment if this prevents them from providing services that are meaningful in attaining their goals. The first step toward clear costs accountability is thus to dissociate the financial operations of the institutions that offer banking services from their non-financial operations. Many MFIs face a dilemma as they cannot meet both their social welfare and financial autonomy objectives and must often opt to abandon the latter, thus giving up their role of building local capacity. This issue of conflicting objectives concerns as well governmental programs as NGO-sponsored MFIs : there inherent conflict when a program has multiple objectives and confusion as to accountability and impact assessment. Mixed objectives only dilute accountability for results, promote inefficiency and increase hidden transaction costs of financial operations.

For instance, when the VBP offers subsidized loans, it acts as a mechanism for income redistribution rather than a financial institution. Doing so, on one hand it distorts the credit and saving markets, and on the other hand does not always achieve its goal of helping the poor help themselves. Indeed, the poorest of the poor often use this first, cheap access to credit as a bridge loan to finance dire survival needs (such as buying food or escaping loan sharks) and funds are diverted from their objectives of production and income generation. Therefore, as long as the loan does not serve to increase the poor's productive capacity and standards of living in a sustainable way, repayment is likely to be defaulted or even to drive the borrower into a circle of indebtedness. Thus, if the costs of social programs are carried by the provision of production funds, the credit program will not achieve its development goals, will not recover costs and

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[23] Most MFIs in Vietnam rely on both methods to capitalize their lending funds, but forced savings are not a sound practice, and most forced saving are highly volatile once the compulsory deposit period is over.

cannot be sustainable. At the local level, this means that for community-based credit schemes to be sustainable, the costs of basic life-supporting services (welfare) must not be supported by loans to individuals, and income redistribution mechanisms must be distinctively separated from micro-financing activities.

It is part of HEPR thrust to provide credit as a tool to help the poorest help themselves but also to provide the necessary social programs to ensure an enabling environment for the poor to reach out of their situations (e.g., the provision of basic services in health, education and support for the destitute poor so that chances are given to all on a fair basis). Accordingly, credit should not be used for education needs, for meeting basic food deficiencies, or for health expenses. Such spending ought to be supported by the community or the government; and the provision of welfare must be anterior to, and distinctly separated from, the provision of production-oriented credit if credit-schemes are to be sustainable. The provision of financial services for its part, must be delegated to financial institutions with specific financial and economic objectives.

This is not to call for increased social spending, but for the clear accountability for and dissociation of costs, results and responsibilities. This point is extensively supported by sound practices which state that sustainable micro-finance programs combine loans at commercial interest rates to voluntary saving mobilization, and that sustainable MFIs provide only financial services, and leave social services to other agencies [Robinson, 1996].

d. Shortcomings of Financial Services and Products Offered

Due to the limited prices that MFIs can charge for their services, many are limited in the kinds of financial products and related services they offer. Standardized loans are offered to minimize operation costs and many households end up receiving a similar amount of credit with a similar repayment period, independently of the investment they intend to use it for. Meanwhile, visits in remote villages are often not regular, and MFI officers cannot build a sound relation with their clientele to understand their needs and develop the most adapted services to answer them.

First, standardized loan terms often do not recognize the need for a repayment schedule adapted to production cycles. For instance, often only 12- to 18-month loans are issued to buy cattle while a cow takes about 3 years to raise. At the end of the credit term, the poor must either sell their cattle before maturity or take an informal loan to repay the first one - or more simply, many do not borrow from the formal MFI in the first place. Often, due to the requirement that a repeat loan can only be taken once proven that the first one has generated some production, the poor may not be able to take a second loan.

Box 16 : Long term versus short term loans and deposits

One of the current shortcomings of the Vietnamese banking system is the lack of long term loans (i.e., loans longer than one year) for which there is a large unmet demand. By 1996, only 18% of VBA lending was long term, and it is estimated that if this percentage could be increased from 18% to 30-35%, total credit to the rural area would increase to VND 2000 bn (i.e., US$182 bn).

There are several reasons why few long term loans are made:

- continuing insecurity about future inflation and interest rates.
- lack of assets to be used as collateral

From the side of the borrowers, there is little interest in making long term deposits given the uncertainty about long term inflation and interest rates. This makes it even more difficult for banks to loan out money for long terms - if they lend long term at a certain interest rate, and the interest rate on deposits subsequently drops, they will have to refinance the loan at lower deposit rates, making the loan less or even non-profitable for the bank [Ruijs and Nguyen, 1996].

Then rural credit is not always *micro*-credit and, for some rural poor, access to productive capital requires much more funds than what MFIs can provide them. For instance, in the coastal regions of Nghe Anh and Ha Tinh Provinces, fishermen cannot make a living from their small boats as they can only practice coastal fishing and cannot spend more than a workday off-shore at a time. To reach any non-depleted fishing area, they need larger boats to spend several days at sea, and possibly on which fish could be frozen and/or processed. Investments needed are superior to what is offered because of price pressure and a lack of adapted insurance market.

Third, standard services do not take into consideration consumption needs (for which money is often used) as most loans are production-oriented and saving are difficult to withdraw quickly. Due to the pressure of consumption needs (buying rice during the lean months before harvest), the poor thus borrow from usurers or are forced to sell their production (cattle or rice) before maturity, in any case jeopardizing the future. Interest-bearing saving schemes and short delays in withdrawing deposits could allow the poor to smooth consumption over the seasons.

Lastly, high hidden transaction costs (gifts to bank officers, travel costs, and the opportunity cost of the working day lost to get there) and the load of administrative paperwork and time required to obtain loan approval deter potential borrowers from requesting a loan. They prefer using the services of a local, informal money lender who processes the loan immediately, without paperwork and directly within the community. The local informal money lender is generally flexible in case of repayment difficulties and is frequently a successful member of the community whose business advise might be considered as more relevant than that of an outsider.

4.2.3 Inadequacies of the Operating Environment for MFIs

Adding to the problems related to the regulation of interest rates which have been extensively reviewed earlier[24], three major weaknesses of the operating environment of MFIs are (a) a general distrust in the financial system; (b) an inadequate legal framework for the development both of MFIs and of micro-enterprises; and (c) a lack of adapted regulatory and supervisory framework to give directions to MFIs' efforts while preserving the integrity of the financial sector.

a. A Lack of Confidence in the Banking System deters Investment and Saving

To reach the national goal of a growth comparable to that of its wealthy neighbors, Vietnam's investment (as a fraction of GDP) needs to exceed the 30% level. Then, to keep foreign debt under control, domestic saving must grow at least as fast as the GDP to finance the investment growth. But even if GDP growth increased from 14% in 1991 to 26% in 1995, domestic saving still represent only 17% of GDP, and bank deposits have fallen relative to GDP from 18% in 1991

[24] The regulation of interest rate was presented in the analysis of banking practices, even though it directly shapes the operating environment of all MFIs in Vietnam. This is due to the influence of the VBP's size and practices. Because of its dominant presence, the VBP can be considered both as a player and as a national policy decision maker (and as a *de facto* regulator) in terms of overall directions of micro-financing activities in Vietnam.

to 13-14% in 1995 [Fforde, 1995]. This decreasing trend in deposits is the opposite of what might be expected with a low inflation, and suggests a lack of confidence in the financial system[25].

Overall the population does not put a great deal of trust in the banking system, especially not in credit-cooperative-type operations, as the 1989 crash is still vivid in many people's mind and banking officials at various levels are unfortunately regularly implicated in "irregularities". The low confidence in the banking system makes deposits particularly volatile, with the exception of those forced to save through the banking system (such as bank employees). The low rates do not either encourage new savers to enter the formal banking system [Ruijs and Nguyen, 1996].

The lack of trust in the financial system (both from international investors and from local clients) is also partly due to a lack of information flow about the market, the players, and their products. The economy as a whole, and the financial markets in particular, suffer from the fact that many macro- and micro-economic data necessary to assess investment nationally and locally are very sketchy, outdated and not detailed enough to make well-educated investment decisions. National income accounts composition is vague (e.g., it does not show clearly the composition of imports and the nature of their financing), data on monetary aggregate are fragmentary, and basic data on labor markets are not detailed enough to spot opportunities for income generating activities. As for exports, market data on potential markets are limited and not easily available. On the macro-scale, all of this does not lay an incentive system for an efficient repartition of the capital. Overall, the lack of timely and accurate information on the economy and its rules does not allow the economy to function on a market-base, and thus excludes many from participating into the formal economy [UNDP, 1996a; Fforde, 1995].

[25] This of course adds to the low incentive for either the banks or the savers to save within the formal banking system: for the banks, saving are costly given the 0.35% spread limitation between loans and deposits; and the low deposit rate makes the banks unattractive for savers. Small amounts of saving - important in rural areas - are even less attractive to banks, as the costs for administering small saving are relatively high. Thus, the VBA accepts saving because it has a legal obligation to do so, but can hardly be expected to go out of its way into the rural areas to mobilize them [Ruijs and Nguyen, 1996].

Then, the lack of consistency and transparency in accounting practices makes it difficult to evaluate risks and return-potentials of investments or saving. Banks and investors cannot check the credit-worthiness of borrowers as there is no central registry for mortgage deeds, or no meaningful accounts. Business itself can only develop among tight networks of trustworthy friends, and so does inter-bank lending (as there is no structure yet to compensate for banks that would go bankrupt). As for savers or potential investors in banks, they cannot know which institutions are safe or financially sound since there is no agency rating the quality of financial institutions based on recognized standards. This situation is dramatized by the existing corruption in the state banking system and the allocation of loans based on political preference rather than on the return potential of the investment contemplated.

In terms of access to micro-finance services, it seems that awareness of formal S&C programs is limited, even in areas where they are very active. As information does not reach the poor, people with alternatives to informal lending may not realize it. Or, even if they know of existing formal MFIs, they do not think they can be eligible for a loan or be interested in other financial services. If the MFIs do not provide more outreach effort by sending officers to remote communities and making sure their services and requirements are well understood by all potential clients, information is unlikely to reach them. Unless there is substantial progress in facilitating information flow, potential MFI clients cannot be aware of the choices available to them.

Lastly, developing more precise and widespread market information in the agricultural sector would allow many farmers who remain in low-profit sectors (e.g., rice cultivation) because they know where to sell and the probable returns they will receive, to diversify into more profitable cash crops. Currently, information on crops grown for export (such as coffee) are difficult to obtain and rarely reach the farmers who make the planting decisions [Fforde, 1995].

b. A Legal Framework Ill-adapted to micro-enterprises and local MFIs

Three major legal issues impede access to credit for the poor: (i) an un-finished land allocation process, (ii) weak cooperative and business laws, and (iii) un-adapted insurance services.

(i) Even though there has been a countrywide redistribution of communal land to farmers, the process of land allocation is still unclear and not completed. Thus, many farmers are still unsure of what land they own and for how long, which provides them with little incentive to invest in it, especially for mid- to long-term productive investments. Besides, many farmers remain ineligible for credit as long as they do not have land for collateral. The earlier the completion of land allocation throughout the country, the better the environment will be for credit to be invested in productive agricultural activities. This completion will require better information on the meaning of the land allocation policies and regulations and on the process for allocation of plots.

(ii) In many instances farmers, traders or fishermen would like to form voluntary cooperatives to ally their technical knowledge and their bargaining powers to purchase inputs and sell their goods. Joining efforts and resources would also help them shield from individual risk - and could potentially be used to underwrite loans to members (single fishermen cannot get loans approved to purchase new boats as a boat is too risky to be taken as a collateral - such loans might be approved with the weight of a cooperative). Yet, the fear of bankruptcy, the lack of knowledge about how to organize, and the uncertainty about legal status of such co-operatives prevent many farmers or fishermen from forming such 'solidarity' groups. Better defined legal status and extents of responsibilities for such associations are required along with management training. The business laws that have been passed in this regard must be more widely disseminated and enforced (e.g., large financial institutions such as the VBA could use their outreach capacities and management expertise to help local entrepreneurs set up cooperatives).

(iii) Then, there is need for insurance products adapted to the diverse production capitals. For the time being, if a farmer can insure a cow, a fisherman cannot insure his boat. Here again, cooperative association might help diffuse risk and make insurance available to fishermen and farmers. Life insurance and insurance against natural catastrophes are necessary but unavailable to the poor.

c. The lack of adapted banking regulations and supervision for MFIs

The VBP is the main arm of the government's policy for extending micro-financial services to the poor and it is the largest provider of micro-financial services nationwide. Because of its proximity to the government and its position of quasi monopoly as a provider of micro-financial services, it can be considered as the *de facto* supervisory and regulatory device of the industry. Thus, the Vietnamese situation in terms of MFI regulation is somehow similar to that of the Grameen Bank in Bangladesh described in Box 3: A major institution has been entrusted with the charge of providing micro-financial services to the poor and, in the absence of a specific set of regulations for MFIs, a one-time chart has been passed to regulate the structure of the bank, its operational procedures and its reporting system.

Unlike Grameen though, the VBP did not originate from the up-scaling of a small-scale project born from field experience, and this influenced greatly the adoption of micro-banking practices that became countrywide norms (or constraints to other formal MFIs). In Vietnam, the VBP was created as a specialized extension of the VBA and therefore adopted many of its procedures, programs, and cultural traits: those of a government-run, heavily subsidized and non-profit-oriented agricultural development bank. While Grameen started at a small-scale, with a shoe-string approach and the need to only adopt the most efficient practices to financially survive, the VBP inherited from the support of the government, apparently ready to sink large amounts of funds in providing credit services to the poor. And, unlike in the Indonesian case (where the BRI was able to downscale its operations from those of a regular provider of rural credit to those of a specialized micro-finance institution), where an interest rate deregulation promoted the use of a cost-recovery interest rate structure and the adoption of sound micro-banking practices (providing adapted services to a large population of formerly unbankable poor, and building local MFIs on a financially sustainable basis), the VBP has not yet encountered the pressure (i.e., competition) and incentives (i.e., profit-orientation) to adopt sustainable micro-banking practices. At this point in time, it is therefore unlikely to be a proper example to build local capacity to create community-owned, sustainable lending and saving funds.

Box 17 : Weaknesses in the VBP's capacity to operate and regulate the MFI industry on its own

The main aim of the VBP is to help hunger eradication and poverty elimination through providing low-cost, productive credit to the poor. It operates with a non-profit orientation but with the intent of covering its costs while preserving and increasing its initial capital [VBP, 1996]. Yet, there are inherent conflicts between the provision of subsidized credit funded by concessionary loans and non-refundable grants and the goal of attaining financial sustainability and building the local capacity to create and operate credit and saving funds using sound practices.

Part of the mandate of the VBP is also to build the national capacity to provide saving and credit mechanisms to the poorest. Yet, it starts with inappropriate tools, and a lack of capacity to handle such a project. Following are the major inadequacies of the VBP practices and policies that bias the operating environment of other MFIs:

Preferential treatment of the VBP by the government:

- VBP is entitled to get profit and capital tax exemption and to receive other preferential policies from the government in order to reduce lending interest rate to the poor.
- VBP is compensated by the government for force majeure risks (e.g., natural calamities).
- VBP is exempted from compulsory reserve deposits [VBP, 1996].

Lack of capacity to adopt sound practices in micro finance

- VBP does not conduct interest rate policies that can cover costs and increase available capital, despite its mandate (see Article 14.4 of VBP chart in appendix).
- Some VBA programs and practices have been adopted without adapting the necessary component to micro-finance needs as required in a down-scaling strategy (see p.32).
- The overlap in cost and responsibilities between VBA and VBP officers render difficult an accurate system of transfer pricing and cost/results accountability.
- Reportedly, the VBP lacks the capacity to pass regulations and procedures for internal policies and practices adapted to micro-finance (e.g., in human resource management, internal financial mechanisms, pricing and incentives) [Coopers and Lybrand, 1996].

Lack of standards and independence in reporting practices

- The VBP must provide the State Bank with necessary information to appreciate results from its operations. Yet, there is no real standards required, and reporting is based on vague recommendations in the VBP chart (Article 14.5 and 16.2).
- Although the VBP is considered an independent entity, its board of management is composed of representatives from ministries, industries, local branches and mass organizations appointed by the governor of the State Bank (the Supervisor-in-Chief is appointed - and can be dismissed - by the board of management - i.e., by the government, Article 28.1). This greatly reduces VBP's autonomy to adapt its practices to market realities.
- Political control coupled with the lack of regular external auditing result in a lack of transparency (e.g., the Supervisor-in-Chief is prohibited to disclose the results of the supervision if not allowed by the Board of Management - Article 28.4 of Chart).

Unsuitable Regulatory and Supervisory Capacity

- Despite VBP's mandate to assist the Government in elaborating policies of funds mobilization, lending, tax, interest rate and program for poor households (Chart, article 22.7.), its lack of adequate capacity to conduct efficient micro-financial operations suggests that it cannot alone decide on regulations necessary to promote the use of adapted mechanisms for micro-financial operations.

All sound practices call for the use of market-based interest rates structures, professional management and clear accountability of costs and revenues. These, along with an appropriate incentive structure to motivate the management of MFIs are unlikely to be attained if banking for the poor is viewed as a charitable action that cannot pay for itself.

The intrinsic conflict of interest of providing subsidized credit while covering costs, coupled with a limited capacity to offer and manage appropriate micro-financial services to the poor (i.e., available, adequate and safe as reviewed in Box 2), limit the capacity of the VBP as yet to be considered as a sound vector for giving direction to sound policies of micro-financing development (through developing MFI-specific regulations) and for controlling operations in the industry (though acting as a regulatory body).

Table 16 : SWOT analysis of the strategic environment of MFIs in Vietnam

Strength

Political and Economic Environment

⇒ Macro-economic and political stability, and the adoption of market-driven strategies for development and poverty eradication efforts.

Good Outreach Capacity

⇒ VBA and VBP have shown impressive outreach capacity (through the use of mass organizations and a willingness to innovate to non-traditional banking practices).

⇒ Most NGO-supported schemes successfully reach poor clients (albeit not the poorest), a market relatively untouched by the formal financial sector.

⇒ The gender orientation of mass organizations (e.g., VWU) and NGO-sponsored MFIs benefit women in accessing micro financial services.

Positive Experiences

⇒ PCFs contain many ingredients of sound MFIs - interests fixed at rates that (might) lead to financial sustainability, saving-driven growth, local control and the backing of the national banking system.

⇒ There is a strong tradition of informal finance (ROSCAs. private moneylenders, and relatives/ friends) to cooperate with in developing local capacity (credit and saving funds and MFIs).

⇒ Some local initiatives (NGOs and PCFs) have proven that S&C programs can function on a sustainable basis among the poor.

⇒ PCFs bring much needed competition in the rural financial sector.

Weaknesses

Institutions not Adapted to Dealing with the Poor

⇒ Formal financial services for the poor are still inadequately developed: the estimated demand for financial services is far in excess of the available supply; and the poor still face specific barriers such as collateral requirements, distance to travel, and lack of institutional adaptation to serve their needs.

⇒ VBA, VBP and their agents (mass organizations) do not master the skills adapted to developing sustainable micro-financial services and institutions (market-oriented management, controlling and reporting of financial operations based on standard and transparent accounting).

⇒ PCFs do not focus on the poor (they are like cooperative banks), and do not directly target those who lack formal financial services.

Micro-Financial Practices are not appropriate

⇒ Incentive structures of large scale institutions cannot attract competent managers.

⇒ Many programs have a weak saving component.

⇒ VBP's once-off loans do not promote borrowers' long term commitment to the institution.

⇒ Conflicting objectives of many schemes.

⇒ Too many loan amounts and terms are not based on household repayment capacity or production cycles.

⇒ There is no formal lending program for consumption needs.

Un-sufficient cooperation and dissemination

⇒ Lack of research in informal practices.

⇒ Lack of awareness of VBP activities. VBP has not yet been able to significantly reach the poorest (most rural areas are still not covered).

Lack of Opportunities for Micro-enterprises

⇒ Weak legal framework for the creation of voluntary, private cooperatives.

⇒ Inadequate technology and vocational/business education (thus lack of innovation and adaptation to market needs).

⇒ Lack of information on marketing outlets and prices.

⇒ Bad transportation, irrigation and telecommunication infrastructure.

Opportunities	Threat

A Market-Economy Drive

⇒ Interest rate policies should be de-regulated to promote equilibrium of demand and supply of financial services at market rates (to cover costs and offer adapted financial services) - Many moneylenders charge usury interests, which leaves room to charge cost-recovering rates. Low inflation would permit stable investment and positive rate of return on saving.

⇒ Most peasants would prefer to use formal MFIs to satisfy at least part of their banking needs.

⇒ In theory, the VBA and VBP function on a market-basis (district offices are considered as 'profit centers'). This is a good basis to improve efficiency in a deregulated environment.

Potential Linkage in Research & Capacity Building

⇒ Independently, many NGOs and governmental organizations provide adapted services in micro-finance, agriculture, or business training. Technical assistance synergies could develop.

⇒ There is a strong need to enhance coordination of international aid management in micro-finance and the dissemination of sound practices.

⇒ PCFs and NGO-sponsored MFIs use adapted financial practices. Meanwhile, VBA and VBP have a wide potential for outreach and dissemination of sound practices and show willingness for forming local alliances.

⇒ There is great outreach potential from mass organizations, especially the VWU, which has proven to be a most capable and motivated partner for providing micro-financial services.

⇒ A tradition of consultation and the Government's willingness to decentralize decision-making are promising to make the best use of successful local experiences to disseminate sound practices and develop clear and enforceable locally adapted regulatory and supervisory devices (there is much to learn from informal structures and practices to develop sound formal MFIs).

⇒ International literature on sound practices on the project and policy level to conduct and regulate/supervise micro financial activities should be translated and disseminated along with local findings.

Political Orientation of Anti Poverty Campaigns

⇒ Current political orientation promotes the use of subsidized lending to the poor. It does not recognize the need to cover costs, based on a market economy orientation.

⇒ Political agendas of many mass organizations may prevent some groups from being reached by micro-financial services.

Flaws in the Regulatory and Supervisory System

⇒ Regulated interest rates prevent from covering costs and from reaching sustainability.

⇒ Lack of transparency and standards for reporting financial institutions' performances

⇒ Key decision-makers (i.e., VBA and VBP officers) are not well educated in Micro-finance, both for operations and policy making.

⇒ Mass organizations and semiformal financial intermediaries suffer from a lack of sufficient financial depth and an ambiguous legal status.

⇒ Distrust in stability and honesty of the financial sector, lack of a clear legal status for financial intermediaries and lax enforcement of Law.

⇒ Poor communication and information networks prevent from disseminating knowledge and developing required MIS.

⇒ Lack of insurance services, leasing and clear land titles in rural areas.

Lacking Devices

⇒ Missing regulatory and supervisory framework for MFIs can cause serious problem in case of deregulation of interest rates and opening of the market (no rating mechanism or agency).

⇒ Policy Analysis on microfinance is limited, especially the requirement for adapted regulatory and supervisory structures.

⇒ Out-dated rural infrastructure prevent from reaching remote communities (transportation and telecommunication channels) and from securing investment (irrigation and dikes).

[Berenbach and Churchill, 1997; CECARDE, 1997; Coopers and Lybrand, 1996; Johnson, 1996; McCarty, 1996; Microstart, 1996; Nguyen and Nachuk, 1996; SRV, 1995]

5. POLICY IMPLICATIONS TO IMPROVE THE PRACTICES & ENVIRONMENT OF MFIs

This chapter presents practical steps that can be taken to improve the capacity of the Vietnamese financial system to service the micro-financial needs of the poor in an efficient and effective manner. It brings together the findings from the Vietnamese experience with the framework for adopting sound practices and establishing an enabling environment for MFIs.

For MFIs to be successful and beneficial to the largest groups, they need an operating environment that (i) enables them to assess local financial and investment needs and constraints and derive adapted answers; (ii) gives them the ability and freedom to operate sustainably; and (iii) facilitates the transfer of skills learnt locally to other similar surroundings.

Accordingly, this chapter reviews steps to take in terms of: re-orienting poverty eradication strategies in the light the failure of subsidized credit to contribute to long term human development (5.1); developing the use of sound micro-financial practices (5.2); setting up a regulatory and supervisory environment adapted to the needs of MFIs (5.3); and making the best use of existing capacities by developing linkages between the micro-financial industry incumbents (5.4).

5.1 Re-orienting Vietnam's Micro-finance Strategies

One aim of the HEPR program is to provide loans to 90% of Vietnam's poor by the year 2000. Yet, by targeting all the poor with similar subsidized loans, it cannot achieve its long term goal of giving people the economic tools to lift themselves out of poverty: on one hand, providing subsidized credit to the entrepreneurial poor is a waste of resources (they value the availability of credit more than its costs); on the other hand, lending to the destitute poor is unlikely to yield economic return. Poverty alleviation strategies should thus clearly dissociate the needs and potentials of the "productive" and of the "destitute" poor to better devise appropriate tackling policies and limit the inefficient allocation of government capital. While the destitute cannot provide for oneself and needs direct help through income redistribution and welfare programs, the (potentially) productive poor would benefit from being treated an as economically sustainable entity.

Currently, VBP's politicized mandate places undue emphasis on credit outflows over recovery and its lending practices are inappropriate to the needs of the poor. This weakens the VBP financially and keeps it dependent on government and external donor funds, while promoting an overall inefficiency of the state-run financial institutions, which nurtures corruption and tends to diminish the overall mass of lending fund available. Therefore, in the light of sound practices, financial services to the poor should not be subsidized, and the national micro-finance policy should shift from directly providing subsidized financial services to setting up the enabling environment that will better allocate existing financial resources and build the capacity of the financial infrastructure to attract and secure more resources[26].

The State should thus become a facilitator and a regulator of the financial industry and focus on: (i) deregulating the interest rate regime; (ii) adjusting the legal environment and creating appropriate legal forms for MFIs; (iii) developing an adapted supervisory structure for MFIs; (iv) encouraging the dissemination of sound banking practices; (v) transforming VBA and VBP into profitable intermediaries between savers and investors; and (vi) providing opportunities for local communities to establish their own local financial institutions [Seibel, 1998].

The example of BRI in Indonesia (see Box 1 & 4) shows the evolution process of a government-run agricultural development bank that turned into a profitable provider of micro-financial services through the adoption of sound micro-financing practices, the development of an appropriate regulatory system, and a deregulation of banking requirements within a stable macro environment. BRI underwent considerable transformation to become a politically autonomous, client-oriented, well-managed, and profitable institution, with the strong support from the Government. It recognized the failure of subsidized credit schemes and changed its village banking operations to fit with the sound practices of micro-finance. Meanwhile, the State was able to reform the national financial sector and thus give more autonomy to market forces [Mukherjee, 1997].

[26] In very poor and remote areas with low population densities though, it is unlikely that local MFIs can reach institutional sustainability, even in the medium-term. The costs to operate in such areas are too high to be recovered, even with interest rates that are quite high. Yet financial intermediation is needed. The particular difficulties of extending services into Vietnam's mountainous regions should thus be given special attention, and possibly be developed as a public service (i.e., without the imperative of operational sustainability), as long as the degree of subsidization of those program is kept explicit [Garson, 1998; McCarty, 1996].

Table 17 : Factors that backed the success of BRI Unit Desa and are/could be present in Vietnam

⇒ A stable macro-economic environment;
⇒ A strong leadership within BRI to conduct the reforms;
⇒ Considerable and prolonged backing in political support and financial and human resources from the government and external agencies;
⇒ Liberal financial sector policies that allowed BRI to design its own products and price them according to cost-recovery principles;
⇒ Complete operational autonomy for the village units without any government mandates on reaching "lending targets" or population groups;
⇒ Large investment in professionalizing the human resource base through staff training, merit-based recruitment, and performance incentives; and
⇒ Clear and transparent financial reporting and accountability.

[Mukherjee, 1997]

The VBA and VBP in Vietnam have similar potentials as the BRI and its Desa Units to become the provider of financially sustainable micro-financial services, and be at the center of the development of a regulatory and supervisory process for MFIs. The VBP already benefits from a large network of branches, a strong backing by the Government and international development agencies, and the current banking expertise of the VBA, all within a stable socio economic and political context. As in the Indonesian case, the Government is also strongly committed to increasing financial deepening at the local level by developing a network of local institutions (e.g., the PCFs). It could very well pursue its current efforts of adapting the national financial system to the needs of the rural economy by adjusting the regulation of the financial sector to the rules of Vietnam's new market-economy, strengthening VBP's understanding and use of sound micro-financial practices (in governance and operations), and developing a strong national system of financial regulation and supervision. This would create an enabling environment and a level playing field for the development of an extensive network of financial institutions adapted to the needs of the growing market economy (both for MFIs and for regular banking institutions).[27]

[27] A prerequisite to promoting the creation of such an enabling environment to develop Microfinance capacity is nevertheless to increase decision-makers' awareness of the needs and constraints of MFIs. Although policy makers in Vietnam recognize the need for providing financing capacity to the rural poor and are concerned about the scarcity of formal credit to the poor, few are knowledgeable about the technical requirements faced by the micro-financial industry. This is how a "regular" agricultural bank such as the VBA was given the mandate to provide financial services to the poor (through the creation of the VBP), without being adequately trained to understand the requirement of the micro-financial industry, nor being provided a truly enabling environment to operate (the Government misunderstood the continuous funding of subsidized loans for the provision of adapted regulatory devices and freedom to adapt to local needs). Micro-finance policies must be elaborated only after a thorough training of the decision-makers to what constitute sound practices at the project and policy level.

5.2 Researching and Promoting Sound Micro-financial Practices

5.2.1 Appraising local situations

Microfinance strategies must be supported by a comprehensive understanding of the financial situation of poor households at the local level, since the objective of microfinance is ultimately to increase household income and address basic needs [Garson, 1998]. As presented in Box 10, household surveys and focus groups can be valuable sources of information to understand (i) specific livelihood and income generating patterns; (ii) current informal financial practices (levels of spending and saving, loans or contribution from/to ROSCAs, moneylenders, banks or family members); (iii) constraints set by the condition of the communication and transportation infrastructure (which affects access to markets and to information); or (iv) languages used, levels of literacy and specific cultural traits of the community that can influence the operation of the MFI (e.g., the ability to use group lending or to lend to women). It is also important at the identification stage that the micro-financial needs and constraints be analyzed by gender (e.g., by having men and women separated into different focus groups) to determine whether and how specific programs should be designed to answer different needs and constraints by gender.

The objective of such research is to identify patterns, in terms of both preferences and behavior, that will contribute to design an effective local micro-financial strategy offering services that may be more attractive than, or complementary to, traditional practices [Garson, 1998][28].

The second important objective of a local appraisal is to put together a complete picture of the actors that are already involved in microfinance at the local level [Garson, 1998]. Understanding not only the needs of the people (e.g., the hidden costs involved in obtaining a loan, the adequate sizes and terms of loans, or the concerns for safety), but the operations of the current substitute for formal micro-financial services allow to develop the most appropriate services and make the best use of existing local capacities at the local level[29].

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[28] As Box 2 presented, typically the needs of the micro-borrower are (i) the availability of the institution and services (proximity of MFI, quick extension of credit and possibility to withdraw saving immediately); (ii) the adequacy of the services which amounts and terms must be adapted to local business needs and capacity to repay; and (iii) the safety of deposits.

[29] e.g., for potential linkage strategies between formal, semiformal and informal MFIs as explained in 5.4

In Vietnam, there is little documented information on the way local informal institutions (ROSCAs, self-help groups, etc.) actually function, and the information available often remains at the district or province level where projects are conducted. They are not fed back to the decision-makers at the national level. Collecting information on what kinds of services informal institutions provide and how, putting them in perspective with the somehow better knowledge of semi-formal institutions (such as PCFs, mass organizations and NGOs) and with the information regarding formal institutions (mainly the VBA and VBP), and aggregating the findings of projects nationwide, would be very valuable in bringing to the attention of national decision makers a clearer picture of the existing formal and informal capacity to deliver micro-financial services[30]. At the national policy level, the interpretation of the findings of the household and MFIs surveys in terms of specific strategies needed to develop microfinance can give the major decision makers (Ministry of Finance, Central Bank and the VBA/VBP) a clearer understanding of the need to address microfinance in a more formal and legal way. A formal approach is actually needed as developing an enabling environment for MFIs calls for mobilizing public saving through offering market interest rates on deposits (with the danger, in an deregulated system, to witness a repetition of the Credit Cooperative collapse of the mid 1980s). Yet, this approach must be based on the careful understanding of the dynamics of MFI practices so that inadequate regulations (e.g., high capital adequacy or reserve requirement) do not box MFIs into practices that require replicating traditional banking, thereby losing their ability to develop locally adapted practices.

Table 18 : Recalling the characteristics of micro-banking policies adapted to the poor's needs

- A delivery system which brings the bank to the people
- A corporate culture which shows closeness and attention to the poor's need
- Business and product policies locally-adapted and sustainable
- Bank procedures set to easily communicate with customers
- Terms and conditions adapted to the local needs
- Risk management and crisis prevention adapted to micro-finance characteristics
- Human resource development must select financially professional staff, yet socially motivated

[30] It is obvious that obtaining information on informal financial practices is a difficult task. Given the bad press written about money-lenders, they are often considered on the "illegal side on informality" and are unlikely to openly cooperate with government official surveying local practices. Nevertheless, the use of university-based research groups, and of appropriate, culture-sensitive approaches (e.g. though PRA methods) should allow to obtain a relatively accurate picture of informal practices.

5.2.2 Formulating National Guidelines for Sound Practices

Concurrent to the efforts of setting up an enabling regulatory and supervisory environment (see 5.3) is the need for MFIs to adopt sound operational practices both at the formulation and at the implementation stage. The sets of micro-financial practices presented thereafter can be used as a basis for developing national guidelines for sound practices in setting up a micro-financial program. Those practices are detailed as they apply to the Vietnamese environment and notably to the experiences of VBA and VBP (the largest national programs). As an illustration of the often mentioned need to adapt practices to the specific needs of different target groups, I mention (when applicable) design issues with a gender approach[31].

Box 18 : The Importance of Gender Issues in Developing Microfinance Strategies

Developing gender-aware microfinance strategies does not simply imply offering micro-credit to women. It assumes offering micro-financial services adapted to differing male and female needs (which are themselves dependent upon the local social and cultural environment and cannot be generalizable).

Empirically, repayment rates of women have been higher than these of men (at least in Asia). Yet this does not mean either that the existing micro-credit methodologies were created to specifically fit women's needs, nor that men would not have higher repayment rates if they were offered micro-financial services more appropriate to their specific demands and constraints.

Besides, even though access to credit may allow many women to become "economically productive", it does not always mean that they enjoy a better life. Their remunerated activity often only adds onto their existing chores as a mother and housewife, and does not always improve their status. When the improvement of their economic situation is detrimental to this of their husbands, they can even be negatively affected by the provision of productive credit.[32]

Gender awareness thus means offering services adapted to the needs of specific customers, male or female and it is important to assess the potential gender impacts of a micro-financing program at its conception stage [Binns, 1998].

Those examples should reinforce the need to not indiscriminately apply practices that worked elsewhere without first asking whether they fit with local needs.

The Vietnamese laws recognize equality between all (men and women, ethnic minorities and majorities), yet there remain empirical discriminatory practices that go against equality (such as the allocation of land titles to men, and the effective alienation of many ethnic minorities from the political and economic decision processes). Existing laws should therefore be clarified and enforced to level the playing field and grant similar social and economic chances to all, irrespectively of their gender or ethnic belonging.

A subsequent stage, aiming at building actors' capacity of using sound practices and at linking MFIs for operational and financial synergies is presented in part 5.4.

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[31] Although I take "gender" as a criteria to show how those practices can be adapted, it must be noted that replacing "gender" by "ethnic group", or "age group" in asking whether each practice is relevant to a given minority can as well help understand the specific needs and requirements of minorities for whom few economic development tools are specifically designed.

[32] A husband who loses face (by being refused access to credit while his wife is receiving funds) may become violent, forbid his wife to make regular repayments or to take a new loan, or simply relinquish the role of bread-winner onto his wife.

a. Sound Practices at the Formulation Stage:

(i) *Recognizing the fungibility of funds:* Although micro-credit must be taken for a productive purpose, cash pressures often push the poor to utilize part of the funds for consumption. MFIs should thus encourage the productive use of funds to generate income, but they should not increase their costs by monitoring too closely the actual spending pattern of the funds. The basis of micro-finance is to empower the poor and borrowers should be trusted to make an appropriate use of funds. Group pressure suffices to insure the timely repayment of the installments. Beside, linking the allocation of a loan to a specific and unique use of the funds (i.e., a productive activity) is generally in disfavor of women who often need to use up to 50% of the amount loaned for consumption purpose - mostly to feed their families (and yet they show high repayment rates) [Binns, 1998].

(ii) *Loan amount/term and repayment size/frequency should be adapted to the investment and its expected return:* To serve its purpose of raising one's standards of living, a loan must be important enough to generate a positive cash flow back into the household (i.e., it must cover all production-related costs; funding only part of the operation results in failure of the enterprise. Then, the term and repayments must be adapted to the investment payback period and be sized according to its cash flow pattern. Only with repeat loans, the borrower should have access to incrementally larger amounts, once s/he has accumulated a sufficient basis of productive assets. The adequacy of the loan size, term and repayments is also sensitive to differences in investment characteristics by gender. Women usually feel more comfortable with taking smaller loans than men to invest in less capital intensive activities. Men's or Women's membership in a micro-credit program are thus directly influenced by the size of the loan which must be appropriate with their respective investment behavior, and the appropriateness of the terms with the revenue-generating pattern of each investment. The frequency and size of the loan repayment must also correspond with the expected income-generating pattern of the productive investment and recognize that female-headed micro-enterprises generally generate smaller cash inflows than their male counterparts. They must as well be adapted to the existing cash habits of the borrower before s/he took the loan. Empirically, regular repayments (e.g., weekly or every other week) of small size allow the borrower to repay his/her loan[33]. This suggests that the VBP limit its loans to financing activities which generate income in the short term, rather than disbursing sometimes comparatively large investment relative to the wealth of its borrowers[34], and that loan terms be shorter and frequent installments be required rather than monthly repayment.

(iii) *Saving products should adapt to the needs and constraints of the poor:* In terms of saving, the poor need *accessibility* (a credit fund close to their home to deposit their surplus cash as soon as they need to), *liquidity* (to withdraw saving quickly in case of urgent need), *positive interest* (a return higher than what could be obtained by investing in a productive activity), and *safety* (trust that the saving fund will not collapse). Successful lending schemes hence provide saving programs both to capitalize the local fund, to help the poor keep cash for the lean months, and to build accountability toward the local fund. Even if saving prior to becoming eligible for a loan is necessary to build the borrower's sense of responsibility, the minimum saving required must not represent a barrier to credit accessibility for the poorest who could not even raise the minimum required funds. Saving products must also be customized gender needs: Women may have different needs and constraints from their husbands: some prefer contractual saving products (such as term deposits) to avoid the family-pressure to withdraw their saving for immediate consumption (e.g., drinking for their husbands) [Binns, 1998].

(iv) *Guarantee requirements should be appropriate, and Confidentiality be respected:* Given the customary allocation of land rights to the man in the Vietnamese household, and the deprivation of real property for most rural women, loan guarantee processes must be adapted to what each spouse can put forward as collateral (e.g., while land ownership can be a man's collateral, a woman should be able to pledge their jewelry). In case of loans to the very poor, group guarantees,

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33 Ideally, repayment amounts should be as close as possible to amounts that borrowers were able to generate before taking the loan to insure that they can repay, even if the investment fails [Binns, 1998]. Realistically though the poor often had a very limited (if any) cash-based activity prior to taking the loan, and non-repayment risk cannot thus be totally absorbed this way.

34 The standard US$100 loan made by the VBP can represent an insufficient start up capital for some ventures (e.g., buying a couple of pigs), but can also be overwhelming if it is aimed at purchasing start-up inventory to make small handicrafts.

or good credit history for repeat borrowers, should replace physical collateral. In the same vein, to prevent some potential disagreements between spouses over the relevance or use of a loan, confidentiality must be respected and MFIs must not release information on the financial status of their members to other than members themselves and supervisory or regulatory authorities.

(v) *Delays in extending loans should be minimal:* One of the recurring reason for not taking a loan from the VBP is the length of the approval procedure (several weeks) to obtain a relatively small loan. More often than men, women are confronted with emergency needs for cash, and MFIs should be able to approve small loans with minimum delays (optimally on the spot). Management must thus be allowed to extend loans within delays appropriate to local needs.

(vi) *There must be strict policies on non-repayment and loan rescheduling:* Although there must be no debt forgiveness (and even, late repayments must be penalized), MFIs must have standard policies to reschedule loans in case of force majeure (e.g., natural disaster or death).

(vii) *Financial products other than Saving and Credit can be designed:* In rural areas, MFIs can be adequate vectors to provide dearly needed services such as leasing and insurance. Leasing allows some of the poorest to surmount their fears of taking a seemingly risky loan. In Vietnam, MFIs could purchase cyclos, or boats and rent them to scheme members. After a leasing time, the member could purchases the productive good from the MFI at a reduced price, taking a loan to finance the balance of the purchase. The VBP could learn from the VBA's current leasing operations branch and adapt them to the needs of the poor. As well, services in life or cattle insurance are also dearly needed to reduce some of the main risks that the rural poor face and there is much potential to develop cooperation with national insurance companies. Micro-financial services must remain flexible and adapted to local needs; they can also develop services in housing credit, health insurance or pension funds, once their members become better-off.

b. Implementation Stage:

(i) *Groups should be self-formed:* Loan groups must be self-selected and their internal governing structure (president, treasurer, secretary) must be self-appointed, yet care must be taken that no group member be in position to abuse others. Thus, in practice, MFI should insure that lending groups are "socially homogeneous" (e.g. that men are not mixed in with women if there is no power-parity between genders in the community), and that no-one is in position to use a "superior" social status to influence or manipulate other group-members (an elder may be used to be obeyed and may not adequately participate in a group process with younger members).

(ii) *Accessibility of Financing services:* To adequately serve all their potential members, MFIs must provide de-localized services, with mobile units and doorstep services. They must identify the different places where men and women can be reached and may have to set up mobile banking units at markets or at other customary gathering places. The places chosen to deliver financial services must be conveniently located and safe to reach, and services must be offered at a convenient time (i.e., not during working hours) [Binns, 1998].

(iii) *Awareness of the needs of the poor:* The Government approach to providing formal financial services to the poor in Vietnam is relatively recent, and remains associated with a welfare service rather than with regular banking transactions. This translates in the field into condescending attitudes toward the poor, and relatively high hidden costs linked to the fact that VBA or VBP representatives feel they extend a favor to the poor by banking with them (thus the poor are morally obligated to present gifts). Those attitudes must be changed by understanding that the poor are fully "bankable" customers who must be treated as such, be offered full and fair services, and be charged accordingly in a respectful and transparent fashion. Similarly, MFIs must insure that their loan officers are culturally acceptable to the potential clients. For instance, if local customs forbid women to meet "foreign" men, or simply if women do not feel comfortable in dealing with male officers (or *vice versa*), MFIs must ensure that they have an appropriate gender and ethnic mix in their staff to answer the different needs of the customers (or at least they must train staff in dealing with the social and gender issues they may encounter in the field).

(iv) *Simplicity of banking procedures:* Despite the high degree of literacy and significant proportion of literate women in Vietnam, illiteracy remains widespread in the most remote areas, and among ethnic minorities (who may even have limited oral skills in Vietnamese). Therefore, banking procedures must not only be simple, but also be adapted to the level of literacy of the clients, both male and female. In addition to simple procedures and direct help in filling up application forms, programs can use short theater plays, role plays and open debates to familiarize illiterate potential customers to the service they offer and to the Bank's procedures. In the VBP, some current procedures, such as involving "poverty committees" in selection process, frighten borrowers, add to delays in loan approval, and push them to turn to informal lenders for immediate credit. This suggests a need to streamline operations, perhaps by better understanding informal lending practices and learning from moneylenders' procedures.

(v) *Adapted lending methodology:* Although the group-lending methodology has been described as specifically adapted to the needs of the poor borrowers (for they represent a form of moral collateral when clients do not have assets to pledge), it should not preclude MFIs from using a lending methodology adapted to its local client base and to its own risk-diversification strategy. It has been noted that helping the poor may be done either directly - through directly providing them with micro-credit to invest in a productive activity - or indirectly - through financing the productive capacity of a better-off member of the community who can generate employment for the non-entrepreneurial poor (see Box 19). Thus an MFI's collateral requirement practices can include both group-lending and individual lending (against regular physical collateral).

Box 19 : Should MFIs only provide services to the poor in Vietnam?

There is a recurring dilemma attached to S&C programs not exclusively targeting the poorest : They lend to borrowers who already have outstanding debts with VBA (i.e., who are 'rich' enough to produce a collateral for VBA loans). This unnecessarily ties up cash that could be of better use to some who do not have the collateral required by regular banking institutions. Yet, helping the non-poor can also help the poor by creating local employment. Besides, discriminating between the borrowers does not help turning the ownership of the fund to the community.

Actually in Vietnam, many NGO-run S&C programs who targeted the bottom poor of a community witnessed difficulties doing so as they were going against the local vision of a fair repartition of resources and were creating jealousies. Many then had to let communities decide whom to include in the schemes, usually more on a solvability basis than on sheer poverty level.

5.3 Setting up a regulatory and supervisory framework for MFIs

5.3.1 Basic Requirements

As reviewed earlier, regulation and supervision are mainly required for full financial intermediaries (i.e. for those MFIs that raise funds from the public) to insure the safety of the deposits, saving and investments they manage. The majority of informal loan providers in Vietnam do not mobilize saving from outside of their communities and do not currently need to be regulated. It was also said that many local financial intermediaries in Vietnam have not as yet reached the critical size that makes it economically feasible to regulate and supervise them. Yet, it is necessary that an adequate infrastructure be incrementally put in place to first satisfy the needs of the largest institutions, and to then prepare the later institutionalization (or "formalization") of a network of smaller MFIs which will need to raise capital in the future.

The content of this part can thus be approached as a framework for reflection adapted to the Vietnamese characteristics, rather than as a normative set of rules to follow. It could form a basis for consultation between relevant actors (funding agencies, macro-level development organizations, Ministry of Finance, VBA and VBP, NGOs, PCFs, mass organizations and local MFIs). It presents tools that can be used in creating a nationwide enabling environment for the development and densification of a network of formally recognized MFIs in Vietnam so they can put their respective advantages in synergy to serve the poor and the less poor.

The main reason for local MFIs to become formal institutions is to obtain access to formal money markets to obtain refinancing from other banks or place their surplus funds. Under their informal or semi-formal status though, most of the current MFIs in Vietnam are not currently part of the formal national banking network. They are not full financial intermediaries, who can legally raise large amounts of capital. Yet, none of the local institution can hope to finance large-scale needs if they are not allowed to access inter-bank money markets. Similarly, their lending practices are not monitored by an adequate banking authorities. They operate in an ambiguous situation as they currently collect deposits and saving from the public without the official license to do so. NGO programs are not regulated by the banking laws, and even if they are professionally-run, they cannot have access to the refinancing potentials of regular banks. PCFs for their parts are under the direct supervision of the Central Bank, but not subject to the strict requirements requested to banks in terms of sound financial management and reserve ratios[35]; they still function as credit-cooperatives, and are often run with a non-profit goal and an non professional management team, which promotes neither the use of sound micro-banking practices, nor the adaptation to the needs of the poor, who are still viewed as risky and unbankable.

Despite their lack of "official recognition", non-bank institutions manage the majority of the banking needs in Vietnam (as mentioned earlier, around 70% of those needs are fulfilled informally). The need to finance a required increase in rural productivity and output to attain HEPR's goal of economically catching up with Vietnam's wealthier neighbors thus requires to recognize the importance and needs of the non-bank intermediation (or informal financial sector) at the local level. It calls for an identification of the extent, capacity, needs and constraints of the informal financial sector by the Government, and the (participatory) development of a set of regulatory and supervisory procedures to increase synergies between financial institutions of all sizes.

In Indonesia, the removal of interest rate ceilings, the opening of the banking sector to formal MFIs (i.e., the prudential deregulation of interests and the creation of legal status for MFIs), macroeconomic stability, and communication between the government, the central bank and the formal and informal banking sectors to understand local financial requirements have greatly contributed to financial deepening, to MFI growth, and to the increased access to financial services by low-income groups [Seibel, 1998b]. A similar approach, with the adjunction of an adequate supervision of MFIs[36], could greatly improve the impact of the Vietnamese Government's effort to increase the choices of economic opportunities to the poor.

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[35] Given the outstretched and limited capacity of the Central Bank to supervise PCFs, it is unlikely than these can dramatically increase their outreach without witnessing the excesses that lead to the collapse of the Saving and Credit Cooperatives.

[36] A lack of supervision is a major cause of the recent collapse of part of Indonesian's financial systems.

From a regulatory/supervisory viewpoint, the Vietnamese Government should then:

- Deregulate elements of the financial markets that must adapt to market constraints (by removing usury laws and limits on interest rate spread and allowing the use of market-interest rates), and create a proper legal status for MFIs as specialized banking institutions (to allow MFIs that meet performance standards to operate as formal financial intermediaries);

- generate a prudential regulatory framework in consultation with existing informal, semi-formal and formal MFIs (by keeping strict entry thresholds and on-going requirements on capital and reserve requirements, reporting standards and transparency of information, etc. which characteristics must be based on local markets' specificities - see Table 9 & 10);

- develop a coherent and cost-effective supervisory structure and enforcement mechanisms (by setting up strict accountability rules; insuring transparency of operations; and by collecting simple standardized reporting documents concentrating on key performance ratios - see Box 8 - to monitor results of different schemes on a comparable basis);

- use its outreach capacity to disseminate lessons learnt from local MFI efforts in terms of implementation of adapted services, and for an adapted, professional management of MFIs;

- promote the fair allocation of resources and information where they are needed by developing rural communications and infrastructure networks;

- continue its efforts to develop a business environment which follows the rule of law and permit to evolve in a clear and predictable fashion (e.g., clear and simple rules on land certification, loans, or licensing, so that firms can concentrate on increasing productivity rather than on finding out whom to bribe - see Box 2);

- keep developing other basic requirement of human development, complementary to micro-financing programs (reducing isolation, improving risk management, increasing access to available resources, increasing participation, and increasing sustainability - see Table 4);

- provide adequate funneling of domestic and international funding to serve as seed capital to set up local MFIs.

Providing an adequate legal framework for the creation and operation of MFIs can result in (i) helping SHGs and other informal providers of financial services merge into formal institutions (such as ROSCAs did in Nepal, merging into the Himalaya Finance & Saving Company, when the Government passed the Finance Company Act); (ii) turning unprofitable state-owned development banks into profitable institutions which mobilize their own internal resources and serve vast numbers of low-income people at market interest rates; and (iii) allowing MFIs to develop their own supervisory structure (for external auditing, inspection and supervision) when the supervisory capacity of the central bank is insufficient or inappropriate [Seibel, 1998b].

5.3.2 Formulating MFI-specific Regulations

a. The consultative process

As mentioned, there are several approaches to regulating MFIs, ranging from requesting MFIs to demonstrate similar financial capacities as regular banks to become formalized (i.e., a lack of MFI-specific regulations) to designing a special set of regulations designed for MFIs. In Vietnam, the VBP Chart (presented in appendix) is the document that regulates the only formal bank providing micro-financial services. Given its serious flaws that do not allow the VBP to be considered as an efficient MFI, it is unlikely that the chart can be used as a sound basis to devise a set of regulations that could be applied to other MFIs. Rather, the Chart of the VBP should first be reviewed to include elements of sound bank management and micro-financial practices.

Box 20 : Adapting VBP to microfinancial sound practices

Clarifying VBP's mandate:

- As BRI did, the VBP should keep its focus on providing financial services to the poor, but should recognize the need to cover costs and clarify all of its policies in this sense (e.g., by discontinuing the use of subsidized credit, the absorption of most costs by the VBA and of losses by the Government).

Adopting sound micro-financial practices:

- Pricing services according to the full local costs (except in very isolated communities - see note 27);
- Appropriately downscale the procedures inherited from the VBA to the needs of the micro-entrepreneurs by: developing attractive saving products (accessible, liquid, and with positive interest rates); decentralizing its management structure and effectively treating each village unit as a profit center, with its own Balance Sheet and Profit and Loss Statement; and adapting its corporate culture and practices to show genuine closeness and attention to the poor (by offering more regular outreach services on marketplaces, simplifying forms, or offering locally-adapted credit amounts and terms).

Adopting standards practices and full transparency:

- Using simple and standardized financial reporting systems (e.g., CAMELS ratios and loan classification procedures) to keep track of financial performance with accuracy and consistency at all levels;
- Developing the use of a Management Information System adapted to the requirements of MFIs (e.g., to capture loan terms and amounts, activities financed, and identify repeat borrowers);
- Actually dissociating the administrative and cost-reporting structures of the VBA and VBP (VBP must assume direct responsibility over the actual management of the credit operations, and transfer pricing between VBA and VBP should be fully accounted for), and setting up a specific structure to answer the need of the poorest and most remote regions, who will continue to need Government subsidies to cover their very high operating costs;
- Creating a staff training and incentive system adapted to the characteristics of MFIs that emphasizes responsibility at the unit level (to increase the accountability of VBP staff for the performance of its portfolio) and attracts managers with strong skills in micro-finance.
- Fully dissociate its operation from political pressures, and disclose results to all the funding partners.

Developing its capacity building and supervisory capacity (or delegating it):

- Consultatively designing a supervisory process for its units and for other MFIs;
- Contributing to develop linkages and synergies between formal, semi-formal and informal MFIs and reach grassroots through cooperation with existing micro-financial infrastructure;
- Researching adapted practices to local specificities and educating key decision-makers with the field-findings to appropriately direct poverty eradication strategies. Inversely, disseminating findings back to the community levels through its wide outreach;
- Use external expertise when needed (through audits such as this done by Coopers & Lybrand in 1996, consultation with donors and forums such as the CGAP or specialized electronic discussion lists).

Then, an adequate set of policy requirements for MFIs can be derived from the consultation of the full scope of micro-financial service providers countrywide. This could be done via a consultative process involving research capacity at local, national, and international scale, forming a tactical coalition between key participants in poverty alleviation and micro-finance to promote performance standards among MFIs, increase the scale of the provision of the micro-financial services on a sustainable basis and improve access to capital markets. Such a coalition could involve (i) leading MFIs (governmental and non-governmental); (ii) key planning and regulatory bodies (relevant ministries, people committees, and mass organizations); (iii) private sector representatives (even if they are few for now, it is a way to attract commercial banking and other investors); (iv) universities and research institutions; and (v) development agencies and funders.

It could decide on a methodology to conduct nationwide rating of MFIs to quantify and assess their operating and financial performance and create a reliable statistical baseline (for now, information remain anecdotal, self-reported, and difficult to use for rating). Surveys could use a method and tools close to that illustrated in Box 8. From the MFI rating, a set of best institutions could be produced and a database of most appropriate practices in Vietnam could be created, thus giving directions for the replication of other MFI practices.

A second phase would develop training based on the lessons from those MFIs and deliver it to all levels, from governmental officials to MFI staff, to potential MFI creators, to students in related fields. Training would cover elements of sound practices, enabling financial and non-financial environment, and the integration of corollary services needed for human development.

A third part of the project is to disseminate awareness of the standards among the industry stakeholders through workshops, advocacy and communication strategies. Those will be directed both at MFIs, private investors and funding agencies to guide them in identifying and supporting the most viable MFI strategies and at the government to assist it in providing an enabling environment for microfinance to operate as an effective human development tool.

Lastly, the project should include long term linkages with similar international efforts[37].

[37] Such a tactical coalition to establish standards for the microfinance industry has been started in the Philippines in 1996. In Vietnam, re-activating and improving the former "MFI forum" through the use of internet could be a valuable, low-cost consultation tools between domestic and international partners/researchers.

b. Regulation

A prudential regulation adapted to the specific risks associated with MFIs is based upon lower capital requirements and different reporting requirements than commercial banks, in return for more limited powers and lower acceptable leverage ratios. Based on the Bolivian example (see Box 6). Sound MFI-specific regulations require: the removal of interest rate ceilings and of subsidies, legal reserves set at minimal percentages above which the Central Bank remunerates funds set aside, the formalization of all non-bank financial intermediaries that meet required standards, and minimal capital requirements denominated in a constant international unit of value. Meanwhile, the risk exposure of capitals entrusted to MFIs is limited by rigorous market entry criteria (see Box 21), limits on loan sizes as a portion of MFIs' capital, and the interdiction to lend to borrowers related to the MFI.

Box 21 : Standard Requirements for MFIs to become formal institutions

Standards requirements on MFIs financial performance, client outreach, and sound business practices must be understood and adopted by funders second-tier institutions, retail intermediaries and clients as eligibility criteria for becoming formalized institutions and accessing support. They can be devised by adapting the following recommendations:

- **Capital Adequacy:** Given the relative lack of empirical data about MFIs' risks and capacity in leveraging equity capital, and the potentially large impact that a small percentage of non-performing portfolios can have on de-capitalizing an MFI, an initial capital/asset ratio should be no lower than 20% for MFIs, subject to downward adjustment as the institution and the industry gain experience.
- **Asset Quality:** to recognize the specificities of micro-loan portfolio management, conventional portfolio protection measures are not appropriate for micro-finance: neither high provisions on un-collateralized loans, nor requiring elaborate loan documentation can be used when banking with the poor. MFIs should rather be assessed on their capacity to maintain loan quality with appropriate tools. Regulators can thus find an adequate substitute to typical asset quality checks in insuring that MFIs assess loan quality on (i) historical performance of portfolios, (b) a statistical sampling of arrears, or (c) a focus on the adequacy of management information systems and policies for dealing with arrears.
- **Minimum Capital Requirements:** Minimum capital requirement is a safety factor to insure the ability of MFIs to rapidly provide new capital in case of emergency. A national consultation of MFIs will indicate appropriate standard requirements which must balance the typically high capital needed to insure the safety of funds with the relatively limited capital typically available to capitalize an MFI.
- **Earning Performance:** (i) excellent repayments with arrears under 10% of principle due and bad debts under 4%; (ii) interest rates and fees high enough to cover financial and operating costs; (iii) progress and plans to cover all costs from internal revenues in 3 to 7 years from starting up (portfolio diversity - to lower risk, capital growth - to invest, lend on and use to leverage domestic resources)[38].
- **Liquidity Requirements:** Given the relative liquidity risks MFIs are exposed to (high portfolio turnover and quick withdrawal needs), while donor funds can be unpredictable and non-donor funds are usually short-term) it is prudent to set relatively high liquidity standards (i.e., a high current ratio).
- **Client Outreach:** (i) a measure of market penetration to low income entrepreneurs (including minorities); (ii) a strong saving mobilization directly or through other local institutions.
- **Sound Business Practices:** (i) a sound governance (through the involvement of local investors) and accountability structure (e.g., dissociating social and financial operations), freedom from political interference; (ii) a competent staff (experienced in micro-finance); (iii) sound operations (using MFI-appropriate practices, effective management information systems and clear financial accountability).
- **Fraud Prevention** can be insured by a sound internal governance pattern which promotes accuracy and transparency (see Table 10), including internal audit, randomly monitored by the supervisory body, and the legal responsibility of the directors to insure such good governance and transparency.

[Barry, 1995; Baydas, Graham and Valenzuela, 1998; Rock, Otero and Rosenberg, 1995]

[38] In evaluating an MFI's profitability, regulators must take into consideration the effects of the direct or indirect subsidies that many MFIs receive (through grants or capitalization at preferential interest rates).

c. Supervision

As the micro-financial industry develops in Vietnam, a supervisory structure will have to be set up (most probably by the Central Bank at first) to insure the sound management of the national micro-financial system. In elaborating such a structure, it is likely that a new body can emerge, gathering representative from major stakeholders (national MFIs governmental agents and funders) and external auditors familiar with MFI operations.

In developing low-cost methodologies for supervising MFIs, supervisors can request from MFIs the regular publishing of simplified procedures to report on the elements of prudential control, standard management, and financial controls required to access the formal status of MFI, backed by random site audits (Box 5 details the contents of such regular auditing reports). Developing transparency through the publishing of such periodic audits using international accounting and auditing standards should minimize the inefficient use of resources, rent seeking and corruption and build up trust between borrowers and financial institutions.

Another important tool for supervision is the dissemination of guidelines and incentives for MFIs to monitor themselves. As mentioned in the Kenyan case (see Box 7), strong internal management skills along with the involvement of local investors are guarantors of adapted micro-financial operations and of the safety of their capitals as it is in the best long term interests of the management and investors that the MFI can become a sustainable, profitable financial intermediary. Beside appropriate control devices, the supervisory body should therefore ensure that there be a continuous flow of information from the grassroots to the national-level decision makers and the other way around about the latest findings in terms of sound practices and market-relevant information. This is were VBA and VBP can play the particularly important role of collecting and disseminating sound practices, training fund managers, and controlling the overall fitness of operations, using their extensive unit network.

5.3.3 Building MFIs' Capacity and Developing Linkages

a. The missing links

The capacity to provide adequate financial services to the poor on a sustainable basis in Vietnam is present through the separate abilities of different actors: (i) the VBA and VBP can provide a nationwide outreach either directly through their extensive network, or via their cooperation with mass organizations; (ii) professionally-run NGOs apply sound practices to the management of MFIs; (iii) PCFs have the capacity to build local ownership of the institutions; and (iv) informal financial intermediaries hold a vast (mostly un-tapped) knowledge about the local needs and constraints of the poor and in terms of micro-finance.

Yet, despite the wealth of potentials to offer adequate micro-financing to the poor, there are several important missing links between the different actors that result in the inefficient allocation of funds in the rural economy (important reserves are held in cash, while credit is scarce). Namely, those missing links are (i) the lack of existence of a clear national map of micro-financial needs, capacity and constraints, starting from the view point of the poor and of local MFIs; (ii) the lack of governmental understanding of the existence of sound methodologies to deliver micro-financial services on a cost-recovery basis, and of the specific regulation and supervision that MFIs require; and (iii) an inadequate incentive system for NGOs to fully disseminate the results of their "experiments" for nationwide replications (because of the "nationalistic" agendas of some foreign development agencies, competition for scarce international funding, and lack of trust in local governments).

There exist several factors strongly favorable to the establishment of the missing links, both for a better communication and for more efficient operational cooperation between actors. First, an important vector for improving communication is the ubiquity of the governmental outreach potential as well to gather information as to disseminate findings and sound practices. Second, is the recent opening of full internet communication in Vietnam which can allow to access expert advice and disseminate information almost instantaneously, to keep timely and accurate tracks of financial data over a national network of institutions (even in remote locations, since information can transit via cellular phones), and to open new markets to local products. A third favorable factor to establishing the required links is the current efforts of international aid agencies to better concert their efforts to implement development aid programs and avoid duplication of efforts and "cannibalization" of international funds (i.e., funding several projects concomitantly for conflicting purposes)[39]. Establishing links is an important part of the challenge, both to research local situations in terms of micro-finance, to build local capacity, to insure that all market needs are covered (through establishing operational linkages), and to channel funds where they are needed (through financial linkages).

b. Linkages for training and Capacity building

The training needs of all actors can be defined during the consultation process described earlier (composed of household and MFI surveys, and of the tactical coalition). From the participation of local experts (informal financial intermediaries), and adding to their own capacity to professionally run MFIs, a combination of NGOs can work with governmental agencies to create workshops and conference and elaborate simple manuals for training MFI practitioners at all levels (VBA, VBP, PCFs, mass organizations, and potential private investors), and for developing appropriate information material and campaign to educate the poor about the availability and convenience of micro-financial services. Emphasis should be put on understanding MFI-specific practices (e.g., adapted loan terms, adequate compensation and motivation of bank staff), transferring sound accounting practices, and promoting the creation of saving funds. Those manuals on running sound MFIs should be included in training programs at all scales of the national and local MFIs (in initial- and on-the-job-training, and in periodic refresher courses).

For their parts, NGOs must build their capacity to better understand the functioning of local administrative frameworks and to work in closer cooperation with mass organizations to help incrementally transfer their skills to local planners and decision-makers, so that their efforts can affect people's welfare in the long term rather than for the sole duration of particular projects.

[39] In micro-finance, programs such as the World Bank's Consultative Group to Assist the Poorest, or the United Nations Capital Development Fund (UNDCP) offer practical advice (both for governments and MFIs) on how to best integrate their actions to create mechanisms for the provision of credit to the poor.

At the national scale, multilateral or bilateral aid programs must insure they coordinate their efforts strategically and do not overwhelm the VBA, VBP or other organizations with related, yet separate training programs. An important area where capacity building is needed is in helping educate supervisory authorities on the difference between micro-finance and traditional banking and setting up an appropriate regulatory and supervisory framework for MFIs.

A pre-requisite for building the different capacity requirements of all actors is to operate under maximum transparency and to better disseminate information. In this regard, to promote transparency and efficient use of resources, international funders should encourage development organizations (both domestic and international, at the micro or at the macro scales) to work in synergy and implement projects in which the best of each agency's expertise is put to the use of a specific project rather than subject to national or political preferences. To promote co-operation between actors, regular meetings of donor groups, government institutions and local development institutions could be held to share projects and works in progress, during which specific funding could go to groups of partners who can demonstrate a profitable integration of their efforts. As well, there could be a reactivation of the NGO credit forum discontinued in 1995. With electronic conferencing, there could easily be a wide dissemination of learning on adapted practices and on the experiences encountered between all institutions. It would be easy to include international partners (banks and special interest groups in micro and rural banking) as Vietnam opens more broadly to internet. This might insure not only that some of the know-how acquired by the NGOs at the local level is actually transferred to relevant Vietnamese actors (such as the mass organizations), but also that all international sources of expertise are consulted.

c. Operational an Financial Linkages

Financial intermediation at the local level is optimal when the complementarity among the inter-linked elements of the local financial infrastructure is maximal. At the local level, financial intermediation is performed by a set of different organizations that are isolated. Capacity building should therefore aim to strengthen these organizations and to develop complementarities among them [Garson, 1998]. For instance, while PCFs are good at building the ownership of the fund by the community, they do not grant credit to the poor (for they require to buy shares, which the poor cannot afford on an individual basis). SHGs for their parts can serve as hedging mechanisms to represent groups of poor and become PCF members, thus allowing the poor, indirectly to access the financial services of the PCFs. Given that PCFs are already close in status to formal banks, it is likely that, under sound prudential regulation and supervision, they could become formal MFIs and obtain refinancing from the national capital markets (thus not being rationed for funds because of their still semi-formal status). In such a situation, simply allowing such linkages (i.e., allowing SHGs to be shareholders in PCFs) would end up strengthening the local ownership of the MFI, and permitting the poor to access formal sources of financing.

In developing networks, there is therefore a need for involving existing capacity both in the conception (through the consultative process) and implementation of the local micro-financing schemes (through the linkage of intermediaries) and policy changes must also happen through the strengthening and adaptation of established and recognized institutions. This means linking the institutional capacities of major actors (large banks, insurance companies, or the postal service) in terms of reporting and controlling procedures, national outreach and a diversified range of services and activities, with the local adaptability of small-scale semi-formal and informal intermediaries (closeness to the communities, ability to treat requests quickly, local ownership of the institution). Linkages strategies can thus be envisaged between banks and farmers or micro-entrepreneurs. Local money-lenders and self-help groups can be used as in India (see Box 9) as grassroots financial intermediaries to cut down on transaction costs for both banks and customers[40]. From their links with the formal banking sector, informal operators can adopt the more advanced knowledge about the financial management of larger institutions. If they success in meeting the required standards, they can later upscale their informal MFIs into formal institutions, with the advantages of obtaining access to larger financing capacities.

[40] For instance, given the experience of the money lenders (who know borrowers personally and can quickly rate their credit-worthiness), they could be used as outreach agents in communities where formal structures cannot send loan officers (because of distance to walk, or limited size of the local market).

Encouraging such linkages could be done by the Government, through the VBA or VBP as India's NABARD did successfully (it encouraged a dramatic increase in rural saving and reduction in bank and clients' transaction costs).

In the short term (before any MFI can graduate to become a full financial intermediary), formal banks have to play an important role in allowing such synergies of efforts. They remain the only full financial intermediaries that can issue guaranteed and exchangeable liabilities against cash deposited by depositors and savers and that can have access to a potentially infinite supply of money through refinancing markets [Garson, 1998]. As such, they are the safest conduits for funds (from governmental, donor or commercial sources) to reach local MFIs. It is thus important that they (along with the other players) be informed about their potential role (and the risk and return they entail) in developing linkages with the rural financial infrastructure.

Table 19 : Example of synergies among local financial service providers Adapted from Garson, 1998.

		Recipient				
		VBA/ VBP	*PCFs*	*NGOs*	*SHGs*	*Moneylenders*
Provider	*VBA/ VBP*		Collect excess Liquidity, provide training, monitor activities			
	PCFs	Can obtain refinancing		Provide funds to refinance NGOs		
	NGOs	Provide training on sound practices	Provide training on sound practices		Extend micro-financial services	Provide training on sound practices
	SHGs	Provide hedging for VBA/VBP lending, collect saving	Provide hedging mechanism for lending activity	Provide hedging mechanism for lending activity		
	Money-lenders			Provide knowledge about market		

To support its efforts in regulating and supervising the large network of MFIs that the creation of an enabling environment would encourage to form, the Central Bank of Vietnam may also think in the medium term of facilitating the creation of a second-tier institution[41]. This politically independent institution (with the power to mobilize funding, a sound knowledge to the market, and the ability to enforce standards and eligibility criteria for support) would act as a supervisory body by (i) building an agreed set of standards as the eligibility criteria for accessing support services; (ii) organizing performance benchmarking systems; (iii) encouraging exchange of experience among participating MFIs; (iv) serving as a wholesaler or broker of seed funding, capitalization funds, refinance of loan funds, and institutional development support; (v) encouraging mutually advantageous linkages between commercial banks and specialized financial intermediaries; and (vi) helping ensure that the appropriate legal, regulatory and supervisory structures and incentives are in place [Barry, 1995].

d. Developing Linkages with non-financial sectors

Although it has been earlier said that MFIs cannot increase their costs by carrying vocational training or agricultural extension programs (or at least, they should charge for their full costs). It is appropriate that their use their knowledge of the borrowers investment needs to help design adapted training programs that can be undertaken by separate entities. These entities can be either public (branches of mass organizations, or specific education or extension programs), or private (NGOs). Training can be envisaged to directly increase the productivity of the poor borrower (e.g., by learning sewing, or processing crops into value-added storable food products), or to facilitate the marketing of the good produced (by linking upstream, regional or national demand with local productive capacity). The example noted earlier of Bangladeshi women renting cellular phone services in their communities to facilitate marketing information flows could easily be replicated in Vietnam. Projects linking the provision of micro-financial services with the dissemination of health or education development program have also proven very beneficial[42].

[41] A second-tier institution is a financial intermediary or network that provides financial and institutional support services to retail intermediaries [Barry, 1995].

[42] Several projects in cooperation between UNICEF-Vietnam and the VWU in which micro-financial services were integrated with the dissemination of health messages and literacy/early childhood development projects showed that the synergy between MFIs and mass organization in can be beneficial to all parties involved. See the reports by UNICEF-Vietnam(1996) and Albee (1996).

6. CONCLUSION : CONTRIBUTION OF THE RESEARCH

This thesis analyzed the current state of micro-finance in Vietnam by (i) reviewing the characteristics of the institutions providing financial services to the poor and of the environment they evolve in; (ii) considering them in the light of international experience and sound practices; and (iii) deriving policy implications to improve the practices and regulatory environment of MFIs in Vietnam.

It showed that microentrepreneurs do not need subsidies and that microlenders cannot afford to subsidize borrowers. Rather, international experiences demonstrate that poor entrepreneurs need rapid and continued access to financial services and that MFIs should treat them as fully bankable clients, delivering micro-services adapted to their needs and capacity to insure and repay loans. Offering such services in a professional manner, by creating financially sound and well managed MFIs, also attracts the saving, deposits and investments of both the poor and the non-poor. This further allows MFIs to strengthen their local ownership while providing a much needed capacity for localities who had never had access to formal banking to place their liquidities.

International experiences also clarify the duty of governments as that of supplying the required market mechanisms for MFIs to adequately provide the services needed and charge for their costs. They call for the removal of practices that promote the use of subsidized credit and for the creation of adapted regulatory and supervisory bodies that insures that MFIs are well-run and can have access to commercial sources of refinancing, promote the use of sound practices for all MFIs, and contribute to integrate the capacities of all operators by developing linkage strategies to answer market needs at the best costs and avoid the inefficient allocation of resources.

The thesis concluded the analysis with a relatively positive impression: despite the numerous inadequacies both in terms of micro-financial practices and in terms of providing them with an appropriate environment, all the potentials are present in Vietnam to develop an efficient infrastructure of micro-financial institutions that will deliver adapted services to the poor on a financially sustainable basis and enable them to re-integrate the productive fabric of the society.

Yet, while the basis are present, the different actors do not yet evolve in an enabling environment and international experience gave some strong backing for specific policies both to improve the management of MFIs, to set up an appropriate regulatory and supervisory operating environment, and to enhance the necessary linkages between all levels of the domestic financial infrastructure. It also gave direction for better allocating international expertise and funds in helping strengthen local capacity in a strategic and coordinated manner.

Developing an efficient financial system to answer the needs of the micro and rural economy is one of the pillar of HEPR's efforts to give the poor better access to existing resources. Thus, this study could be used to implement some of the suggestions of Chapter 5, starting with a consultation of a large representation of all financial intermediaries (formal and informal) to better understand the micro-financial processes already happening and the needs and potentials of all actors, followed by the incremental planning of adapted regulatory and supervisory devices, which are at the core of enabling all micro-financial institutions to evolve in a transparent and predictable environment where inefficiencies are reduced and actors can be trusted.

An immediate challenge in Vietnam in terms of capacity building for devising poverty alleviation policies that integrate appropriate micro-finance strategies is thus to educate key decision makers to the need of providing an effective regulatory and supervisory framework, which is at the basis of improving the poor's access to financial resources, and ultimately to better standards of living and improved choices in life. It is also to better integrate separate poverty alleviation efforts both at the domestic and multilateral level to improve synergies between programs that look at similar situations from different angles. For the poor to become a successful micro-entrepreneur s/he needs more than simply access to financial services: the promotion of health education and relevant literacy and vocational training programs are dearly needed and could for instance use some of the outreach and communication infrastructure put in place for the efficient functioning of the micro-financial sector, provided their costs are clearly dissociated from this of financial operations and are fully compensated for.

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Appendixes

a. Glossary of main loan terms used in this study [Renz and Massarsky, 1997]

Assets: Interest in real or personal property which can be appropriated for the payment of debt.

Bad Debt: Debt that is not collectible and is therefore worthless to the creditor.

Bridge Loan: Short-term loan to provide temporary financing until more permanent funding is available.

Business Plan: A document that describes an organization's current status and future plans. It generally projects opportunities for the enterprise and maps the financial, operations, marketing and organizational strategies that will enable the organization to reach its goals.

Capital: Broadly, all the money and other property of an enterprise.

Capitalization: Long-term debt, preferred stock and net worth. The loan capital of a community development loan fund includes that which has been borrowed from and is repayable to third parties as well as that which is earned or owned by the loan fund.

Collateral: Assets pledged to secure the repayment of a loan.

Debt: An amount owed for funds borrowed.

Default: A failure to discharge a duty, or pay a loan installment.

Delinquent: In a monetary sense, a payable that is overdue.

Equity: The value of property in an organization greater than total debt held on it.

Loss Reserves: That portion of a fund's earnings or permanent capital designated as a reserve against possible loan losses and, as such, unavailable for lending purposes.

Market Rate: The rate of interest a company must pay to borrow funds currently.

Net Working Capital: Current assets minus current liabilities.

Net Worth: Total assets minus total liabilities. Aggregate net value of the organization.

Opportunity Cost: The potential benefit that is foregone from not following the best (financially optimal) alternative course of action.

Portfolio: A combination of assets held for its investment benefits, including financial and non-financial returns. The asset mix is usually varied in kind and size to maintain an acceptable level of risk and return.

Term: Refers to the maturity or length of time until final repayment on a loan.

Working Capital: Technically, current assets and current liabilities. Commonly used to refer to net working capital or to all short-term funding needs for operations.

b. CAMEL Ratios [Srivinas, 1997]

CAPITAL ADEQUACY RATIOS	
• *Dependency Ratio:* Donations and grants/Total performing assets	Shows dependency of institution on outside funding for operations
• *Capital to Assets Ratio:* Capital/Total performing assets	Shows overall capital sufficiency
ASSET QUALITY	
• *Debt to Asset Ratio:* Total liabilities/Total performing assets	Indicates provisioning requirements on loan portfolio for current period.
• *Loan Loss Provision Ratio:* Loan loss provision/average performing assets	Indicates provisioning requirements on loan portfolio for current period
• Portfolio in Arrears: Balance of loans in arrears/value of loans outstanding	Measures amount of default in portfolio
• *Loan Loss Ratio:* Amount written off/Average loans outstanding	Indicates extent of un-collectible loans over the last period. Any loan more than on year past due is considered un-collectible.
• *Reserve Ratio:* Loan loss reserve/Value of loans outstanding administrative expenses + provisions.	Indicates adequacy of reserves in relation to portfolio.
MANAGEMENT	
• *Number of Active Borrowers per Credit Officer:* # of active borrowers/# of loan officers	Indicates performance of loan officer and efficiency of methodology
• *Number of Active Borrowers per Management Staff:* # of active borrowers/# of management personnel (excluding loan officers)	Indicates performance of manager and efficiency of methodology.
• *Portfolio per Credit Officer:* Indicates potential financial productivity of loan officer	Value of loans outstanding/# of loan officers.
• *Cost per Unit of Money Lent:* Operating costs/total amount disbursed	Indicates efficiency in distributing loans (in monetary terms).
• *Cost per Loan Made:* Operating costs/# of loans made	Indicates efficiency in disbursing loans.
EARNINGS	
• *Return on Performing Assets:* Financial income/average performing assets	Indicates financial productivity of credit services and investments activities.
• *Return on Average total assets:* Financial income/average total assets	Parallels the Return on Performing Assets, yet includes non performing assets.
• *Financial Cost Ratio:* Financial costs/average performing assets	Shows costs of funds . Affected by mix of net worth, soft loans and hard loans.
• *Administrative Cost Ratio:* Administrative expenses/Average performing assets	Key indicator of efficiency of lending operations
• *Operating Self-Sufficiency Ratio:* Financial Income/Financial and administrative expenses + Provisions	Shows ability of institution to cover costs of operations (financial and non-financial expenses) with internally generated income.
• *Financial self-sufficiency Ratio:* Financial income/financial and administrative expenses + provisions + (Imputed cost of capital including grants and donations).	Shows ability of institution to be fully sustainable in the long-run by covering all operating costs and maintaining value of capital.
LIQUIDITY	
• *Current Ratio:* For a six month period - projected cash inflow/projected cash outflow	Shows ability of institution to meet projected near term obligations

Note: / is used for "divided by"

CHARTER OF VIETNAM BANK FOR THE POOR[43] [VBP, 1996]

(Promulgated the 14th March 1996)

[...] **Article 2.** Vietnam Bank for the Poor is a State-owned Credit Institution having nationwide operation and having function of mobilizing funds from individuals, institutions at home and abroad, receiving credit fund for the Poor from State budget and other sources [...]in order to set up lending funds for the Poor for poverty alleviation target.

Article 3. VBP is a legal entity, having its Board of Management, Headquarters, its domestic branches and legal capital amounting to VND 500 billions. VBP operates in principle of non-profit, self-maintaining fund, self-recovering operation costs and risks ; VBP is entitled by the Government to get profit and capital tax exemption and to receive other preferential policies from the Government in order to reduce lending interest rate to the Poor [...]

Article 6. VBP shall conduct its operation under the direction of its Board of Management and under the management of its Director General.

Article 7. VBP is allowed to carry out the following operations:

7.1. Fund mobilizing

7.1.1. Exploiting, mobilizing fund from internal, external sources of organizations and social strata.

7.1.2. Issuing debentures, discount and rediscount borrowing from the State Bank of Vietnam, internal and external borrowing for projects sponsored by the Government which will be relent to the Poor.

7.1.3.Carrying out saving mobilization within the poor community.

7.1.4. Receiving funds in trust from International and national organizations, individuals at home and abroad to finance the Poor

7.1.5. Receiving non-refundable grants from International and national organizations and other organizations to supplement into lending funds for Poverty Alleviation targets.

7.2. Lending

7.2.1. Extending short-term and medium-term loans to finance production of and dealing with goods and service of the Poor.

7.2.2. Based on the potential Resources, may join with economic organizations and mass organizations at home and abroad to co-finance production and business programs and project for the Poor.

Article 8. VBP's clients are those poor households who have labor ability but lack funds for production and business. No collateral is required for poor households to borrow from VBP, poor households shall take responsibility to repay the borrowed loans (including principal and interest) as committed when the loans are matured.

8.1. VBP provides loans to poor households based on the standard of poor household and poor areas clarified and issued from time to time by the Ministry of Labor, War invalids and Social Affairs in collaboration with other concerned institutions.

8.2. The Poor households will be borrowers of VBP only, when the Poverty Alleviation and Hunger Reduction Units at commune level shall review, select the list of poor

[43] The original text has been cut ([...]), but wording has not been modified.

households who are eligible to be borrowed. [...]

8.4. The Head of household is the representative of his/her family in every credit transaction with VBP. VBP only extends loans to the poor households who are not having outstanding loans with any other credit, financial institutions, mass associations organizations and other banks.

Article 9. Method of lending

9.1. VBP gives loans directly to the poor household.

9.2. VBP in collaboration with Farmer's Association, Women's Union and other mass organizations to build up "Saving and Credit" Group within poor community in order to mobilize funds and channel capital directly to poor households. These "Saving and Credit" Groups shall be certified to organize and permitted to operate by the People's Committee at commune level or adjust the existent credit and saving operation such as Joint liability Group or credit collateral Group into "Saving and credit" Groups.

9.3. The Regulation on Management of direct lending and Operation of "Saving and Credit" Group shall be issued and guided by VBP in coordination with other related organizations and in accordance with this Charter and functions of each related organization.

Article 10. VBP is not allowed to

10.1. Extend loans to other beneficiaries which are not specified in this Charter.

10.2. Contribute funds to joint-venture organizations enter into alliance for other purposes organizations invest funds abroad,

10.3. Carry out foreign exchange operations.

Article 11. Management of VBP

11.1. Managing, utilizing of its funds and properties,

11.2. Collaborating with Vietnam Bank for Agriculture to execute its operation in accordance with VBP's targets and responsibilities.

11.3. Collaborating with economic organizations and mass associations at home and abroad to co-finance production and business programs and Projects for poor household.

11.4. Carrying out credit operation and other banking services for the Poor household.

11.5. Managing and exploiting resources in order to strengthen funds for poor households.

11.6. Developing, applying managing limit in order to calculate loan amount to each household in accordance with production and business sector in each region and in conformity with fund resource and Government's policies for the Poor households.

Article 12. Finance Management Right of VBP

12.1. After fulfilling its interest paying obligation on borrowed capital management costs risk-recovering reserved fund, the remainder is used to get up funds as specified by the Government.

12.2. VBP is compensated by the Government for force majeure risks (such as natural calamities and diseases...).

12.3. VBP is exempted from compulsory reserve deposits, credit lines. Rediscount interest and free of tax on capital and profit.

Article 13. VBP shall be empowered to request borrowers to submit necessary information of their production and business to VBP. VBP may refuse any credit relations with clients in case the business involved is deemed to be unprofitable organizations the purpose of the loan is not for production or business. [...]

Article 14. Obligations towards the State

14.1. Effectively receiving, utilizing, maintaining and developing funds and resources provided by the Government.

14.2. Concentrating resource on implementing Poverty Alleviation Projects as assigned by the Government.

14.3. Conducting credit interest rate policy to the Poor in principle of self-maintaining funds, self-recovering of cost and operation risks. [...]

14.5. Maintaining Statistic, accounting and regular report promulgated by the Government, take the responsibilities for the authenticity of the reports.

14.6. Respecting regulations on inspections promulgated by relevant authorities under the law.

Article 15. For VBP's operations [...]

15.2. Developing VBP's annual and five-year business plans in accordance with the tasks assigned.

15.3. Renovating VBP's management procedure and method, modernizing banking technology. [...]

15.5. Be supervised by funds and other resources owners for VBP and make report required by representative of project owners finance to VBP.

Article 16. Obligations on accounting and financing

16.1. VBP shall strictly follow Government's regulations and policies on assets, funds management, responsible for the truth and legitimacy of its financial operations.

16.2. Providing necessary information to the State for true and objective appreciation of VBP's operation results.

16.3. Carrying out interest payments, recovery fund (principal and interest) to trusted fund owners to VBP. [...]

Article 18. Responsibility for the management of mobilized, borrowed & trusted funds.

18.1. Mobilized funds, being the property of various owners, VBP can use and has to repay timely and fully in term of principal and interest to the owners. [...]

18.1.1. Time deposits and demand deposits of inhabitants at home and abroad,

18.1.2. Deposits of socio-economic organizations,

18.1.3. Mobilized funds within the poor community.

18.2. Borrowed funds at home and abroad

18.2.1. Borrowed funds from domestic inhabitants and organizations

18.2.2. Borrowed funds from foreign inhabitants and organizations.

18.2.3. Funds formed by issuing debentures (short-term, long-term bonds and bills).

18.2.4. Borrowed funds from State Bank of Vietnam

18.3. Trust funds from State budget, domestic and foreign inhabitants and organizations.

18.4. Other funds formed on business activities of VBP will be utilized in accordance with regulations of Government's competent agencies.

Article 19. The network of the Vietnam Bank for the Poor consists of

19.1. The Board of Management and its Representative Units in provinces, cities under the management of the Central, in districts, towns under the management of provinces.

19.2. Its Headquarters has branches in provinces, cities under the management of the Central in districts, towns under the management of provinces, organized in the form that VBA's branches are in charge of and specializing in VBP's activities and managed under a nation-wide system. It also has a separate accounting - statistics mechanism of the uniform system in the whole country.

Article 20. The Board of Management is the organ managing the operations of the BVP. [...]

Article 21. The office term of the member of the Board is 5 years. The members of the Board may be re-elected [...]

Article 22. The BOM has the following duties and attributions

22.1. Drafting the chapter on VBP organization and operations to submit for the Governor approval of the state bank after getting Prime Minister opinion.

22.2. Making review and approval to annual report of the Director General on

22.2.1. Operations and finance plans.

22.2.2. Operation risks settlement.

22.2.3. Fiscal year settlement.

22.3. Promulgating regulations on activity principles and procedures, organizations and personal, operation principles, internal financial mechanism, interest rates, commission charges, bonus, fines.

22.4. Giving approval to annual report of VBP supervisor-in-chief. [...]

22.6. Maintaining regular and incidental reports in accordance with regulations.

22.7. Organizing economic studies, making analysis studies in order to assist the Government in evaluation, promulgation amendment of policies on funds mobilizations lending, tax, interest rate and programs for the poor households. [...]

Article 28. The supervisor-in-chief is appointed and dismissed by the Board of Management, having the following duties and powers

28.1. Proceeding role of internal supervision on the compliance of guidelines, policies, regulations, practices, rules and regulation in order to enhance the credit quality, banking services and to secure the assets of the State. the customers and of the Bank. [...]

28.3. Making supervision reports; appraisal report on the annual financial position and his proposal on the meeting of the Board of Management

28.4. Being prohibited from disclosing the result of the supervisor when not allowed by the Board of Management. [...]

Article 29. There shall be a consultant group consisting of experts from various concern industries. These experts shall be appointed by these industries and decided by the Chairman of the Board of Management

The consultants group has the following duties

29.1. Providing consulting ideas on problems related to the guidelines. policies, regulation for the operation of the Bank for the Poor

29.2. Preparing documents which are within the cognizance of the Board of Management as stipulated at Art. 22, Part I, Chapter IV of the present Charter. [...]

Article 30. Representative Unit of the Board of Management

30.1. At the Provinces and cities under the Central Government, there shall be established representatives units being under the management of the Board of Management. At the district, municipal towns, under the province administration, there shall be established representative unit being under control of the provincial representative units. The structure and component of these representative units are similar to those of the Board of Management of the Bank for the Poor. As the case may be, other member may be included when deemed necessary. In some areas, the Board on poverty alleviation and famine deletion may concurrently assume the function of the Representative Units of the Board of Management for the purpose of work coordination but stipulation on members and structure must be observed. [...]

30.3. The duties of the Representative Unit are set forth as follows:

30.3.1. Cause to implement the resolution, decision of the Board of Management and of the Representative Unit of higher level.

30.3.2. Making plan, program for funds mobilization and extending loans to the poor in the locality ; submitting the plan to the higher level for approval. The Representative units have the power of exploiting and pooling the funds available from many sources to make more loans to the poor in the area.

30.3.3. Directing, supervising the Bank for Agriculture branches in collaborating with the Bank for the Poor in implementation of the Bank's assignment.

30.3.4. Coordinating with other mass organizations and people's organization in establishing "saving and credit groups".

30.3.5. Conducting the studies, generalizing and requesting BOM to submit to the Government the recommendations on the issuance and amendment of credit policy to the poor.

30.3.6. Observing principles on reports to higher level, and management agencies of the Government, to other owners having contributed capital to the Bank for the Poor as stipulated. [...]

Article 31. The headquarters of the Bank for the Poor shall be in charge by the Vietnam Bank for Agriculture. [...]

31.2. The management of the operation at the provinces and cities, districts, municipal towns shall be assumed by the Vietnam Bank for Agriculture in the manner of providing services, but, the job shall be done by a specific division called "branch of the Bank for the Poor".

The branch is a legal entity having its seal and direct transaction with the clients, with internal accounting within the common accounting system of the Bank for the Poor.

31.3. To manage the Bank for the Poor branch, there shall be a director, deputy directors and specialized divisions

31.3.1. Statistics and accounting division directed by a chief accountant : following the internal system from the headquarters to its local branches.

31.3.2. Professional division : control and cause to implement the deployment in the locality.

31.3.3. Lending activities, loans collections shall be implemented by the mobile lending groups, transaction office of the Bank for Agriculture and village or inter-village credit officers.

31.4. At the district, commune, village, hamlet, there shall be "saving and credit groups". The mobilization of funds shall be done through these groups as said at item 3, Article 9 and item 2, Article 39 of the present Charter.

31.5. The chief accountant of the Bank for the Poor shall have the power and responsibility as stipulated under the Decree-Law on Accounting and Statistics.

31.6. Officers and staffs of the Vietnam Bank for Agriculture are assigned to specialize in or concurrently assume the tasks of the Bank for the Poor at any level. These employees shall be paid by the Vietnam Bank for Agriculture in terms of salary, bonus and other allowance in accordance with the regulation of the Vietnam Bank for Agriculture.

Article 32. The Director-General of the Bank for the Poor shall have the following duties and powers

32.1. Organizing and managing the operations of the Bank for the Poor in conformity with decisions made by the Board of Management, Standing Commission of the Board of Management and other her guidelines and policies of the Government.

32.2. Being allowed to issue the documents on

32.2.1 Funds mobilization and lending.

32.2.2. Rules on professional management, labor and organization

32.2.3. Organizing training course announcing guidelines, policy, regulations on professional techniques.

32.2.4 Supervising and fostering implementation

32.2.5. Drawing up operation plan. annual financial plan and submitting those to the Board of Management for approval and cause to implement these documents.

32.2.6. Organizing brief and overall review on the operation in a fixed or unusual term to evaluating the impact of the operation and submit these to the Board of Management. Making monthly brie reports on the position and operation results which shall then be sent to members of the Board of Management for information to issue decision.

32.27. implementing other tasks assigned by the Board of Management.

32.3. Being responsible for the direct management over assets. working capital and preserving. developing the capital and assets of the Bank. [...]

Article 33. Members of the Board of Management. Representative units, consultants. managers of the 'saving and credit groups' State agencies, enterprises, people's organizations and individual .. involving in the operation of the Bank for the Poor shall be considered semi-specialized an shall not have the rights such as : salary, allowance, subsidiary remuneration.... Basing on its financial capacity, the Bank for the Poor may pay allowances. bonus to the above-mentioned subjects.

Article 34. Relations with clients

34.1. The Bank for the Poor shall be liable to its clients for

34.1.1. For the physical assets, funds and its commitments

34.1.2. For the secret of data, favorable conditions for the operations of the clients with the Bank in accordance with the Law.

34.1.3. The Bank shall be liable to observe its engagement committed with household borrowers.

34.2. The clients shall be responsible to the Bank to

34.2.1. Observe the practice, regulation on saving and lending of the Bank.

34.2.2. Use the borrowed loans in proper purpose and pay back both the principal and interest thereof in due time; participate in the "saving and credit groups" in the community of the poor in order to help one an other in production and business ; supervise the utilization of loans and be co-responsible for paying back the Bank's loans.

Article 35. Relations with the State Bank.

Vietnam Bank for the Poor shall

35.1. Be subject to the State management in terms of monetary, credit and banking services policies.

35.2. Be allowed to borrow funds from the State Bank of Vietnam.

35.3. Conduct other credit services authorized by the State Bank of Vietnam.

Article 36. Relations with the Vietnam Bank for Agriculture

36.1. The Bank for Agriculture and Bank for the Poor are two legal entities which are bound one an other economically through contracts. [...]

36.2. The Vietnam Bank for Agriculture is responsible to arrange and organize training courses for staffs seconded by the Vietnam Bank for Agriculture to work in the Bank for the Poor and to implement other- regulations concerning these staffs in accordance with clause 31.6, article 31 of the present Charter.

36.3: The Vietnam Bank for Agriculture shall arrange the office, working facilities for the Bank for the Poor and incur all costs thereof. [...]

Article 37. Relations with State financial agencies. The Bank for the Poor shall [...]

37.2. Observe financial and accounting regulation ; approve annual final financial reports.

37.3. Be contributed with capital stock.

37.4. Receive trusted capital and credit services from government for the purpose of poverty alleviation and famine deletion program.

37.5. Loss of the Bank shall be covered with grant in accordance with existing policies : force majeure case are subject to financial management regulation on the Bank for the Poor.

Article 38. Relations with Vietnam Women's Union, Vietnam Farmer's Association and other people's organizations.

38.1. These association and organization shall mobilize their members to carry out the guidelines of the State in terms of loans made to poor household for production aiming at poverty alleviation and famine deletion.

38.2. Coordination and directing the formation of "saving and credit groups" within the community of the poor.

38.3. Helping to work out policies ; supervising the operations of the Bank for the Poor.

38.4. Calling capital from domestic and international individual and organization to co-finance or to support the Poverty alleviation and famine deletion program.

38.5. The Bank for the Poor shall respect and shall not intervene in the private activities of these associations and organizations.

Article 39. Relations with People's Committee at any level.

39.1 The people's committee of provinces or cities, the people's committee of districts, municipal towns shall help to direct the operations of the Bank for the Poor in the following areas [...]

39.1.2. Appointing representative(s) of the People's Committee at the same level to direct every programs, activities regarding funds mobilization, lending, collecting loans in support of the poverty alleviation and famine deletion programs, and to direct the coordination between many branches, authority and social organizations ; linking the lending programs to other programs in the fields of : technology transfer, production promotion, assisting the poor household to get acquainted with or to gets access to the production economy, finance and banking ; coordinating production programs with services business which supply material for production and with those in terms of products consumption, production rotation and infrastructure construction.

39.2. The people's committee at the commune or villages are the organization which implement the guidelines and policies on poverty alleviation and famine deletion. The people's committee shall

- Direct to establish and issue decision to acknowledge the "saving and credit group" ; elaborate its funds mobilization and lending, loans collecting programs at the commune and village for the purpose of poverty alleviation and famine deletion program.

- Approve the list of households eligible for loans proposed by the poverty alleviation and famine deletion committee ; supervising the utilization and paying back the loans of these households.

39.3. The People's committee at any level shall supervise the branch of the Bank in terms of guidelines, policies and funds mobilization plans ; having necessary measures against ineffective operations, proposing amendments, addendum to policies and regulations to higher level for discretion and decision.

39.4. The representative units of any level and branches of the Bank shall be liable to make regular report on the position and results of activities such as : funds mobilization, lending, observations of law, policy, regulation by households. The reports shall be sent to the people's committee of higher level.

Article 40. Relations with international, national organizations, non-governmental organization, domestic and foreign individuals

The Bank for the Poor is a State credit institution, having power to negotiate and sign loans or finance contracts, receiving technical assistance, staffs training assistance as stipulated by the Government on the basis of free will, equality and cooperation. [...]

Article 42. Establishment of Fund

42.1. In conformity with stipulation of the State, the Bank are allowed to establish the following fund

42.1.1. Risk prevention fund

42.1.2. Fund for supplementing the capital stock

42.1.3.Technique and professional development fund.

42.1.4. Welfare fund

42.1.5. Bonus fund.

42.2. Fund for depreciation and major repairing (for the separate assets of the Bank for the Poor).

Article 43. In case of loss

43.1. When the Bank incurs loss for a long continuing period of time and goes insolvent, in such a case, the Bank shall be dealt with in accordance to the Bankruptcy Law.

43.2. In case the Bank implements the programs assigned by the Government and incurs loss thereof, the loss shall be considered for compensation by the State.

43.3. When the dents suffer from risks in production on business and go insolvent, such as : death or lost borrowers having no heir, the loss shall be covered by the risk prevention fund. If the fund is insufficient, the State shall take the case into consideration and grant support. [...]