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## **THE VIETNAMESE MICROFINANCE SECTOR**

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## **Introduction**

The microfinance sector in Vietnam stands on the brink of a new era. The promulgation of Government Decree 28, a March 2005 declaration based on “Organization and Operation of Microfinance Institutions in Vietnam”, provides, for the first time, an avenue to create independently licensed, professionally managed, and commercially funded microfinance institutions (MFIs) in Vietnam. With the decree’s passing, the growth of new, more sustainable MFIs will strongly support the Vietnamese government’s poverty reduction objectives, as well as assist in social and economic development in pursuit of the Millennium Development Goals.

As the microfinance sector begins to develop two main factors will constrict further growth. First, the dominance of subsidized, state-owned rural lending programs has long-strained sustainable microfinance programs by creating an expectation for cheap credit among borrowers and putting downward pressure on interest rates below sustainable market levels. As long as the state-owned banks widely subsidize rural credit it will be difficult for a healthy and sustainable microfinance market to mature. Second, microfinance programs in Vietnam to date have mostly been managed by non-government organization and government staff who have good community development skills but often lack adequate financial management and accounting skills to implement a professional microfinance program. As the Vietnamese microfinance sector emerges more support will be needed to develop staffs’ capacities and relevant skill-sets.

This paper begins with an overview of the microfinance sector in Vietnam. It then progresses into a brief description of recent changes in the regulatory environment and how new legislation will affect future opportunities for the sector. Finally, key constraints to further growth and policy suggestions to overcome those constraints are identified and discussed.

## **The Microfinance Sector in Vietnam**

Since the Vietnamese government started the “Doi moi” economic reforms in 1986, considerable alterations have been made to Vietnamese financial systems and promotion of rural microcredit services has received increased attention. Today, the microfinance sector in Vietnam is generally classified into three main sub-sectors: the formal sector, semi-formal sector, and informal sector.

The formal sector refers to activities of financial institutions that operate under banking laws of the State Bank of Vietnam (Law on Credit Organizations and Law on Cooperatives). Included in the formal microfinancial sector are the Vietnam Bank of Agriculture and Rural Development (VBARD), Vietnam Bank for Social Policy (VBSP, formally the Bank for the Poor), and People’s Credit Funds (PCF) all of which are state-owned banking institutions. The formal sector dominates rural lending in Vietnam. According to the 2002 Vietnam Living Standards Survey, 20% of poor households had taken loans from the VBARD and 40% had taken loans from the VBSP.

The Vietnam Bank of Agriculture and Rural Development (VBARD) is far and away the largest rural lending institution in Vietnam. Although several donor projects have worked with the bank to improve outreach to poor households and collateral is not required for small loans, the

centrally-controlled bank does not have an explicit mandate to provide microfinance services and internal incentives do not generally promote microfinance lending. Interest rates on loans from the VBARD range from 0.9 to 1.2% per month.

The People's Credit Fund (PCF) is a decentralized network of independently managed financial cooperatives that provides savings and lending services to poor households. The network collapsed in the 1990s, creating wide distrust of banks among the many clients who lost their savings – a sentiment that lingers today. However, the PCF network has been completely restructured and strengthened with significant technical assistance and is now one of the healthier financial institutions in Vietnam. As the revised operations of the network are still in a pilot stage, the network remains quite small and most branches are located in relatively wealthy communes, so overall outreach to poor households remains limited. The interest rates charged on loans from the PCFs generally range from 1.1 to 1.4% per month.

The Vietnam Bank for Social Policy (VBSP) was renamed in 2002 from the Bank for the Poor after poor performance and need for new management. It works through various government channels, including the VBARD network, to provide subsidized credit to low income households. The interest rate on loans can range as low as 0.5% per month (lower than the market deposit rate), so the VBSP is unable to attract capital from savings deposits and must instead rely on funds allocated by government poverty reduction and social policy programs. Clients of the bank must be notarized as being poor by local government officials, which often means that poor people without political connections have a difficult time accessing the service. The VBSP is still relatively new and its track record is unproven but there are significant concerns about its financial health and lack of proper internal incentive systems, particularly because little institutional change has occurred since the days of the Bank for the Poor.

The semi-formal microfinance sector refers to a vast array of government and non-government lending programs usually integrated as a component of broader poverty alleviation programs. Mass organizations (government organized socio-political organizations such as the Women's Union, Farmer's Union, Labor Union, and Youth Union) often provide loans on their own, implement international non-government organizations' (INGOs) programs, or organize groups to access loans from the VBARD and VBSP. The scope and quality of the programs varies widely. Some still provide heavily subsidized credit, whereas others—particularly some of the programs supported by INGOs—focus heavily on building sustainable programs based on international microfinance best practice standards.

Although semi-formal microfinance programs have served a modest percentage of households who have access to credit (less than 6%) they have succeeded in reaching some of the most disadvantaged segments of the poor, one that is currently unable to access the services of the VBSP and other state-supported programs for the poor.<sup>1</sup> Many of these programs have been designed to stimulate the diversification of income sources among the poor while promoting good saving habits and discipline.

Although accurate figures are hard to find, an estimated 40% of poor and low-income households still do not have access to financial services from the formal or semi-formal

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<sup>1</sup> Save the Children Japan (2003), *Non-governmental Organizations' Microfinance Programmes in Vietnam*

microfinance sectors.<sup>2</sup> This underserved market must make do with informal sources of lending from local moneylenders, friends, relatives, and rotational savings and credit associations (ROSCAs). The informal sector may constitute as much as 50% of the total microfinance market in Vietnam.<sup>3</sup> Interest rates on loans from the informal sector are significantly higher than the formal and semi-formal sectors. The widespread incidence of informal lending in Vietnam's predominantly rural economy reflects a large unmet demand for microfinance services and proves that the poor can and will pay higher than sustainable market interest rates for access to credit.

### **Regulatory environment changing**

Vietnamese microfinance is rapidly changing with the approval of Government Decree 28 on "Organization and Operation of Microfinance Institutions in Vietnam" in March 2005. The decree allows existing microfinance programs to become licensed microfinance institutions (MFIs) for the first time in Vietnam. Three key consequences of the decree are: (i) MFIs will now have legal basis for their operation, allowing them to become sustainable institutions independent of the donors or government organizations that started them, (ii) MFIs will be able to mobilize capital from authorized domestic and international lending institutions, and (iii) MFIs that meet strict financial management and audit standards will be able to mobilize voluntary savings.

Previously, no legislation existed for creating independently licensed MFIs in Vietnam. As a result, INGOs have worked with mass organizations, particularly the Women's Union, to implement microfinance and poverty alleviation programs. A consequence of this practice is that many of the semi-formal microfinance programs in Vietnam use part-time staff of the mass organizations who are not finance professionals and, thus, struggle with limited commitment and technical skills. Furthermore, ownership concerns have been very tenuous between the programs themselves, the mass organizations that implement them, and the donors and INGOs that support them. The lack of ownership transparency has led to concerns about long-term institutional sustainability and accountability. The new decree clarifies ownership issues by creating legal title to MFIs that will be independent legal institutions.

Additionally, microfinance programs have had difficulty accessing capital because banks and other capital lending instruments are unwilling to lend to microfinance programs that are only semi-formal in nature without official license for their operation. Even the Microfinance Loan Fund component in the World Bank's Rural Finance Program, which is intended specifically for lending capital to MFIs, has not found any existing programs in Vietnam to be suitable for lending. As a result, microfinance programs have been dependent on donor funding for growth, and donors have become less enthusiastic about subsidizing capital for microfinance programs. The new decree improves this situation by allowing MFIs to mobilize capital from authorized domestic and international lending institutions.

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<sup>2</sup> Dao Van Hung (2001), *Report on Improving LIHs Access to Formal Financial Institutions in Vietnam*

<sup>3</sup> World Bank (2004), *Vietnam Development Report 2004*

Increasing capital by mobilizing voluntary saving has not been an option in the past because it was illegal and programs were not sufficiently well-managed to handle the additional risk involved in mobilizing significant savings. The new decree provides two levels of licensing to distinguish between MFIs that intend to mobilize voluntary saving versus those that will only mobilize small amounts of compulsory saving. Those that mobilize voluntary saving will be subject to much stricter regulations and will need substantially more professionalism in management. However, MFIs that can effectively mobilize saving will now be able to generate more local capital while allowing beneficiaries to increase their savings, a service at least as valuable as access to loans.

The new decree removes many barriers that have previously hindered growth of the microfinance sector. However, there are some factors that will continue to inhibit growth of the sector if not addressed. These factors are discussed in the following sections.

### **Subsidies and market distortions**

Subsidized government lending programs have had a significant impact on the microfinance market. The VBSP and, to a lesser extent, the VBARD offer loans to poor households at heavily subsidized interest rates. There are also a preponderance of small-scale government, INGO, and mass organization programs offering subsidized credit to poor households as part of integrated poverty alleviation programs. This behavior has created an attitude of dependency on both sides of the market, as poor households expect access to cheap credit and fund managers believing that the poor cannot afford market rates.

General awareness of microfinance best practices has increased among Vietnam's INGOs in recent years. Thus, most are aware of the need to charge market interest rates and manage programs in a sustainable manner even if they have not transformed their programs to charge market rates. The new decree will increase the incentive to transform programs into sustainable institutions, as such programs will have to meet regulations requiring sustainable interest rates and professional management or cease operations within two years.

The VBSP and VBARD, however, will not be subject to the new decree and thus may continue offering subsidized credit. The scale of lending from these two institutions compared with other microfinance programs is significant (at least 40% of households, as mentioned above), so their continued subsidized lending will have a strong downward pressure on interest rates and may crowd out new entrants who want to serve the poor in a sustainable manner. In practice, well managed microfinance programs have been able to compete with the VBARD and VBSP even at higher interest rates because they provide services that have lower total costs or are more highly valued by the poor, such as simple procedures, close geographic proximity, no collateral or government approval required, timely access, recurring access, group solidarity, and training on business planning and productive use of loans.

Subsidized credit is a form of social redistribution that, arguably, can be appropriate in targeting the poorest in society, but should not be used on a wide scale because it distorts the market and undermines sustainability. In Vietnam, subsidized credit is used as a socio-political tool with

cheap credit offered to hundreds of thousands of households without reaching the poorer households. The current practice of subsidized credit in Vietnam creates unfair competition against sustainable programs that are more effective at reaching the poor. It is a practice that should be stopped without delay.

The VBSP would be much more effective by acting as an apex lending institution, providing capital to MFIs that would subsequently lend to the poor at market rates. Apex lending could be selectively subsidized in order to support new entrants or MFIs that are not yet able to access capital from commercial lending institutions. Apex funding should be used as a tool to nurture good behavior among MFIs with the long-term intention of weaning them off the subsidies.<sup>4</sup> In other countries, donors have been enthusiastic about providing capital and technical support to apex institutions in order to have widespread impact on as many MFIs as possible. Currently, the VBSP does provide apex funding to microfinance programs on the condition that the programs lend with the same subsidized rates as the VBSP. This effectively promotes bad practice by microfinance programs and is an activity that should be promptly reformed in order to encourage good behavior among MFIs in the form of proper management and sustainable interest rates.

### **Staff capacity**

The second major constraint to growth of the microfinance sector is weakness in staff technical skills. Avenues need to be developed for building more relevant financial and management expertise among staff in the microfinance sector. This can be done by developing more training resources and encouraging links to Vietnam's burgeoning private sector where such skills are more common.

Most existing microfinance programs are managed and implemented by government and non-government organization staff who excel in community development skills, but lack financial management and accounting skills. Under the new decree, the bar is raised significantly on requirements for financial management and most of the existing microfinance programs will have to ramp up their professionalism to become licensed MFIs. Staff will need to learn more about double-entry accounting, management information systems, liquidity management, internal control, and a host of other skills. This will be especially true for MFIs that intend to mobilize voluntary savings, as those institutions will be subject to much stricter regulations. Management-level staff—those with proven capacities to build and manage a professional MFI—are exceptionally rare in Vietnam and the passing of the microfinance decree is likely to cause a rush of competition to attract and retain such individuals.

To date, microfinance in Vietnam has focused very strongly on the credit side of financial services to the neglect of saving services. Experience worldwide has shown that saving is a valuable, and often more important, component of microfinance than credit. Under the new microfinance decree, MFIs that meet strict standards will be allowed to mobilize voluntary saving, a service that has previously been very difficult in the Vietnamese legal context.

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<sup>4</sup> CGAP provides an overview of the roles, characteristics, and challenges of Apex institutions in a donor brief on the CGAP website: [http://www.cgap.org/direct/docs/donor\\_briefs/db\\_05.php](http://www.cgap.org/direct/docs/donor_briefs/db_05.php)

However, an MFI that takes saving from poor households must manage itself in a much more professional manner and have significantly more technical expertise than an institution that provides credit alone. Management of liquidity, insurance, and management information systems need to be upgraded. However, it is difficult to say whether many of the socially oriented programs that are converting to MFIs thoroughly understand the necessary capacities that must be developed in order to provide saving services.

In order to improve skills relevant to microfinance, training resources and services need to be enhanced in Vietnam. This would be an effective avenue for donors to pursue, either by providing technical assistance directly to aspiring MFIs, or supporting the development of training centers or services. A promising opportunity for a training center is the existing microfinance working group in Hanoi, which is an informal network of organizations involved in microfinance established under the Vietnam NGO Resource Center. The working group's stated goal is to improve the quality and sustainability of Vietnamese microfinance practices. The working group has expressed interest in developing a more formalized microfinance association or starting one or more training centers, an initiative that could benefit from strong donor support.<sup>5</sup> The working group is also a key resource for knowledge sharing across the sector through announcements, bulletins, workshops, and study tours.

Vietnam's growing private sector has the potential to be a powerful resource for the emerging microfinance sector. The accounting and financial management skills necessary to develop microfinance are very common in the private sector. Specialized training institutions for developing these skills in the private sector already exist and could be tailored to the specific needs of MFIs without much difficulty. However, the private sector generally has low awareness of microfinance and will probably not get involved without some persuasion. Government and donor organizations could effectively support the microfinance sector by running awareness campaigns for private sector networks in the form of seminars, informal talks, university programs, publications in trade journals, and articles in business newspapers. Furthermore, some qualified individuals from the private sector might be attracted towards working directly in the microfinance sector, particularly in management roles where exceptional management and financial talent will be highly valued in the coming years.

## **Role of donors**

After approval of the recent microfinance decree, donors may be anxious to provide capital support to newly-minted MFIs. However, a flood of capital into the microfinance sector could backfire if MFIs are not prepared to manage their increased size. An excess of capital given to poorly managed institutions will only increase the number and size of poorly managed MFIs. A better solution would be to focus on providing technical support and ensuring they are prepared to handle increased capital. Donor resources would be most effectively allocated by (i) giving direct technical support to individual MFIs, (ii) facilitating development of technical training institutions, and (iii) supplying capital to well-managed MFIs directly or through apex institutions that will rigorously scan institutions and lend to those that have staff capable of

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<sup>5</sup> Nguyen Thanh An (2004), Ford Foundation, *Notes from Preliminary Review on Microfinance for Poverty Alleviation in Vietnam*

managing increased capital effectively. The goal should be to breed MFIs that can access capital at commercial rates in order to ensure long term growth and sustainability.

INGOs and other donors have long-played an important role in Vietnam promoting reform of the regulatory environment and pushing microfinance into underserved markets, such as ethnic minority groups living in mountainous regions. They will continue to play an important role in encouraging further reform of microfinance laws and related laws, promoting new financial services (such as saving and insurance), and broadening to new markets (such as the growing number of urban poor and migrants).

## **Conclusion**

With approval of the Vietnamese government's new decree on microfinance, the microfinance sector has entered a new era. In the transition from semi-formal microfinance programs to licensed MFIs, technical support to build staff capacities will be a key activity. MFIs will need technical support from donors, training centers, and the private sector in order to meet rigorous new requirements. Furthermore, state-owned banks should end the practice of subsidized lending direct to poor households because it is crowding out the development of a healthy and sustainable microfinance sector that would reach deeper to poor households and support the poverty alleviation efforts of the Vietnamese government and its partners.

## **ABOUT THE AUTHOR**

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In his role as chairperson, he facilitated a dialog between the State Bank of Vietnam and the NGO community regarding the drafted government decree on regulation of microfinance institutions.

Dan will be entering the Johnson School of Management at Cornell University in the Fall of 2005 where he intends to focus on expansion of multi-national corporations into emerging markets and their potential to support international development through public-private partnerships.