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Original Article

Development of Microfinance Organisations in Vietnam

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Abstract: The aim of this paper is to examine the development of microfinance in Vietnam from the early 1980s. This provides a particularly interesting case study in view of the large-scale changes that have taken place in the economy over the period, which has experienced the transition from a Central Economic Planning System towards a "socialist-oriented market economy", with increased integration in the world economy. Starting from a framework, or taxonomy, of microfinance organisations, the paper explores how the two main objectives of microfinance organisations - of meeting the economic needs of borrowers and being sustainable - have eventually been met using a diversity of organisational forms.

Keywords: Microfinance, microfinance organisations, Vietnam.

1. Introduction

The aim of this paper is to examine the development of microfinance in Vietnam from the early 1980s. This provides a particularly interesting case study in view of the large-scale changes that have taken place in the economy over the period. Indeed, the formal use of the term, "microfinance" is relatively recent[1]. Previously, microfinance meant micro-credit, which corresponded to a credit of low amount designed for people who had very little income. Recently, the term microfinance refers to the supply of other financial services, such as savings, micro-credit, and so on. These services are offered by various institutions, with different institutional structures, ranging from state-owned banks to non-governmental organisations, both for and not-for profit, and using contrastive lending methods.

An important motivation for the analysis of microfinance is that access to small amounts of credit is generally regarded as an important factor to encourage entrepreneurial activity and to reduce poverty in developing countries where poverty levels are high. The majority of asset-constrained people in developing countries do not have access to standard commercial joint stock banks, which ration credit and require collateral. The market failure arises from

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[1] The term microfinance institutions entered the Law of Credit Institutions in 2010.

asymmetric and costly information problems. To fill this gap in the market, microfinance organisations (MFOs) have developed.

2. Types of Microfinance Organisation

When discussing a wide range of organisations, it is useful to begin with a framework, or taxonomy, within which the various forms can be placed [1]. The credit market for low-income people is risk-driven, given a high level of asymmetric information. When borrowers cannot afford collateral and signal their credit-worthiness, for example by providing accounting information, it is costly to evaluate borrowers' riskiness. This, combined with adverse selection, means that joint stock banks not to provide much-needed credit to those without collateral. Therefore, MFOs, the main credit suppliers in the market, have developed certain organisational forms to fill the market failure. MFOs can be divided into a small number of categories, as shown in Table 1. In view of space constraints the table shows just a sample of the main MFOs. This divides MFOs according to three methods of lending and three methods of funding. The different forms may or may not be registered. In the table, three asterisks are used to indicate those forms which are registered.

As seen in Table 1, joint liability and mixed lending are not used by those MFOs which depend on members' funds. In Vietnam, there are no examples of individual lending with third party, or donor, funding, nor of joint liability lending with public funding; however, these types of lending are used in other countries [1].

3. The Command Economy with Mono-banking: Pre-1988

Microfinance institutions and microfinance itself in Vietnam can be traced from the early 1980s. Before the start of the economic reform policy *(doi moi)* in 1986, Vietnam was under a centrally planned economy, which followed the model of the former Soviet Union. The economy was characterised by an extensive system of government controls. Ownership of the means of production (land, building, machines, and other assets) was under collectives, and private ownership and private economic activities were not allowed (Table 1).

3.1. State Financial System

Until 1988, Vietnam had a mono-banking system, in which the State Bank of Vietnam performed the functions of a central bank and an intermediary bank. The banking system was supply-driven, heavily subsidised, and interest rates were controlled. Small loans were provided mainly from two sources, formal credit institutions and informal sources. The formal credit institutions included the State Bank and credit cooperatives, which provided credit only to State enterprises and production cooperatives; these form the two main production entities of a centrally planned system [2]. There was no formal institution to supply financial services for low-income individuals.

Until 1991, interest-rate spreads were negative; that is, the interest rate on deposits was larger than the interest rate on credit [3]. The aim of this policy was to reduce the cost of production in order for the economy to recover from deterioration caused by the war. As a result, the banking system could not generate sufficient revenue to cover costs and the losses due to the negative interest-rate gap.

Hence, the fiscal deficit was funded by printing money [3]. This triggered hyperinflation, from the middle of the 1980s until 1990, with many negative consequences for the banking system and the economy.[2] The real interest rate was negative, so depositors had no incentive to save.

[2] The inflation rate in 1986 was 774 per cent. This was one year after the "currency modification" in which the value of one "new" Vietnam Dong equalled 10 "old" Vietnam Dong. If the old value had been used to calculate the inflation rate, it would have been higher than 7,700 per cent [3].

Table 1. Classification of MFOs in Vietnam

Lending method	Funding method		
	Donor or third party funds	Members' funds	Public funds
Individual lending		People's Credit Funds (***) Vietnamese Co-operative bank(***)	TYM (previously a government microfinance programme) (***) Maritime Bank Finance for community Centre
Joint liability lending	VietED Foundation (Microfinance NGO) ThanhHoa microfinance institution (***) SEDA Microfinance NGO Women Development Funds in provinces Child Fund Vietnam Dzambala Foundation Center for Women and Community Development (CWCD) Cao Bang women development Fund Capital Aid Fund for Women's Economic Development (CWED) in Tien Giang province The Golden Hand Programme (BTV) Dariu Foundation		
Mixed	VBSP(***) and VBARD(***) (Duong & Izumida, 2002) M7+(Working under Community Finance Resource Center - and NGO) (***)		CEP Vietnam (Capital aid for Employment of the Poor Microfinance Institution Ltd.) (***)

Due to the absence of a demand-responsive banking system, it was difficult for self-employed individuals and low-income households to have access to institutional credit without prior allocation from the relevant authority. As a result, the supply of rural finance was mostly from informal sources (such as friends, family, rotating saving and credit groups, and moneylenders) and from the system of credit cooperatives [3, 4].

3.2. Credit Cooperatives and Their Collapse

The credit-cooperative system, as an important source of rural finance, has a long history in many places in the world. Many of them produced desirable outcomes, such as the *Raiffeisen* German credit-cooperative system in the 1840s, or the *Caisse Rurali* of Italy in the 1880s. They succeeded while developing institutionally [5]. However, the first generation of Vietnamese credit cooperatives in the 1980s were not successful.

By the mid-1980s, there were about 7,200 credit cooperatives in Vietnam, covering most of the communes, each of which covered some three to four villages [6]. The main functions of credit cooperatives were to gather small deposits and provide credit to individuals, farm households, small state-owned enterprises and production cooperatives [2, 6].

In Vietnam, credit cooperatives were set up as local financial intermediaries on behalf of the State Bank, not by members themselves. In practice, they were established within small communities and managed by the local Peoples' Committee. As such, the term "cooperative" in this context reflected an administrative operation of the local authority

[2]. For that reason, credit was not granted on a secured basis because property rights were not clearly defined, and contract enforcement regulations were not available[4] [4].

Therefore, it is not difficult to identify reasons for the collapse of the system of credit cooperatives in Vietnam. First, managers lacked the incentives to take responsibility and monitor staff performance[5] [7]. Second, the failure of the credit-cooperative system in Vietnam was also caused by a lack of repayment incentives [3]. An important incentive facing borrowers exists when defaulters are less likely in future to obtain credit.

After the *doi moi* policy, the State Bank no longer automatically refinanced the credit cooperatives as it did before 1988 [2]. There were only 190 credit cooperatives in 1990, compared to the peak of 7,180 in the mid-1980s [3]. With the adoption of the Banking Ordinance that year, just 80 of them received a licence to continue operating. Up to early 1997, 78 out of 80 had been transformed into people's credit funds [7]. The collapse of the system had reduced the confidence of the public in credit cooperatives, and in the banking system as a whole[7].

3.3. Informal Financial Source

A rotated savings and credit association is an indigenous informal savings and credit association. This source of funds, together with money from moneylenders, friends, and relatives has financed a certain part of the credit demand of low-income people. Data from the 1992-1993 Vietnam Living Standards Survey revealed that 47 per cent of rural households and 38 per cent of urban households were in debt to both formal and informal financial sources.[8] The same source reported that private moneylenders and individuals provided 73 per cent of loans outstanding in rural areas. State-owned banks and the semi-formal financial sector accounted for 23 per cent. However, in 1997-1998 these figures changed to 51 and 49 per cent, respectively, showing that the rural poor have had better access to formal financial sources [9].

4. A Time of "Renovation" :1988 – 2005

The government responded to the crisis with a new policy, called *doi moi* (Renovation) in order to design to transform the centrally-planned economy into a market-oriented economy. The new system created more favourable conditions for the development of the banking and microfinance sectors. It reduced restrictions on private-sector activities and private asset ownership, thereby creating incentives for private investment and a demand for funding [10].

An important development of the banking sector was the transformation of the mono-tier into a two-tier banking system in 1988, in which the State Bank of Vietnam acts as a central bank and the four state-owned commercial banks function as intermediary banks [6]. However, until the beginning of the 1990s, the term microfinance institutions was not formally recognised.[9] In 1990, The Ordinance on Banks, Finance Companies, and Credit Cooperatives provided a legal framework for financial institutions in Vietnam, including the State Bank, commercial banks, and credit cooperatives [6]. The Ordinance was replaced by the Banking Law in 1997. However, microfinance was not explicitly

[4] The first Civil Law of Vietnam in which contract-enforcement terms were included was in 1995. This was replaced in 2005, which was in turn replaced by a new one in 2015.

[5] One of the successful rural-credit systems in Indonesia in the 1990s provided incentives via performance-based compensation (such as, profit-sharing, collection fees) and management's quasi-equity contributions in the form of efficiency earnings [8].

[7] The collapse has been compared with that of the Irish Loan Funds in the 1840s, the causes of which were from an exogenous shock, unfavourable legal and regulatory conditions, and weak governance [5]

[8] This was the first official Living Standards Survey on a national scale: see. http://microdata.worldbank.org/index.php/catalog/1910

[9] The term microfinance institutions entered the Law of Credit Institutions in 2010.

identified in this legislative document, although there were microfinance operations in the financial market.

4.1. Vietnamese Agricultural and Rural Development Bank and Mass Organisations: Post-1988

This section discusses two important post-1988 changes, the establishment of the Vietnamese Agricultural and Rural Development Bank (VBARD), and Mass Organisations, along with the involvement of the latter in VBARD lending.

4.1.1. Vietnamese Agricultural and Rural Development Bank

VBARD is the first commercial state-owned bank to provide rural finance. Its funding is from two main sources. First, savings from public depositors (commercial sources) are used to give loans on commercial terms to the rural and agricultural sector. Second, funds from governments and donors (concessional sources) are allocated for small loans in rural areas, according to sponsors' requests. VBARD has a nationwide network allowing it to reach a large number of clients, even in remote and mountainous regions.[10] Before the establishment of the Bank for the Poor in 1996, the Vietnamese Agricultural and Rural Development Bank solely provided loans for the agricultural sector as well as for low-income households. Since 1996, the Vietnamese Bank for the Poor (VBP) has carried over the specialised task to give financial services to low-income households using subsidies and other financial support. VBARD continues to focus on the rural and agricultural sectors, but on a more commercial basis.

In the rural-finance sector, VBARD offers the largest range of banking services, with substantial economies of scale. In terms of savings, VBARD provides various types of deposits, from demand deposits to term deposits with interest terms based on market rates. The geographical closeness to depositors and the prominence of a state-owned bank has brought the bank advantages in mobilising funds from the public.

4.1.2. MOs and the Lending Process of VBARD

Mass Organisations (MOs) form one part of the political system of Vietnam, which consist of *The Party* (with a Party Leader), *The State System*, and *Social-Political Organisations* (or Mass Organisations). MOs are established for the economic improvement of members, as well as to strengthen solidarity between members and to encourage members to follow the economic and social policies of the State. MOs which are often involved in the lending process in Vietnam are the Women's Union and Farmers' Association, among others.

The lending process of VBARD in the rural areas involved with MOs is as follows. If group lending is applied, the groups are established by the local MO committee and certified by the Local Authority, which ensures the group's legal status. Each group may choose to have a head, and this person helps the bank and the MO by, for example, setting up regular meetings and, in some cases, collecting repayments together with the MOs. The head of the group may receive a small commission, paid by the bank, as an incentive. With individual lending, the borrower fills out necessary documents, the lending is processed directly with the bank, and the MO's role is as guarantor for the borrower's characteristics. This means that the borrower has MO certification about their ability and willingness to repay.

4.2. Vietnamese Bank for Social Policies: Post-1996

To develop an institution that specialises in delivering financial services for poor people, another state-owned bank was established: the Vietnamese Bank for the Poor (VBP). The establishment of the VBP separates the special lending programme for the poor from the lending activities in rural areas of the VBARD.

[10] At the end of 1988, there were 22,134 staff working at 1,291 business centres including headquarters, branch offices, and transaction offices [11].

In 2003, VBP changed its name to the Vietnam Bank for Social Policies (VBSP) and established its own business headquarters and hired its own staff. Before that, it used the extensive network of the VBARD and paid administrative costs for it [12].

The VBSP relies heavily on funds from the State, and mandatory deposits from commercial banks. Currently, commercial banks in Vietnam are required by The State Bank of Vietnam to maintain 2 per cent of their total general public deposits in VBSP, with lower interest rates than market rates. The VBSP has also been supported financially by international donors, in terms of aid or concessional loans. Funding from public deposits is not a major source because VBSP primarily aims to supply credit. As with the VBARD, the VBSP has nationwide business branches. This extensive network allows poor people access to nearby banking services, thereby reducing transaction costs. The VBSP also cooperates closely with the Local Authority and the Women's Union, paying the latter a commission based on the amount of money repaid by customers [13]. The commission paid to MOs is small compared with the costs the bank would otherwise incur[11].

The VBSP uses both individual and group lending. However, group lending is used for costless peer monitoring, peer enforcement and social sanctions, rather than for joint-liability purposes [11]. Hence, group members do not have liability for other members' debts. In order to make other members jointly liable for a group's repayments, group lending in VBSP is applied for other dynamic incentives, such as future credit denial for the whole group. Hence, the VBSP enhances repayment as a result of peer enforcement, rather than by members having to pay for others. The loans provided by VBSP are subsidised. However, other administrative costs of subsidised loans are high [14].

4.3 People's Credit Funds: Post-1993

As already mentioned, the Ordinance on Banks, Finance Companies, and Credit Cooperatives in 1990 provided the first legal framework for financial institutions in Vietnam, including the State Bank, commercial banks, and credit cooperatives [6]. The nature of the institution is mutual-based, and is now known as the People's Credit Fund. This name helps customers not to confuse the new institutions with the previous unsound credit cooperatives [12].

The PPCFs are regulated savings and credit cooperatives under supervision from the State Bank of Vietnam. They are established by members who voluntarily join the PPCFs for mutual benefits. Their main functions are the mobilisation of local savings (both from members and non-members), and provision of credit services, primarily for members.

Savings provide the major funding for PPCFs. On average, more than 80 per cent of the total liability of People's Credit Funds is from members' savings, 10 per cent from its capital and surplus (retained earnings), and the rest from borrowing from other sources, such as from the Apex organisation [6].[12] The PPCFs use traditional individual lending contracts, in which PPCFs and borrowers sign contracts bilaterally. Individual contracts make the borrower take sole responsibility for repayments, and the PPCFs deal with the residual credit-risk claimants. Credit terms are on a commercial basis, since People's Credit Funds have to break even in order to be viable. Loan sizes are based on the demand of the customers, as well as the value of the collateral, which normally consists of Land Use and house-ownership certificates [6]. Loan size is normally set at from 70 to 80 per cent of the

[11] One credit officer in An Giang province in the Mekong River Delta said that she was in charge of 35,000 households, having made approximately 5,000 loans in one year. This large number would not have been possible without the involvement of mass organisations [11].

[12] The Vietnam Co-operative Bank acts as the Apex organisation, which collect funds from PPCFs that are in surplus and transfers the funds to the PPCFs that are short of funds.

market value of the collateral. That may explain the fact that PPCFs target the less-poor in rural regions compared to other microfinance organisations, such as VBSP. In terms of value, the average loan size of PPCFs is 700 USD to 800 USD, compared with 280 USD of the Bank for Social Policy [4]. The interest rate is based on local conditions, and is normally equal to market interest rates, or a little higher. Due to their closeness to borrowers, the People's Credit Funds can usually provide more varied loan products. Some of them provide lending for education and emergency purposes, such services that effectively reduce members' reliance on money lenders [4]. In addition, the decision-making procedure for loan approval is kept short and simple, which makes it less burdensome for small borrowers in rural areas.

4.4 Microfinance Organisations, NGOs, and Microfinance Schemes

Since the 1990s, Vietnam has received considerable support from international individuals, governments, and NGOs. As microfinance is considered a tool of social and economic development, a large number of NGOs have supported the microfinance sector of Vietnam with financial or technical assistance, or both. The Vietnamese government also recognised the necessity of assisting poor people as a goal of economic development. A number of microfinance NGOs, and NGOs microfinance schemes and projects have been involved in rural finance.

Microfinance NGOs in Vietnam include both indigenous and international NGOs involved in providing financial services for the poor, especially the poorest. NGOs' involvement in microfinance can be categorised into two approaches: non-integrated and integrated[13]. In the first type, NGOs run microfinance schemes or projects as a sole activity. For the integrated NGOs, microfinance is supplementary to other objectives. Non-integrated NGOs normally have their own staff, with the cooperation of MOs, while integrated NGOs may use local MO networks.

Microfinance NGOs are donor-subsidised (in this sense, NGOs are similar to state-owned banks, when they are dependent on a third party's order) and cannot mobilise voluntary savings. Mandatory savings - an amount of money borrowers have to save before they can get a loan - is considered not to be a part of the funding source, but rather a requirement for getting a loan. Most microfinance NGOs in Vietnam use a member-based model for delivering credit. This lending method has been popular in microfinance NGOs as it helps to reduce costs of lending [1] . To apply for a loan, borrowers form themselves into groups consisting of from eight to 20 persons, with joint liability. In a group, members have to be responsible for other members' obligations to repay.

The share of microfinance NGOs' in the rural market is less than 10 per cent [16]. However, it has reached the poorest in the country. This is maybe because it has received donors' funds, which allow them to serve poor people without having to break even.

5. Standardisation and Under Formal Regulations: Post-2005

As mentioned above, the term "microfinance organisation" was made legal in Vietnam for the first time by the Credit Institutions Law of 2010. The Law gives clear legal status to microfinance organisations. They are regulated credit institutions, and in that sense they are similar to commercial banks, showing that the microfinance sector in Vietnam has integrated into the banking sector. Microfinance integration into a country's mainstream financial system is recommended by many microfinance practitioners [17]. This is because regulated microfinance institutions can legally mobilise funds from the general public and also can have access to commercial debts. With more resources, they would expect to serve more low-income clients.

[13] This approach is known as a minimalist approach, as in Berger (1989) [15].

Understanding the need for a complete legal system in the microfinance sector, and to formalise the activities of microfinance institutions, a new legal framework for the establishment of regulated microfinance institutions was introduced. Decree No. 28/2005/ND-CP in 2005 and Decree No.165/2007/ND-CP in 2007 set the legislation for the establishment and operation of microfinance institutions. According to this legal infrastructure, microfinance services are provided by either regulated microfinance institutions or unregulated microfinance institutions. Whereas the regulations limit the unregulated institutions, they can supply only a limited number of services and are not allowed to mobilise voluntary deposits, whereas the registered institutions can supply a wider range of banking services and can leverage their equity up to 11 times.[14] Regulated institutions are also different from unregulated institutions, because they are under banking regulations and supervision. Therefore, regulated microfinance institutions are required to maintain prudent banking ratios relating to: minimum capital ratio; capital adequacy; liquidity requirements; asset quality and loan-loss provisions; and Portfolio diversification. Regulated institutions can also have access to discounted funds from the State Bank.

The new legislation is applied only for the establishment of new microfinance institutions. Four Vietnamese NGOs have transformed into regulated organisations. They are TYM, and CEP Funds, the two largest microfinance NGOs in Vietnam, and Thanh Hoa and M7+. There will probably be more in the future.

6. Lessons Learnt From the Development of Microfinance in Vietnam

Microfinance in Vietnam has served poor people and small customers for almost half of a century. It has experienced success and failures along the journey. The achievement of microfinance organisations in Vietnam as we see today is a result of lessons learnt through their fluctuations. Some lessons from the development of microfinance in Vietnam can be drawn.

The first lesson is the importance of microfinance organisations and their development. Microfinance institutions play an important role in poverty eradication in Vietnam, as in other developing countries. This is because commercial banks have rationed credit to borrowers who cannot pledge collateral. As a result, these borrowers have been unable to start production due to a lack of capital, or their production faces difficulties in expanding for the same reason. Some of them have to seek finance from informal sources that make them even more vulnerable. Using microfinance organisations with a suitable lending technique is one way to help low-income people to access formal credit. Thus it is important for microfinance organisations to achieve better repayment performance, which helps them to develop good policies, when government subsidies and donors' money is not a given.

The second lesson is the uses of joint liability lending and repayment performance of microfinance organisations. A high probability of a loan being repaid helps microfinance organisations to be sustainable; therefore, there is less of a burden on taxpayers and donors. From the use of group lending in Vietnam, there can be a few things to help it work better. First, group lending should only be established in regions where the borrowers live close to each other (normally in a small geographical area) and have substantial information about each other's business and personal characteristics. Second, the presence of credit officers reduces the unwillingness of the borrowers to repay, due to their perceived misunderstanding about low-interest-rate loans from microfinance organisations being gifts, donations, or free credit [18]. The presence of credit officers in the village helps to eliminate these problems by frequent meetings with

[14] This is according to the Basel Convention rule that suggests the minimum equity for a financial institution at 8 per cent of its risk-weighted assets.

groups and reinforcing the loan terms. The presence of the loan officers also helps to prevent improper use of the loans and opportunistic behaviour; credit officers actually have a considerable impact on a microfinance organisation [19, 20]. Finally, the involvement of mass organisations in Vietnam in the lending process is also very important regarding how microfinance organisations reduce information asymmetries and to improve repayment.

Third, one lesson learnt from the collapse of the system of credit cooperatives is that the successful microfinance institutional arrangements need to create incentives for parties who are involved in its operations. Finally, the institutional arrangement of microfinance in Vietnam has been settled with the involvement of mass organisations and local people's committees. This is considered to enhance the ability of microfinance providers to have a larger outreach with fewer costs and to create incentives for the borrowers to repay by imposing less-costly social sanctions.

7. Conclusions

This paper analyses the evolution of microfinance organisations in Vietnam through three main stages. The first stage under the centrally planned economic system created unhealthy activities of subsidised microfinance organisations. This period was marked by the collapse of credit cooperatives. After the transformation of the economy to a market-oriented structure, with relevant changes in economic policies and legal infrastructure, the microfinance sector in Vietnam has developed significantly. The establishment of the two state-owned banks and the new system of People's Credit Funds have increased institutional financial access to low-income people. The final period marked the integration of the microfinance sector into the banking sector, with the transformation of NGOs into regulated institutions.

The lesson learnt from the collapse of the system of credit cooperatives is that the successful microfinance institutional arrangements need to create appropriate incentives for parties who are involved in its operations. Later, the institutional arrangement of microfinance in Vietnam was improved by the involvement of mass organisations and local people's committees. This is considered to enhance the ability of microfinance providers to have a larger outreach with fewer costs and to create incentives for the borrowers to repay by imposing less-costly social sanctions.

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