Financial Sector Policy Issues Note:

VIETNAM BANK FOR SOCIAL POLICIES

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The World Bank
Financial Sector Group
East Asia and Pacific Region

ACRONYMS USED

BOD	Board of Directors
BRI	Bank Rakyat Indonesia
CGAP	Consultative Group to Assist the Poor
CAS	Country Assistance Strategy
CPRGS	Comprehensive Poverty Reduction and Growth Strategy
CSGs	Credit and Savings Groups
DAF	Development Assistance Fund
FSDP	Forest Sector Development Project
IAS	International Accounting Standards
ICB	Industrial and Commercial Bank of Vietnam
MFI	Micro-Finance Institution
MIOLISA	Ministry of Labor, War Invalids, and Social Affairs
MIS	Management Information Systems
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
NGOs	Non-Government Organizations
NPLs	Non-Performing Loans
ODA	Official Development Assistance
PRSC	Poverty Reduction Support Credit
ROSCAS	Rotational Savings and Credit Associations
SBV	State Bank of Vietnam
SOCBs	State Owned Commercial Banks
USD	United States Dollar
VAS	Vietnamese Accounting Standards
VBARD	Vietnam Bank for Agricultural and Rural Development
VBP	Vietnam Bank for the Poor
VBSP	Vietnam Bank for Social Policies
VND	Viet Nam Dong
VPSC	Vietnam Postal Savings Corporation

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This Policy Issues Note was also circulated to the relevant departments of the State Bank of Vietnam and the Ministry of Finance for review and comment.

Comprehensive review and comments were provided by Ms. Bikka Randhawa, Senior Financial Specialist, and Mr. Joselito Gallardo, Consultant, of the Financial Sector Operations and Policies Department of the World Bank. In addition, Ms. Jennifer Isern, Lead Microfinance Specialist of the Consultative Group to Assist the Poor provided review and brief commentary on the note. Finally, the Note was circulated for review and comment to specialists in the Poverty Reduction and Economic Management Group and Rural Development Group of the World Bank Vietnam Country Office.

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EXECUTIVE SUMMARY

The Vietnam Bank for Social Policies (VBSP) was established to take over the small-scale policy and directed lending programs previously administered by the SOCBs and other government entities, including the Vietnam Bank for the Poor (VBP). This was done in recognition of the need to transition the policy lending programs from the State Owned Commercial Banks (SOCBs) and to consolidate the numerous policy lending programs into one institution. The bank became operational on March 11, 2003, and its operational target for 2004 is to achieve VND 13 trillion (approximately USD 830 million) in loans outstanding to over 3.3 million borrowers.

The VBSP appears to represent the creation of a special state owned bank. The VBSP institutional arrangement envisions a non-profit bank that offers a full range of financial products and services at subsidized rates, but the bank is exempt from many of the regulatory provisions that govern the operation of the SOCBs and will not be covered by the proposed regulatory framework for microfinance institutions (MFIs). The creation of this special bank raises a number of financial sector policy issues specific to the VBSP. These issues are six fold:

- (i) weak supervision by the Government of the VBSP operations,
- (ii) confused corporate governance of the VBSP,
- (iii) unclear protection of public deposits being channeled into the VBSP,
- (iv) inefficient intermediation of public savings and government funds by the VBSP,
- (v) distortions in the microfinance and commercial banking credit and savings markets,
- (vi) unclear fiscal implications for the costs and liabilities associated with the VBSP's operations.

This policy issues note is designed primarily to broadly explore the operations of the Vietnam Bank for Social Policies (VBSP) and the financial sector policy implications raised by the VBSP's operations in Vietnam. The note also aims to inform the Government debate about the future direction of VBSP development and potential future engagement by international assistance agencies in supporting the developmental needs of the VBSP going forward. Further research and investigation of the microfinance market in Vietnam and the impact of the VBSP, operations and management of the VBSP, and international comparative models for the transformation of microfinance banks.

1. INTRODUCTION

Vietnam is in the process of a fundamental transition from a centrally-planned, monobank system, to a more diversified, market-based financial sector. Vietnam's structural reforms will be increasingly critical for private sector development, primarily due to the role the financial sector plays in (i) mobilizing and intermediating savings to productive segments of the economy; (ii) imparting financial discipline at the enterprise level; (iii) adhering to prudential standards that support underlying stability, viewed as critical to investors for risk-taking; and (iv) ultimately serving as the basis for sustainable lending and investment flows for enterprises that are able to demonstrate a capacity to meet underwriting requirements. Based on experiences in other transition economies, once these conditions have been met, providers and users of capital generally have common objectives. However, when systems are not adequately harmonized or when incentives are distorted, the benefit of this convergence is lacking and will ultimately undermine the ability of economies to develop and grow in a sustainable and internationally competitive way.[1]

Vietnam is currently grappling with these market distortions, many caused by the intermixing of policy / directed and commercial lending within the financial system. A key structural reform component of Vietnam's Comprehensive Poverty Reduction and Growth Strategy (CPRGS) for 2003-2005 was to complete the removal of policy lending from the SOCBs. This was supposedly realized through the separation of the VBP from the Vietnam Bank for Agricultural and Rural Development (VBARD) to allow the VBP act as a purely policy-based bank. The World Bank worked closely with the Government to develop the CPRGS and to support the Government's reform vision through the Country Assistance Strategy (CAS), which mirrors the CPRGS on this issue. The World Bank's first Poverty Reduction Support Credit (PRSC)[2] set out to assist the Government in the transfer of all policy lending and non-commercial directed lending from the SOCBs to a planned policy bank.[3] The Government now claims that all policy lending has been separated from the SOCBs and transferred to the specialized institutions – the successor to the VBP, the VBSP, for directed lending to small-scale borrowers and the Development Assistance Fund (DAF) for large-scale borrowers. Thus, the Government claims it has achieved one of the key banking reform goals of the CPRGS/CAS/PRSC, however evidence indicates that there policy lending initiatives are still conducted through the SOCBs.[4]

This Policy Issues Note is not intended to provide a full assessment of the state of microfinance in Vietnam or to provide a comparative analysis of microfinance and policy lending schemes worldwide. Instead, the policy issues note is designed primarily to explore the operations of the Vietnam Bank for Social Policies (VBSP) and the financial sector policy implications raised by the VBSP's operations in Vietnam. The note also aims to inform the Government debate about the future direction of VBSP development and potential future engagement by international assistance agencies in supporting the developmental needs of the VBSP going forward.

Further research is needed in a number of areas, including an in-depth survey of the microfinance market in Vietnam and the quantifiable impacts that the VBSP may have in this market. Given VBSP's mission of policy-based lending on a directed and targeted basis, another important

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[1] Based on "Financial Sector Development Strategy: Europe and Central Asia Region," ECA Private and Financial Sector Development Department/The World Bank, February 2003.

[2] "Proposed Poverty Reduction Support Credit," President's Report, The World Bank/East Asia and Pacific Region, Report No. P-7446-VN, p. 24, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/06/07/000094946_01050305490082/Rendered/PDF/multi0page.pdf.

[3] Note that the separation of policy from commercial lending also involves the transfer of policy lending to the Development Assistance Fund (DAF), which was created in 1999 to manage medium- and long-term lending at preferential rates, credit guarantees, and on-lending of Official Development Assistance (ODA) towards state-directed investment projects.

[4] For instance, news reports indicate that the Government/SBV intervenes in the setting of interest rates for certain targeted borrowers and it does not appear that the Government is providing the SOCBs the difference between the market rate and the rate at which such loans are made.

related area that deserves to be examined more closely and thoroughly relates to the methods and mechanisms for poverty-targeting and beneficiary/client or recipient identification. The role of various forms of subsidies that VBSP has been endowed with, not only in capital and funding, but also in organization and operations, should also be explored in more detail. Beyond these VBSP specific issues, a comparison of potentially applicable models of transformation should be developed, with both successes and failures, to allow the VBSP and the Government to better understand the potential decisions that need to be made to move the VBSP towards sustainable operations in the future.

2. Creating a New Policy Bank

The VBSP was established under Decision 131/2002/QD-TTg of October 4, 2002, with the charter approved on January 22, 2003 (Decision No. 16/2003/QD-TTg).[5] The VBSP was created to take over the small-scale policy and directed lending programs previously administered by the SOCBs and other government entities, including the VBP. This was done in recognition of the need to transition the policy lending programs from the SOCBs and to consolidate the numerous policy lending programs into one institution. The VBP was seen as successful in reaching the poor, but it was institutionally very weak and highly dependent on other entities for its operations (see Annex 3 for more on the VBP). The bank reportedly became operational on March 11, 2003, and the VBSP is in the process of transitioning all 14 million accounts, duties, capital, assets, records, and staff of the VBP[6], as well as some operations of the VBARD. The VBSP is based in Hanoi and has 61 branches and 600 transaction offices throughout all 64 provinces of the country.[7] The operating duration of the bank is for 99 years. The VBSP's solvency is guaranteed by the Government and it acts as a non-profit institution with a compulsory reserve rate of 0%. The VBSP is fully exempt from taxes, state budget remittances, and the deposit insurance scheme. However, the VBSP operates under the Law on Credit Institutions and is supervised by the State Bank of Vietnam (SBV).

The management board of the bank is chaired by the SBV Governor and the other members of the board are from other government ministries or are appointed by the Prime Minister. The Managing Board of the VBSP consists of 12 members (3 full-time, 9 part-time), all of whom are appointed by the Prime Minister for terms of 5 years. The full-time members are the Acting Chairman, the General Director, and the Head of the Control Board. The nine part-time members include:

- SBV Deputy Governor;
- Vice Minister of Finance (MOF);
- Vice Minister of Planning and Investment (MPI);
- Vice Minister of Labor, War Invalids, and Social Affairs (MOLISA);

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[5] Decree No. 78/2002/ND-CP of October 4, 2002 on Credit for Poor People and Other Policy Beneficiaries and Decision No. 180/2002/QD-TTg of December 19, 2002 Promulgating the Regulation on Financial Management Applicable to the Social Policy Bank also directly relate to the governance of the operations of the VBSP.
[6] See Annex 3 for background on the VBP.
[7] Vietnam is organized administratively into 64 Provinces, that contain approximately 10 Districts each. Within each District are Communes, and there are over 10,000 Communes across Vietnam.

- Vice Minister of Agriculture and Rural Development;
- Vice Minister of the Nationalities Committee;
- Vice Minister of the Government's Office;
- Vice President of the Vietnam Peasant's Association; and
- Vice President of the Vietnam Women's Union.

The MPI guides the operational policies of the VBSP, with the MOF determining the financial management of the bank. The MOLISA determines the salary and allowance schemes for employees of the VBSP. The People's Committees are primarily responsible for overseeing the establishment and regulation of local savings and capital borrowing groups, supervising the use of loan capital and repayment, determining lists of poor households eligible for borrowing from the VBSP, and coordinating with other lending organizations and social policy programs on local credit policies.

Decision No. 180/2002/QD-TTg of December 19, 2002 regulates the financial management of the Social Policy Bank, including the specific allocations for expenses and the operations / use of capital. In addition, the regulation details the accounting standards the VBSP must adhere to Vietnamese Accounting Standards (VAS), with a stipulation that the VBSP submit to the MOF financial plans for capital usage, revenue and expenditure plans, budget allocations for offsetting interest-rate differentials and management charges. In addition, the VBSP is mandated to provide quarterly and annual reports to the MOF, audited by state auditing bodies, which includes full balance sheet reporting and the situation of overdue, bad, and unrecoverable debts. The organizational chart in Annex 1 provides the details of the current structure of the VBSP.

Policy Issues: Weak Supervision and Confused Corporate Governance

The VBSP appears to represent the creation of a special state owned bank. The VBSP institutional arrangement envisions a non-profit bank that offers a full range of financial products and services at subsidized rates, but the bank is exempt from many of the regulatory provisions that govern the operation of the SOCBs and will not be covered by the proposed regulatory framework for microfinance institutions (MFIs). This wide range of exemptions for the VBSP will likely pose some difficulties to the supervision of the bank by the SBV and will require special procedures and significant training for inspectors to enable effective prudential regulation of the bank. The May 24, 2004, amendment to Article 4 of the Law on Credit Institutions states that the "policy banks shall, in principle, operate in compliance with the Law of Credit Organizations," but that "the Government shall provide regulations on their specific organization and operation, which are suitable with characteristics and type of policy banks." This recent change adds some potential uncertainty on the applicable legal framework for the VBSP and the relevant regulations for the supervision of the VBSP.

The effective supervision of the VBSP will be further constrained due to the conflicting roles that the SBV plays in the institution – that of management and supervisor.[8] The SBV Deputy

[8] This is also the case to a lesser degree for the SOCBs, where the SBV often is involved in the management decisions and planning, but simultaneously has the responsibility for supervising the SOCBs.

Governor is a member of the VBSP Board of Management and at the Provincial level, there is a parallel Board structure also with the SBV Branch Director membership. Possibly due to the issues above, the VBSP is not supervised by the SBV in the same way that SOCBs are at the provincial level and thus far, only a limited number of SBV supervisory inspections of VBSP branches have taken place.[9] The objectives of SBV supervision of the VBSP are not entirely clear, nor are the sanctions for non-compliance with the various regulations governing the bank.

Beyond the conflicting role of the SBV in the management and supervision of the VBSP, the other corporate governance structures are not well-defined at the Provincial level. The governance structures at the Headquarters level are better defined in regulation, but in practice very confused. At the central Board of Directors (BOD) level, there are at least nine different government and political organizations involved in the management of the VBSP, with a supervision board and consultants group reporting directly to the BOD. There are also Provincial-level BODs that report to the BOD directly. The roles and responsibilities of all of these entities that report to the BOD, including the roles of the Provincial BODs, are not clear and it is difficult to discern what impact they have on the operations of the VBSP. To add to the confusion, the local political organizations and governments play various roles in the daily operations of the VBSP and their exact relation to the bank and the system of local-level BODs is not well-established. These roles should be clarified before the VBSP embarks on its plan to further decentralize its operations and these uncertainties in the governance structures will likely severely limit the operational autonomy of the VBSP into the future.

The conflicting and opaque corporate governance structures are further exacerbated by the weaknesses in the VBSP accounting and information systems. This will of course also further hinder effective supervision of the bank. According to the regulations governing the VBSP, the standards will be VAS-based with auditing oversight provided by state auditing bodies and the MOF, and the credit management capacities are weak (more on this topic in Section 4), there is a significant risk that the institution will not be able to adequately account for the costs of its operations and a significant portion of the state, public, and external provided to the VBSP will become unproductive in the form of Non-Performing Loans (NPLs). If the VBSP is to remain in its current form, which is essentially a non-profit SOCB, it should adhere to strict accounting rules and move towards International Accounting Standards (IAS) in the future in tandem with the SOCBs. These more robust standards will also cover the classification of overdue and non-performing loans and, more importantly, the provision of reserves (which VBSP is apparently exempt from) that are consistent with: (i) the maturity profile of the loan, and (ii) the periodic amortization/loan repayment profile of a given loan. This should add further clarity to the accounting for the potential NPLs and other fiscal costs incurred by the VBSP (this issue is covered in more depth in section 4 below).

3. WIDENING THE CAPITAL RESOURCE BASE

The VBSP reportedly has received VND 1.515 trillion (USD 100 million) in charter capital from the state budget[10] and is scheduled for an additional infusion of VND 3.5 trillion (USD 230

[9] SB supervisory inspections of the VBSP have reportedly taken place at the Lao Cai and Bac Lieu branches.
[10] Information based on data provided by the VBSP in meetings with the IMF on June 10, 2003 and the World Bank on June 19, 2003.

million) in charter capital. The VBSP's funding sources will also be complemented by mandatory contributions of 2 percent of total VND deposits by the SOCBs, which will amount to approximately VND 3 trillion (USD 200 million). The rates paid to the SOCBs will be negotiable.[11] This total capital of the bank is predicted to expand with Official Development Assistance (ODA) on-lending, deposits, and borrowing from various sources, including the Vietnam Postal Savings Service Company (VPSC), the Social Insurance Fund, and the SBV. The capital of the VBSP grew to nearly 11.4 trillion VND (USD 726 million) by March 31, 2004. According to the VBSP management, this growth trend will continue and will amount to nearly 14 trillion (USD 892 million) by 2005. The cumulative capital sources of the VBSP to March 31, 2004, are detailed in the table below.

Capital Resources of the VBSP as of March 31, 2004

No.	Funding Sources	Capital (VND Billions)
1	**Charter Capital**	**1,517,032**
	+ Charter capital of VBSP	1,015,000
	+ New injection from MOF	500
	+ Additional Funds for Charter capital	2,032
2	**Borrowings from SBV**	**1,531,239**
3	**Funds received from programs (intended for charter capital)**	**2,420,902**
	+ from National Fund for Job creation Program	2,060,902
	+ from Fund for Training	160,000
	+ from designated funds of the Government (for housing loan with deferred payment)	200,000
4	**Mobilized funds**	**5,179,060**
	+ Deposits of credit organizations	3,807,901
	Of which mandatory deposits of SOCBs	3,691,084
	+ Savings mobilization (except the one of credit organizations)	864,751
	+ Others (including the one of State Treasury)	10,165
	+ Funds mobilized from economic organizations	504,000
5	**Trust funds**	**427,333**
	- Received by the Headquarters (IFAD project)	51,044
	- Received by the local branches	376,289
6	**Assisted funds**	**137,538**
	- Received by the Headquarters	8,069
	- Received by the local branches	129,469
7	**Borrowing from overseas**	**144,606**

[11] The VBSP is now paying 0.68% / month in interest plus a fee to the SOCBs for the mandatory deposit contributions, which is approximately 0.12% / month higher than the average market deposit rate.

	- OPEC	144,606
8	**Others**	**12,289**
Total Capital		**11,369,999**

SOURCE: Data from the VBSP on March 31, 2004.

Policy Issues: Unclear Protection of Public Deposits and Inefficient Intermediation

The VBSP is aggressively seeking out deposits from the public to grow its capital resources for preferential lending. However, the VBSP is exempt from the deposit insurance scheme. Therefore, this situation presents a potentially large contingent liability for the Government due to its explicit guarantee of the VBSP's solvency. Alternatively, this situation could present a presumably unaccounted for risk for those depositors who have placed their savings with the VBSP if the Government changes its position on the guarantee of the VBSP.

In addition, the public's deposits are channeled in part to the VBSP via the mandatory contributions of the SOCBs and it is unclear whether these deposits will be contributed on a cumulative, annual basis, or will simply be done once and updated yearly to capture overall increases in the SOCB deposit base. The VBSP also borrows from the SOCBs (and other credit institutions), as well as from other sources that mobilize public savings. However, the VBSP may not be acting as an efficient financial intermediary, as a commercial bank should, in terms of channeling these pooled savings into productive investments based on objective project analysis and financial viability. Therefore, it would appear to be more appropriate and transparent to fund the operation directly from the Government budget or indirectly through the issuance of government-guaranteed bonds instead of taking deposits (either directly, through mandatory contributions by the SOCBs, or by borrowing from credit institutions). This could potentially reduce the financing costs of VBSP as the interest rates of government guaranteed bonds are usually lower than those of similar-term deposits. This method of funding is frequently used by policy banks in other countries and has proven to be quite effective. This method of funding also allows for a clear separation between commercial lending and government policy lending thus, allowing a true accounting of such lending programs.[12]

4. EXPANDING PREFERENTIAL LENDING

The capital resources, at least in part, will likely first be invested in the coming six months in developing the bank's branch network country-wide; transitioning VBP, VBARD, and other government subsidy operations into the VBSP; and recruiting and training staff for the growing VBSP network. However, the primary goal will be to direct the substantial resources of the VBSP towards greatly expanding preferential credit to poor households, as well as people and organizations eligible for social benefits and policies. The VBSP will also provide preferential credit to policy beneficiaries serving as laborers abroad and post-high school level students. The VBSP will provide non-collateralized loans of differing maturities and rates based on the purposes and borrower's ability to repay and the size of the loans are limited to VND 15 million

[12] A separate, but integrally related concern, is that the VBSP (and the DAF) do not represent the end of policy lending from the SOCBs as continuous reports indicate that the Government is still indirectly forcing the SOCBs to undertake policy lending operations.

(approximately USD 955) for household businesses towards job creation purposes, VND 7 million for housing (USD 446), and VND 10 million (USD 637) for individual households. However, businesses can borrow up to VND 200 million (USD 12,739) and the loan size does not appear to be limited for some of the other categories of target borrowers.[13] Generally, the loan maturities do not extend past 60 months. At end-2003, the VBSP had 3.3 million borrowers, of which 2.8 million were poor households. The table below provides a snapshot of the lending terms, interest rates, and projections for loans outstanding by target group in 2003.

Lending Terms and Targets for 2004

Target Group	Target Clients	Eligible Loan Usage	Loan Terms	Lending Interest Rates	Projected Loans Outstanding (in VND Billions)
1	Poor Households	Procuring materials and agricultural inputs, other business and capital expenses, as well as for partial payment of living expenses.	Maximum VND 7 million per household with no collateral. Borrowers must be certified by Commune People's Committee and part of a Credit and Savings Group (CSG). For households of big animal husbandry or long-term industrial trees, etc., the maximum loan amount may be VND 10 million/household).	0.5% per month or 0.45% per month for borrowers in Regions III and special difficult communes	8,248
2	Poor Students	Supplies and tuition in universities, colleges, or intermediate vocational training.	Maximum VND 300,000 x schooling months with a guarantor (family member) of the loan.	0.45% per month.	96
3	Job Creation	Investments to create employment.	Maximum VND 15 million per household based on creditworthiness of borrower with eligibility certification by MOLISA. Maximum VND 200 million per business with a collateral requirement or to a maximum of 70% of the value of the assets pledged as collateral with eligibility certification by MOLISA.	0.5% per month or 0.35% per month for businesses that employ disabled persons, war invalids.	1,956
4	Laborers Abroad (Export Laborers)	Training fees, service charges, deposits, and airfares.	Maximum shall be VND 10 million/borrowers	0.5% per month.	6
5	Economic Organizations / Household Businesses on Islands, Mountainous Areas II / III, Program 135, etc.	Production and business expenses.	No maximum loan amount, but collateral is required for the loans.	Undecided rate because VBSP has not started lending these borrowers	0.17

[13] The VBSP program with an unlimited maximum loan amount, for economic organizations and household businesses on Islands and Mountainous Regions II and III, has apparently not been activated. The VBSP maintains that the program should be eliminated from the VBSP mandate and commercialized through the banking system.

6	Other subjects as determined by the Prime Minister, including housing loans in the Mekong River Delta and Central Highlands		Maximum VND 7 million per borrower with no collateral requirement, but the borrower must be certified by the provincial People's Committee.	3% per year with a 5 year grace period.	42
Total					**16,680**

SOURCES: Data from the VBSP on March 31, 2004 and Izumida, Yoichi, Draft "Policy Lending for Social Policies: Challenges for the Vietnam Bank for Social Policies," University of Tokyo / JBIC, October 2003.

As stipulated by the MOF, the bank will set aside 0.02 percent of the total outstanding loan to provision for losses and will have credit manuals for each target population.[14] The bank has already established many of the credit procedures for different borrowing groups, such as lending to poor households. Lending to poor households is conducted via group lending methods, whereby the criteria for membership in the lending group, credit and savings groups (CSGs), is established and approved by the local (Commune level) People's Committee and the members and groups are provided training by the bank on procedures for borrowing. By end-2003, over 220,000 CSGs were active. Collateral is not required for most borrowers and background checks and verification for the poor borrowers is conducted by the local People's Committees. An outline of the operational structure of the VBSP is outlined in Annex 2.

The loan terms are based on the business plan of the borrower and monthly or quarterly payments are mandated for the borrowers, but the precise terms are subject to negotiation by the bank and the borrowers. Principal is due at the end of the loan for small loans and partial principal payments are due for larger loans. The outstanding VBP loans were evaluated based SBV Decision 05. The VBSP does not have to repay state for the legal transfer of capital to VBSP – in 2003, 440 billion VND will be transferred and the subsidies will probably be 440 billion VND/year, but will be adjusted every year based on actual subsidy provided by the VBSP. In addition, the Government will also increase funds for national programs as liabilities if losses are not due to VBSP lending practices (bankruptcy, etc.). The subsidized loans will be classified in two ways: 1) performing loans; and 2) NPLs – some overdue, some frozen, some carry over losses from VBP. These NPLs will be defined according to Decision 488 of the SBV, so if a payment is one day overdue it will be considered an NPL, but in three separate categories:

1. till 180 days overdue.
2. from 181 days to 360 days overdue.
3. over 360 days overdue.

The state budget will cover the subsidized lending and some reasonable losses the bank incurs. The bank is now installing credit information and maintenance systems, beginning with larger borrowers. However, the terms for debt extension are extensive and it appears that the provisions in the legal framework for the VBSP to resolve and/or account for non-performing loans (NPLs)

[14] According to interviews with the VBSP, the bank sought to have a higher level of provisioning.

are confused by the process of coordination with local administrations and/or socio-political organizations.

To mitigate the credit risks posed by its operations, the VBSP has developed lending sub-credit manuals for each target group, which include all of the relevant details for administering the credit (such as eligibility, conditions, maturity, rate, disbursement, monitoring, provisioning, etc.). In addition, the VBSP has had international financial sector consultants provide an initial assessment and recommendations on the development of a full credit manual for the VBSP.[15] The VBSP is now in the process of developing the credit manual and is seeking external assistance and expertise to fully develop its policies and implementation. Many of the VBSP credit officers are new, but the VBSP has instituted a two month training program for these officers before they begin to work and the managers at the District and branch levels of the VBSP are primarily former managers of VBARD operations with extensive banking experience. For additional security, the VBSP credit officers visit the borrowers prior to undertaking the loan and in cases where collateral is warranted, the VBSP actually possesses the Land Tenure Certificate. Despite these measures, the issue of NPLs may become problematic due to a lack of sufficient credit management expertise and systems at the VBSP, as well as due to high degree of involvement of local administrations and/or socio-political organizations in the determination of the recovery of debts.

Policy Issues: Market Distortions and Unclear Fiscal Implications

In order for the VBSP to achieve its objectives and be accountable for its on-lending, the targeting of the core beneficiaries for policy lending, as well as the monitoring of the loans for intended purposes, must be robust. Out of the six target groups, the lending towards job creation appears to have the least sufficient safeguards against misuse of preferential policy lending due to ambiguities in the in applicant screening.[16] The Government should identify those segments of the market that are not financially viable prospects for commercial banking relationships and focus its policy lending (or alternately, encourage non-governmental organizations and other non-profit MFIs to focus) on this population.[17] Many NGOs and MFIs already involved in the provision of finance, many supported by international donors, apply best practices from other international contexts and emphasize sustainability. However, the VBSP is poised to automatically take a dominant market position for the provision of microfinance in Vietnam through the take over of the VBP and the rapid expansion of its retail network.[18] The subsidized lending as currently conducted by the VBSP already creates a disincentive for commercial banks and MFIs to enter the rural and microfinance markets. Therefore, the regulations may need to further define very clearly, and narrowly, the VBSP target groups to prevent the VBSP from competing with and crowding out commercial banks and MFIs.

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[15] IFG Development Initiatives Inc., "Report on a Review of the Credit Manual and Policies of the Vietnam Bank for Social Policies," October 3, 2003.
[16] Based on assessment from Izumida, Yoichi, Draft "Policy Lending for Social Policies: Challenges for the Vietnam Bank for Social Policies," University of Tokyo / JBIC, October 2003.
[17] The Government should further identify those segments of the poor population that do not have sufficient means to service loans, but instead should be eligible for grant-based social welfare programs.
[18] See Annex 2 for a summary of microfinance in Vietnam.

Recent studies have shown that some of the Government's subsidized lending programs offered average annual interest rates at close to 7 percent below the rates charged by private banks and SOCBs that would conceivably compete for the market segment that is commercially viable.[19] As the table below demonstrates, the VBSP is providing an annual average 4.8 percent subsidy on its loans compared to the market.

Comparison of VBSP and Commercial Banking Rates

Comparative Interest Rates	Annual	Monthly
Average Market Lending Rate	10.80%	0.90%
Average Market Deposit Rate	6.70%	0.56%
Typical VBSP Lending Rate	6.00%	0.50%
VBSP Spread (VBSP Lending Rate - Average Market Deposit Rate)	-0.70%	-0.06%
VBSP Subsidy (VBSP Lending Rate - Average Market Lending Rate)	4.80%	0.40%

Sources: SBV and VBSP Data as of end-2003.

The interest rate figures above also present another challenge for the VBSP, cost recovery. The VBSP has a negative spread between its average lending rate and the average market deposit rate, which it provides for its depositors. This indicates that the bank is not even covering its cost of funds, much less its costs for operations and risk. This analysis is oversimplified as the actual cost of many of the sources of the VBSP's capital is not known at this point, however the VBSP has already shown that its expenses exceed its income, by VND 44 billion in 2003 alone.[20] The subsidized interest rates should at least cover the cost of capital and operations of the VBSP, which would have to at least 0.7 percent higher on average per year than the current rate. These interest rate subsidies are also only a part of the overall costs associated with the operations of the VBSP. As mentioned earlier, the mandatory channeling of 2% of the SOCBs' deposit base to the VBSP also presents additional and complex policy and fiscal problems, in terms of: (i) protecting the integrity of the financial position of SOCBs and the interests of their depositors (part of whose funds are channeled to VBSP), (ii) the contingent budget and fiscal cost to the government of its explicit guarantee of deposits with VBSP, and (iii) assigning a suitable notional cost to the funds covered by mandatory transfers. In addition, the infusions of equity capital from the Government budget have an assignable and quantifiable cost, which need to be factored into assessment of VBSP's sustainability. Part of this calculus will be the costs of any additional budget funds which may be required to cover operating and asset losses, including guaranteed liabilities from VPSC, Social Insurance Fund, SBV and other organizations that VBSP should incur over its operations in the future, and which the government may be called upon to make good or replenish.

Related to these fiscal implications is the VBSP's rapid expansion of lending operations without adequate consideration for the viability of the project or the borrowers cash flow and ability to repay the indebtedness. This operational weakness may result in widespread NPLs and thus, add greater potential fiscal liabilities the Government. Based on the information available on the VBSP, it is uncertain that the VBSP will be able to effectively manage its credit risk exposure

[19] McCarty, Adam, "Microfinance in Vietnam: A Survey of Schemes and Issues," Mekong Economics Ltd., p. 11, http://www.mekongeconomics.com/publications/Microfinance%20English.doc.
[20] Loss figures for 2003 according to presentation by VBSP General Director, February 27, 2004.

under prudent standards. Most financial institutions use a "Credit Manual" for the basic guidelines and policies to address credit practices at the bank, including methods of mitigating credit risk. The VBSP has guidelines for lending to each target group, but the VBSP does not yet have a formal credit manual that covers, in a systematic way in one document, a description of: (i) the organizational structure; (ii) credit products provided by the VBSP; (iii) core credit policies that apply to all credit facilities provided by the VBSP; (iv) delegated authorities to approve credit facilities and expose the VBSP to credit risk; (v) stand procedures that apply to all products and target clients; and (vi) reporting on credit activities. In addition to the lack of a coherent credit manual, the staff of the VBSP is relatively new and the terms for debt extension and NPL resolution appear to be quite liberal. In fact, organizations with no professional qualifications in credit management or banking principles are involved in coordinating with the VBSP on operational policies that will impact the credit risk profile of the VBSP. For example, local administrations and socio-political organizations are involved with coordinating debt recovery policies and People's Committees are responsible for establishing, regulating, and supervising local borrowing groups. Although the VBP, which had similar institutional structures as the VBSP, reported a 94 percent repayment rate, no clear reporting exists as to whether this rate was accurate and the scale of the VBP's operations was much more limited than the VBSP's plans suggest.

6. FACING THE DEVELOPMENTAL CHALLENGES

According to the SBV and the management of the VBSP[21], the primary challenges facing VBSP development are:

- Development of the bank's branch network, including the deployment of mobile banking units for greater outreach;
- Transition of the personnel, assets, and loan portfolio from the VBP (and in certain functional areas, VBARD), as well as finding additional highly qualified staff for the expanded VBSP network;
- Training the personnel of the bank to conduct its operations;
- Decentralizing accounting and internal audit functions to the branches;
- Marketing the VBSP services to the public;
- Mobilizing capital to lend to the target groups; and
- Setting of appropriate interest rates for the preferential loans and the related incentive structure for the operational management of the credit risk.

The VBSP plans to strengthen its network of 600 district offices across all 64 Provinces (with a branch office in each Province) and end the agency relationship it currently has with VBARD for administering its programs in various locations. The bank will also complete the transition all 14 million accounts from the VBP that are actually held at VBARD. As of 31 December 2003, the VBSP already had 4,870 employees as of December 2003, 31 percent newly recruited from

[21] Based on presentations by SBV Governor Le Duc Thuy, April 22, 2003, Monthly Donor Group Forum, UNDP and by VBSP management on February 27, 2004, as well as discussions with the VBSP management.

undergraduate study. The new staff will require improved and continuous training on the bank's operations and the creation of such a large branch network by the VBSP would require a substantial investment of resources, particularly in implementing IT solutions similar to the other SOCBs. However, the full costs of the establishment of the VBSP and the implementation of new systems, training, etc., are not known due to data constraints.

The VBSP is developing a transition strategy for the bank to achieve full sustainability in the long-term. This strategy is influenced in part by the experiences of Bank Rakyat Indonesia (see Annex 5 for more). Through external assistance, the bank hopes to shorten the duration of its preliminary three stage business strategy for the next 25 years as outlined below.

<u>Stage 1 (by 2010):</u> VBSP will try to reach poor populations with government subsidies as it will take an extended period of time to transition the operations of the bank towards non-subsidized lending. This transition will require changes in regulation, bank operation, and a mindset change within the borrowing populations. The bank will make subsidized loans to target groups, but may begin market rate-based lending for some groups, such as migrant workers, because these target groups have good sources of income. The VBSP wants technical assistance and loans to help it move from a subsidy-dependent bank to an operationally sustainable bank in seven years.

<u>Stage 2 (by 2021):</u> The bank will achieve operational sustainability where it can cover its operational expenses, but it will not yet achieve financial profits because of the continued policy lending operations it is undertaking. It is foreseen that the need for such subsidized policy lending will diminish rapidly during this period if Vietnam continues it's on its current path of high economic growth and development.

<u>Stage 3 (by 2028):</u> All policy-based lending will be phased out and the bank will achieve full financial sustainability.

This development plan is likely too gradual to be realistic. The more probable course of development will be more binary in the first stage (to 2010), either the VBSP maintains the status quo with some operational improvements or the VBSP is transformed into a commercially-based microfinance bank. These choices will be made by indecision (in the case of the status quo) or strong decision (in the case of transformation) and if the current environment is any indication, indecision is likely to prevail. The current thought process behind microfinance initiatives in Vietnam appears to be geared towards preferential credit and the more remote and poor an individual is, the more preferential the credit should be despite the costs and risks involved in such transactions. This is building a cheap credit culture in many areas of the country among borrowers, lenders, and the authorities, which will be increasingly difficult to change in the future. In addition, it will be operationally challenging for the VBSP to implement a variety of differentiated programs (i.e., market-based, subsidized, etc.) simultaneously. Instead, the improvement of the VBSP's operational procedures and policies, transparency through accounting and information systems, and staff and management capacities over the course of Stage 1 may present the Government with a full understanding of the potential costs and impacts of the VBSP. This would enable Government decision makers to take (or not take) the necessary decisions to change course to allow the transformation of the VBSP into a sustainable microfinance institution.

7. FUTURE ASSISTANCE NEEDS

The VBSP has recognized the weaknesses and potential financial sector development challenges described in the sections above. Therefore, the bank has put forward assistance requests to various international donor agencies, which are detailed in the table below.

Summary of VBSP Assistance Needs

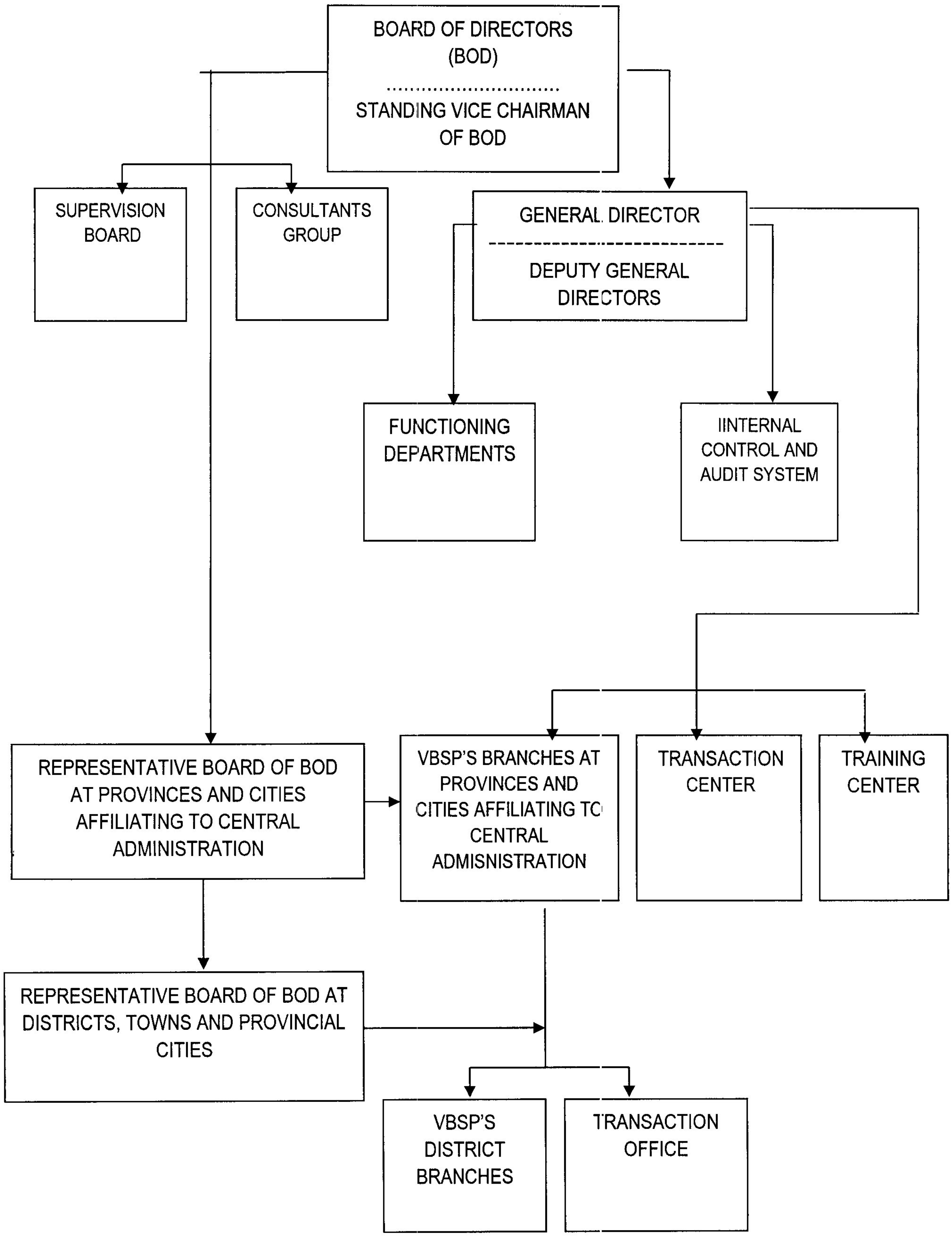
VBSP Objectives	Requests for Assistance
• To increase access and outreach to targeted borrowing groups with greater efficiency • To strengthen the management, accounting, and administrative capacities • To enhance the IT and human resources capabilities	• Formulating the organizational structure of the VBSP • Assist in developing internal operating procedures, including accounting and financial management • Improving credit risk management and differentiated risk management for various target groups • Developing the information technology and management information systems infrastructure

Despite the requests and the substantial developmental challenges, very little external assistance has actually been provided to the VBSP. Limited training workshops on credit policies have been provided to the VBSP by the National Life Finance Corporation of Japan and the Policy Research Institute of Japan's Ministry of Finance. The VBSP has requested substantial assistance from the World Bank in a number of other areas of its operational development. In addition, the SBV has already requested inclusion of the VBSP for the World Bank's follow-on lending operation to the Payment System and Bank Modernization project.

The VBSP is participating in the World Bank Forest Sector Development Project (FSDP) to extend preferential credit to smallholder forest plantations through the VBSP in four provinces (see Annex 6 for more on the FSDP). Through this project, the World Bank provided technical assistance to the VBSP for the review of the bank's credit policies and procedures, and to develop a separate credit manual for the FSDP. The World Bank, in close cooperation with the VBSP and the SBV, put forward a US$371,500 technical assistance proposal to the Asia-Europe Meeting (ASEM) Trust Fund on October 22, 2003. The approved project would provide the VBSP with limited assistance in reforming the organizational structure, developing internal operating procedures, implementing sound accounting practices, improving credit risk management and differentiated risk management for various target groups, improving human resource capacities, and assessing the information technology and management information systems infrastructure needs. This technical assistance project will be conducted by an international bank or firm with expertise in microfinance and policy lending institutions and is scheduled to begin in mid-2004.

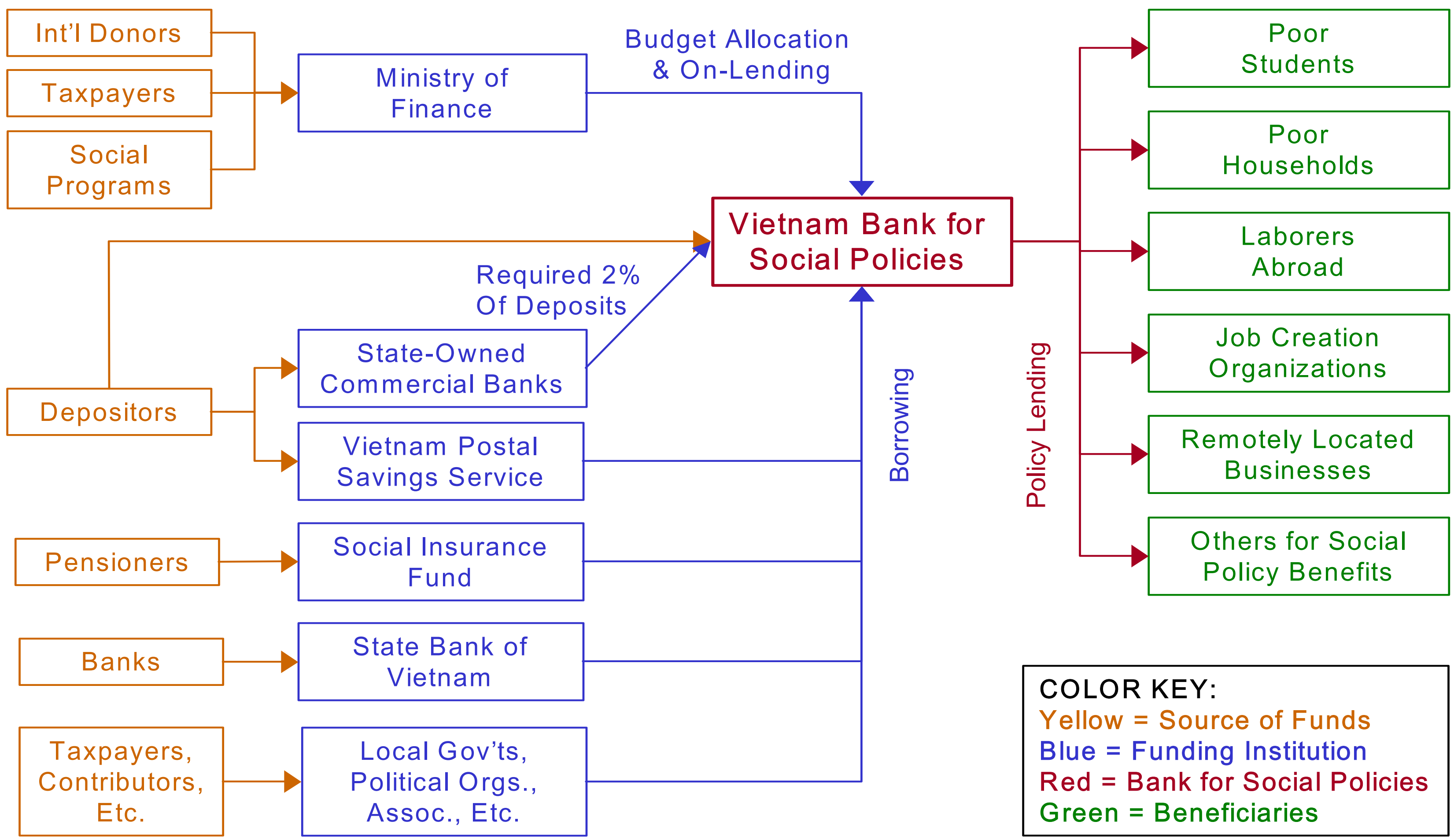
These short-term assistance projects will likely result in numerous assessments and recommendations for future development that will necessitate much larger, follow-up projects in the medium-term (the next 3-5 years). Further research would also be warranted to determine the exact role and impact of the VBSP in the microcredit marketplace, to evaluate the full costs and benefits to the Government and the target clients of small-scale policy lending in Vietnam, and to compare the VBSP to the other potential international models of best practice of microfinance, such as Bank Rakyat Indonesia. This type of follow-on assistance should also include strategic research and planning for the development of the VBSP in the long-term, based on a comparison to applicable international models of best practice of sustainable microfinance institutions.

ANNEX 1: Current VBSP Organizational Structure



ANNEX 2:

Vietnam Bank for Social Policies: Operational Structure



ANNEX 3:
Summary of the Vietnam Bank for the Poor[22]

The Vietnam Bank for the Poor was established in 1995 by a decision of the Prime Minister and began operations in 1996. The VBP was designed to address what the government saw as a major issue in combating poverty – lack of access to capital for production poor households. The Bank's mandate was thus to extend small loans to the poor for production purposes, such as farming, animal husbandry or handicraft. The loans were extended to individuals only, not to enterprises, and the bank did not lend for mortgages, or education or consumption purposes. The VBP operated in both rural and urban areas, though its primary target clientele for the most part appears to have been rural households. It reached some 2.8 million clients.

The bank received its funding from a variety of sources. It did not mobilize savings from its clients. Its total funds amounted to approximately VND 6,000 billion, of which the bank's equity was about 16.2 percent or VND 1,015 billion placed into the bank by the Government. VBP had further received approximately VND 412 billion (or 6.6 percent of total funds) from local governments as trust funds, VND 940 billion from the SBV, and some VND 200 billion of foreign trust funds (IFID) and on-lending (OPEC) funds. For the funds received from Government or its agencies, the VBP did not pay interest. Finally, the bank borrowed approximately VND 3,700 billion from the commercial banks – primarily from VCB and VBARD – under the auspices of a government guarantee. The VBP paid market rates for these borrowed funds, but received a government interest rate subsidy for the gap between its lending rate and the borrowing rate.

VBP did not have its own network and relied on VBARD's branch network as a disbursement, collection and accounting agent for its funds according to policies set by the VBP. Thus, it did not offer funds transfer or other banking services. The bank had a formal board structure comprising vice-ministerial level officials from the various relevant cabinet offices (including the Prime Minister's office), as well as general directors from the SOCBs, the Farmer's Association, the Women's Union, etc. The Vice Governor of SBV acted as the Chairman of the Board. The Board met to discuss operations and the mobilization of funds for VBP from the various government sources they represented. On the provincial level, there was a board structure that was very similar to the bank's Board of Directors that was chaired the Vice Chairman of the People's Committee. This provincial board engaged in the supervision of the VBP activities in the province with the local Farmer's, and Women's Unions that participated in supervision of the VBP 'Loan and Savings Groups' on local level.

The VBP extended its loans on pre-qualification basis, whereby the eligibility to borrow was based on a list of poor households provided to the bank by communal level People's Committee. The loans were extended based on a production plan submitted by the borrowing household. The bank then extended loans in two maturity groups: short-term loans of 12 months or less and medium-term loans of one year to five years. The maximum loan size was about VND 3 million (USD 200) and the average loan size was about VND 2 million (USD 130). The loans were

[22] All information was taken from: "Vietnam Banking Sector Review," Financial Sector Group/East Asia and Pacific Region, The World Bank, June 2002.

administered on a group lending basis and clients were required to meet with the local VBP "Loan and Savings Group" each month to both pay their interest and a small mandatory savings contribution (VND 5,000 to 10,000) that were placed in VBARD or used for payment of interest or principle. The Groups also encouraged voluntary additional savings by their members who placed funds through the group structure or directly with VBARD. The Groups placed all funds with VBARD and the funds were individually accounted for (rather than being kept as a group account). There were 250,000 such groups with leaders trained by VBP. The World Bank has previously provided funds for the purposes of training these leaders.

VBP reported a 94 percent on-time repayment rate although it was somewhat unclear what the exact definitions used by the bank was. The overdue rate was reported to be 6.6 percent, though net of natural disasters of only 2.2 percent, with the government covering the natural disaster effect. VBP also estimated that some 30,000-40,000 households had graduated to VBARD loans and thus "out of poverty".

The VBP, along with other government programs, reached only a subset of the poorer population in Vietnam. The SOCBs and government programs appeared to reach and service the upper segment of the poor households, with VBARD serving segments with annual average household incomes of VND 1.8 million; the VBP of VND 1.3 million and People's Credit Funds of VND 300,000. Altogether, close to 2.4 million low income households were borrowing through these vehicles in 1999. The influence of the informal financial sector – comprising of money-lenders, relatives and rotating savings and credit associations and other individuals – appeared to continue to be very significant constituting close to half of all lending to rural poor households.

The VBP operations were entirely dependent on government funds, guarantees and interest rate subsidies. The bank lent to its clients below market rates, paid no interest for a large part of its funds, and received an explicit government guarantee and interest rate subsidy for the bulk of its funding. While VBP built a very impressive structure and processes, its operations were not financially or institutionally sustainable without these support mechanisms.

ANNEX 4:
Overview of the State of Microfinance in Vietnam[23]

Households in Vietnam generally have access to several sources of credit, both formal and informal. Some have the characteristics of transfer programs and other sources of credit accessible to the poor are the Vietnam Bank for Social Policies and, for farmers, the Vietnam Bank for Agriculture and Rural Development. In addition, several communes run savings-and-loans schemes, usually with help from local NGOs, mass organizations provide credit programs, and there are many informal sources of credit. Overall, it appears that a majority of households have had access to credit, in one way or another, though the poorest farmers are likely to be more dependent on informal financial services. Previous surveys showed that low-income households represented 61 percent of micro-lending in 2001.

There is strong demand for the micro-finance in Vietnam as evidenced in the 47 percent growth in lending between 1998 and 2001. However, the many disparate players in the microfinance market have created fragmented approaches, regulations, and impacts in the sector. This fragmentation has resulted in some specific concerns about the extent to which subsidized operations will undermine the sustainability of the microfinance sector and generate potentially large fiscal liabilities, both in terms of loans and deposits in the system, for the Government in the future. This is particularly relevant considering the nascent state of credit risk analysis and management at the formal financial institutions. In addition, a uniform legal, regulatory and supervisory framework for microfinance activities does not exist and may contribute to further undermining the sustainability of micro-finance provision in Vietnam.

There are two formal sector financial institutions that dominate the provision of micro-finance in Vietnam, VBARD and VBSP, provided credit to 8.3 million rural households in 2001. VBARD accounted for 60 percent of the total number of loans and provided largest size loans on average (approximately 6.45 million VND, compared to 2 million VND for VBSP). While VBARD is the dominant player, VBSP is expanding its operations rapidly. VBSP took over the functions of the Vietnam Bank for the Poor and will become the channel for subsidized micro-credit provision by the Government, which were in the past conducted through ministries under various poverty reduction or social policy-oriented projects and programs. The VBSP plans to develop a network of 500-700 transaction offices across all 61 provinces. It will concentrate its subsidized lending to poor households and businesses in remote areas. By end-2003, it has 10.35 trillion VND in loans outstanding and expects to have over 12.42 trillion VND by end-2004.

Accessing credit from VBARD is common among farmers. Loans of up to 10 million VND do not require collateral if the applicant is sponsored by the Women's Union or the Farmer's Union. The sponsoring mass organization becomes jointly responsible for servicing the loan. Households classified as poor at the local level lose their "poor certificate" if they access a loan from VBARD. Collateral is needed for all loans above 10 million VND. Loans are typically for six months, renewable for another six. Interest rates are in the range of 0.8 to 1.2 percent per month, and fluctuate with the market. VBARD offers a variety of repayment formulas, from

[23] This section was taken from "Vietnam Development Report 2004," World Bank, Poverty Reduction and Economic Management Unit/East Asia and Pacific Region, Report No. 27130-VN, November 17, 2003.

lump sum to regular installments. Debt rescheduling is not uncommon, but a higher interest rate applies to arrears. Compliance with debt obligations is higher than in the case of VBSP. According to the surveys, less than one third of the loans are non-performing in poor communes. The mass organizations, including the Vietnam Women's Union, the Vietnam Farmer's Union, the Vietnam Youth Union, as well as the Commune People's Committee and District Governments, are deeply involved with the micro-credit process at the local level, mainly through the development and certification of credit groups. Some of these local organizations, such as the Women's Union, also operate savings and credit operations.

In addition, some 57 international NGOs support micro-finance activities in Vietnam, some channeled through the mass organizations. A micro-credit mechanism set up with help from the Center for Rural Progress in Ninh Thuan province is a good example. Set up in 2001, it already has 2,124 member households in three communes. Each of them has to save 10,000 VND per month, and is eligible to take a one-million VND almost immediately without collateral. But loans are given to groups of five member households, who are jointly responsible for repayments. These groups receive three-day trainings on procedures and how to better use the money. Credit is used for a variety of small investments, typically for the development of a small business enterprise. Repayments are on a bi-weekly basis, for both interest and principal. Households who comply with their obligations are entitled to take loans of 1.5 million VND in a second round, and two million VND in the third round. This scheme became financially sustainable in 2003. The total size of activities supported by NGOs amounts to only 5 percent of all micro-credit offered in Vietnam, but these activities often play a significant role in poor localities. In Cam Xuyen district in Ha Tinh, an NGO-supported scheme run by the Women's Union reaches more households than either VBARD or the VBSP. Like many such schemes, it is considerably more pro-poor.

The informal sector continues to be of great importance in the provision of micro-finance in Vietnam, with moneylenders, rotational savings and credit associations (ROSCAs), and lending between friends and relatives comprising the majority of this segment. The informal sector comprises close to 50 percent of the total micro-credit market based on relatively old statistics, but the average borrowing rates are significantly higher than the formal financial sector finance. The average rate charged by informal lenders is approximately 4 percent per month, and can reach as much as 10 percent, whereas the formal lenders charge approximately 1.3 percent per month. The discrepancies have been attributed to a number of factors, including the borrower's lack of collateral, the small size of the loan, and the related high transaction costs.

On the savings side of the ledger, few households in poor communes save through formal mechanisms, such as bank accounts, and most are unaware of the existence of postal savings. The formal micro-finance institutions (VBARD and VBSP) also provide savings products at the same interest rates, but the VBSP has not been able to mobilize any substantial amount of deposits to date. The establishment of a more extensive range of facilities for profitable cash savings could be an important mechanism to help poor households better manage the risks that crop up in daily life.

ANNEX 5:
Bank Rakyat Indonesia as a Possible Model for Transformation[24]

The VBSP management is increasing looking towards Bank Rakyat Indonesia (BRI) as an example of the successful transition of a state-owned bank towards international best practices for microfinance.[25] Despite the wide differences in the operations of the two institutions today, there are indeed many parallels between the current situation of the VBSP and the state of BRI in the 1970s.

At that point in time, BRI was a fully government-owned bank designed to promote rural development through credit programs. In 1973, the Government of Indonesia introduced a large scale, subsidized agricultural credit program to lend to rice farmers for purchasing various inputs with the overall goal of achieving self-sufficiency in rice production. This program, called *Bimbigan Massal* ("Mass Guidance"), or BIMAS, was channeled through BRI and over 3,626 branch offices (unit *desas*) of BRI were established to administer this program through 1983. The state-directed BIMAS program failed miserably, beginning with 5.28 percent arrears in 1973 and ending with 33.3 percent arrears in 1983 valued at over US$30 million. A corresponding increase in operational losses, from US$3 million in 1976 to US$14 million, and administrative subsidies, from US$4 million in 1976 to US$24 million in 1983, occurred during this period. The operational reasons for the failure of this state-directed policy lending program included the following:

- A lack of ***autonomy*** of the bank in the credit decision-making process with numerous other government agencies involved in the targeting, approval, and monitoring of loans.
- The ***interest rates*** charged on loans were well below the market rates, thus resulting in large subsidization costs and attracting ineligible borrowers to the program.
- The ***financial accountability*** of the bank in administering the lending program was limited because the organizational and incentive structure for monitoring and recording loans was not adequate.
- The policies for ***loan forgiveness*** and rescheduling were not adequate to protect the bank from a substantial accumulation of non-performing loans.
- A lack of ***organizational and human resources capacities*** to assess creditworthiness of borrowers, conduct appropriate targeting, and undertake monitoring and collection of loans. Most staff were not well trained, paid, or supervised and the bank was organized as a conduit for administering the credit program, not based on commercial banking principles.

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[24] Based on Mukherjee, Joyita, "State-Owned Development Banks in Micro-finance," CGAP Focus Note No. 10, August 1997, Robinson, Marguerite, "The Microfinance Revolution: Lessons from Indonesia," Volume 2, The World Bank / Open Society Institute, May 2002, and comments from Bikka Randhawa, Senior Financial Specialist, and Mr. Joselito Gallardo, Consultant, of the Financial Sector Operations and Policies Department, World Bank.
[25] Other models of sustainable microfinance banks should also be explored in more depth for parallels to VBSP transformation, both good and bad examples. Thailand's Bank for Agriculture and Agricultural Cooperatives (BAAC) is another regional example of a best practice microfinance bank.

As highlighted in this policy note, these are all issues currently facing the VBSP's operations today to varying degrees. Therefore, the VBSP is looking to the experience of BRI's transition from this failed state of operations into the most successful (state-owned) microfinance bank in the world.

The transformation of BRI from a failed policy bank to a successful microfinance bank began in 1983 with strong decisions by the Government to allow the bank to operate on a more commercially-oriented basis. The Government provided considerable financial support to BRI as it made the transition towards market-based activities in the mid-1980s, but allowed BRI full operational autonomy without lending targets or client groups and allowed the bank to design its own products and services priced at rates to achieve full cost recovery (and eventually profitability). In addition, the Government maintained sound marcoeconomic policies and provided full political support to BRI during the transition. The bank also received substantial assistance from external sources as well.

BRI was able to rapidly institute a number of changes because of these factors, with BRI management in full-control of the decision making process. The branches, or unit *desas*, became separate profit centers with full operational and managerial autonomy, standardized financial accounting and reporting practices, and management information systems to track the performance of the bank. The bank improved the internal supervision and internal audit functions to safeguard the operations of the bank. BRI had no exemptions from the prudential banking regulations, and therefore also had no choice but to comply with the appropriate banking regulations that were applied to all commercial banks. BRI immediately and dramatically increased the training of its staff and the accountability of the staff was tied to the performance of the branches. The staff had direct responsibility for the loan approval, monitoring, and collection (and the bank bore the full credit risk of its operations). Since its organization in 1983-84 to the present (or for some 20 continuous years) the Unit Desa Micro Division of BRI had, and continues to have, the benefit of in-house resident advisors (professional staff and specialists from Harvard University). During this transition period, BRI created new lending and savings products to meet the demands of the market priced at rates that enabled the bank to vastly expand access to finance across Indonesia and to generate profits for the bank.

The results of these changes were immediately apparent – the statistics tell the success story. By 1986, BRI had transformed itself into a profit-making institution and by 1987, the bank began to operate without any subsidization. In 1983, none of the branches were profitable – by 1996 98 percent were profitable. From 1983 to 1996, the savings mobilized under these changes rose from US$18 million to US$3 billion; the number of loans outstanding rose 641,000 to 2,488,000; the value of loans outstanding rose from US$103 million to US$1,710 million; and the total arrears as a percentage of the outstanding loans decreased from 33.3 percent to 3.6 percent.

Many lessons can be learned, both by the management of the VBSP and the Government of Vietnam, from BRI's transformational experience as the VBSP implements its strategy. Therefore, further research and analysis is recommended to apply the lessons of BRI's transformation to the VBSP in the Vietnamese context.

ANNEX 6:
Overview of the Forest Sector Development Project

The Smallholder Plantation Forest component of the Forest Sector Development Project (FSDP) will be US$62.56 million covering four provinces of Quang Nam, Quang Ngai, Binh Dinh, and Thua Thinh Hue, will establish forest plantations and promote small-scale tree growing by rural communities, many of whom are poor, based on different cropping systems, including fast-growing plantations, mixed forestry-agriculture crops, and fruit trees. In addition, special attention will be paid to improving productivity of already existing but poorly performing plantations. It will include the following subcomponents and activities:

(i) participatory site section involving village consultations and technical and environmental screening of proposed sites;
(ii) land allocation and land use right certificate (LUC) issuance which is an eligibility criteria for the investment credit;
(iii) extension and services delivery to assist the smallholders in all aspects of plantation forestry;
(iv) plantation design and management; and
(v) plantation investments in the form of credit to eligible households.

The fifth sub-component above provides a financing in the form of a line of credit through the VBSP to smallholders and other eligible project participants for forest plantations based on the agreed planting models. Participation in the plantation activities will be voluntary and demand-driven. It is estimated that the project will provide credit for the establishment of some 66,000 ha of plantations. In addition to screening for eligibility, the sub-component will also establish a system of field inspection of plantation sites, linked with authorizing disbursement of credit installments if performance and quality criteria are fulfilled Credit for seedlings will only be given to growers that purchase planting materials (seedlings, cuttings and tissue culture) that originate from approved sources. The VBSP will be responsible for the implementation of credit component. Key activities of the VBSP will include:

(i) overall management of credit component;
(ii) finalization of credit manual for the credit program;
(iii) management of special account; and
(iv) preparation and implementation institutional development plan for participating provinces and districts, training and logistical support to district branch offices.

Many of these activities above have already begun, including the development of credit manual for lending under the FSDP, and the project is schedule to begin in mid-2004.