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RURAL AND MICROFINANCE IN THE LOWER MEKONG REGION

Policies, Institutions, and Market Outcomes

Binh T. Nguyen and Robert Vogel

Asian Development Bank

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Abbreviations

ACLEDA	–	Association of Cambodian Local Economic Development Agencies
ADB	–	Asian Development Bank
AMK	–	Angkor Mikroheranhvatho Kampuchea
APB	–	Agricultural Promotion Bank
BOL	–	Bank of the Lao PDR
BRI	–	Bank Rakyat Indonesia
CCF	–	Central Credit Fund
CDC	–	Binh Minh Community Development Consulting Company
CEB	–	Cambodian Entrepreneur Building
CEP	–	Capital Aid Fund for Employment of the Poor
CGAP	–	Consultative Group to Assist the Poor
CIC	–	Credit Information Center
CMA	–	Cambodia Microfinance Association
CMLF	–	community-managed loan fund
DPF	–	Depositor Protection Fund
GTZ	–	Gesellschaft für Technische Zusammenarbeit
IFC	–	International Finance Corporation
Lao PDR	–	Lao People's Democratic Republic
LBP	–	Land Bank of the Philippines
LWF	–	Lutheran World Federation
LWU	–	Lao Women's Union
MFI	–	microfinance institution
MIX	–	Microfinance Information Exchange

NBC	–	National Bank of Cambodia
NDT MFI	–	non-deposit-taking microfinance institution
NGO	–	nongovernment organization
PCF	–	People's Credit Fund
PMO	–	Prime Minister's Office (Lao PDR)
RDB	–	Rural Development Bank (Cambodia)
RFSDP	–	Rural Finance Sector Development Program 2006–2010 (Lao PDR)
ROA	–	return on assets
ROE	–	return on equity
SBV	–	State Bank of Vietnam
SCU	–	savings and credit union
SMEs	–	small- and medium-sized enterprises
VBARD	–	Vietnam Bank for Agriculture and Rural Development
VBSP	–	Vietnam Bank for Social Policies
VRF	–	village revolving fund
VSCG	–	village savings and credit group
VWU	–	Vietnam Women's Union

Foreword

The Asian Development Bank (ADB) recognizes rural and microfinance as one of the potent tools for improving the lives of the poor and marginalized and promoting economic growth, as part of its overarching goal to reduce poverty in Asia and the Pacific. To support the growth and development of institutional microfinance operations in its developing member countries, ADB has been on a constant search for the most effective and efficient interventions that could be implemented. In 2000, ADB published its *Microfinance Development Strategy* focusing on (i) creating a policy environment conductive to microfinance, (ii) developing the financial infrastructure necessary to deepen and broaden microfinance services and the participation of private institutions as microfinance service providers, (iii) building up viable microfinance institutions, (iv) supporting innovations that ensure that microfinance services reach certain categories of the poor who tend to be excluded because of risk-return considerations, and (v) supporting social intermediation.

Over the past 2 decades, the rural and microfinance landscape in the three Lower Mekong Region countries of Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam has undergone significant changes. The sector is seeing steady progress in liberalizing the legal and policy environment, improving the supportive financial infrastructure, and increasing the quality and outreach of products and services. The central bank is assuming a clearer role as regulator, while the sector is becoming more viable with the participation of both banks and nonbank financial institutions in providing microfinance to the poor. In Cambodia, from mostly small nongovernment organizations supported by international donors in the early 1990s, the sector now includes 21 formally registered microfinance institutions (MFIs) that together have an outstanding portfolio of about $300 million in microloans to nearly 1 million clients. In the Lao PDR, the sector is undergoing unprecedented reforms with the leading Agricultural Promotion Bank (APB) undertaking fundamental institutional and operational changes to becoming a market-based, state-owned rural banking institution. At the same time, grassroots MFIs in the Lao PDR are growing in both number and assets, having at the time of this study 23 registered MFIs serving about 15,000 rural clients. In Viet Nam, unlike the other two countries, the sector has traditionally been dominated by state-owned banks receiving government subsidies for policy lending. The outreach in Viet Nam has been remarkable with more than 10 million clients and total loans outstanding over $7 billion. However, the sector's sustainability and efficiency have always been an acute issue of debate among stakeholders. The government recently recognized new developments in microfinance and the increased role of privately owned MFIs and has allowed them to register as a formal part of the country's finance sector.

This publication contributes to ADB's search for sustainable and efficient models of institutional microfinance. It reviews microfinance operations in Cambodia, the Lao PDR, and Viet Nam over the past decade, focusing on the policy environment, institutions, and market outcomes. It compares the similarities and differences among the countries and highlights challenges and constraints and possible future development patterns for each country. In conclusion, the study recommends broad measures to address the particular sector development needs of the three countries. It is hoped that this study can provide a reference guide for policy makers in government as well as bilateral and multilateral development agencies in choosing which measures are needed to expand and deepen the reach of rural and microfinance services to ensure a robust and sustainable development of the sector in the region.

The study was prepared under the supervision of Jaseem Ahmed, director, Financial Sector, Public Management and Trade Division of the Southeast Asia Department. Binh T. Nguyen and Robert Vogel are the authors. Jenny Mendez-Santos provided secretarial assistance, and Benny Rayco edited the paper.

Kunio Senga
Director General
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This study is the product of a team effort. Much of the credit for its material goes to our local collaborators in each country: Dinh Thi Minh Thai in Viet Nam, Somphone Sisenglath in the Lao Peoples Democratic Republic (Lao PDR), and Hoy Sophea in Cambodia. These colleagues not only provided important insights into the operation of rural and microfinance in their respective countries but also helped secure meetings with key government officials and representatives of domestic and international nongovernment organizations and financial institutions, and provided essential interpretation and translation in these meetings. They also helped gather data through a review of pertinent government documents and records and the conduct of the survey, both in the distribution of the survey instrument and in follow-ups to obtain further information. In addition, we would like to thank Timo Hogenhout for his invaluable insights, information, and updates for the Lao PDR chapter and for his consultation on our behalf with the stakeholders in the Lao DPR to finalize the chapter.

We greatly appreciate the courtesies and assistance provided by government officials and representatives of microfinance institutions, research institutions, mass organizations, and donor agencies whom we met or interviewed and who supplied us with the essential information for the report along with their particular insights into the operation of rural and microfinance in their respective countries. They were generous in the time they made available to us and in the openness and frankness with which they answered our questions. We cannot name all of them here, but our gratitude goes to them. We especially thank the officials of the State Bank of Vietnam, the Bank of the Lao PDR, and the National Bank of Cambodia for their support and particularly for their coordination on behalf of their governments in providing sector stakeholders' consolidated comments on our draft report.

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Executive Summary

This study examined progress in rural and microfinance operations in the three Lower Mekong Region countries of Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam as compared with standards set by international best practices. Particular attention was paid to the policy environment, which includes regulatory norms and their implementation, as well as the financial infrastructure (e.g., credit bureaus and microfinance associations). Special attention was also focused on the impact of this environment on the development and performance of institutions providing micro and rural financial services. Ultimately, this examination should provide guidance for government officials and international development agencies on which types of interventions can be most supportive of an array of efficient and sustainable institutions providing financial products and services that are attractive to the poor, especially those in rural areas.

The study first reviewed recent literature on rural and microfinance in the three countries and then literature on micro, rural, agricultural, informal, and small- and medium-enterprise finance in developing countries pertinent to understanding the situations in the three countries. The authors then visited the three countries, each for an intensive period of 4 to 6 days, working with a local partner in each country. During these visits, they met with key officials of relevant government agencies and the main entities providing rural and microfinance services, including public and private banks, microfinance institutions (MFIs), and financial cooperatives. They also distributed a standard questionnaire to all rural and microfinance service providers, requesting basic information on the entity (e.g., size and the extent of its collaboration with local governments and mass organizations) and detailed data on deposits and loan portfolios. Seventeen microfinance providers in Cambodia, 13 in the Lao PDR, and 19 in Viet Nam responded to the survey questionnaire. Based on the foregoing information, draft country chapters were prepared and then reviewed by the local partners, government officials, and officials from some of the entities surveyed in each country. At the same time, the two introductory chapters were written and reviewed. Finally, the concluding chapter was written to summarize the findings, highlight similarities and differences among the three countries, and provide recommendations.

Starting from rather similar conditions a decade ago, the three countries have diverged significantly both in the approaches they have taken to ensuring the delivery of rural and microfinance services in the rural areas, especially to the poor, and in the results they achieved. Of the three countries, Viet Nam appears to depend most heavily on the government and its institutions, not only in providing the legal and regulatory framework and institutional infrastructure for rural and microfinance but also in delivering financial products and services. This approach has resulted in a very limited role for private entities in rural and microfinance, both because of the legal and regulatory framework (indeed, the infrastructure for rural and microfinance is the most advanced of the three countries, especially the credit bureau) and because of the crowding out of private entities by government rural and microfinance providers that are supported by subsidies.[1] The government's Vietnam Bank for Social Policies (VBSP) has received very high rankings from the Microfinance Information Exchange (MIX) for its lending operations. It is ranked among the top five in Asia in the following categories: outreach to borrowers, percentage of the poor reached, and the productivity of its loan officers.[2] In contrast, only four private Vietnamese entities are included in the MIX database, and only one of these has been mentioned among the top hundred in Asia.

Cambodia presents a very different picture, with only one inconsequential government bank and a number of highly successful private MFIs making up its rural and microfinance subsector. Fourteen such entities report to MIX, and of these, five are ranked among the top hundred MFIs globally. These results, of course, are due not primarily to an absence of government banks but rather to the support provided to these entities by Cambodia's government, including and especially a legal and regulatory regime that has emphasized transparency and equal treatment of different types of entities. Support has also included training and technical assistance

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1 These subsidies include cheap funding and, more important, the costs incurred by Viet Nam's mass organizations, such as the Vietnam Women's Union, in providing client selection and loan recovery services, normally the most costly aspects of rural and microfinance, to rural and microfinance service providers.

2 On the other hand, VBSP does not appear in the MIX list of the largest MFIs in terms of outreach to depositors, most likely because its access to subsidized funding provides little incentive to pursue deposit mobilization aggressively.

for the implementation of international best practices in rural and microfinance, focused not just on individual entities but also on building a coordinating organization devoted to strengthening rural and microfinance in general. Most recently, this support has taken the form of offering nonbanks showing good performance and the ability to manage risks permission to mobilize deposits. These approaches have been supported by international development agencies and international nongovernment organizations (NGOs) that have been attracted to Cambodia by the equal treatment given to foreign investors. Nonetheless, important challenges remain, among which are the successful implementation of deposit mobilization regulations and creation of an effective credit bureau.

The Lao PDR approach appears to resemble Viet Nam's more than Cambodia's. The government's Agricultural Promotion Bank, by far the largest provider of rural financial services in the country, has had serious loan recovery problems leading to substantially negative net worth and a need for significant infusions of capital. Even with these capital infusions and the creation of the Nayoby Bank to take over policy lending, it remains uncertain if reforms of its operations and full support for these reforms from government officials at the highest levels will be sufficient to overcome its problems.[3] Nonetheless, the government has recently issued important decrees to clarify rules governing credit unions and other types of financial cooperatives and to divide MFIs into those that can and those that cannot mobilize deposits from the public, although it is too soon to know if these decrees will be effectively implemented, or if these will lead to desired outcomes. At the same time, the Lao PDR needs major support from international development agencies and international NGOs, not only for technical assistance and training to implement international best practices but also to develop infrastructure for rural and microfinance (e.g., a coordinating entity for MFIs and a more inclusive credit bureau, along with basic elements such as improvement in accounting and auditing for transparency and risk management).

Because of the substantial differences among the three countries, recommendations for potential improvements in their respective rural and microfinance subsectors also differ significantly. In Viet Nam, rural and microfinance based on an overwhelming role for government appears to be quite successful. However, this relies on

[3] It is also too soon to tell what path the Nayoby Bank will follow.

significant financial subsidies and, perhaps even more important, on implicit subsidies for client selection and loan recovery provided by mass organizations. For Viet Nam to catch up with current practice in rural and microfinance elsewhere in the world, it is necessary that the government fundamentally change its approach. To start with, the country needs a thorough analytical survey of rural finance similar to the one carried out for the Lao PDR in 2004. This survey must fully examine the extent of the outreach of formal financial services—including the impact of mass organizations on the efficiency of resource allocation. The survey should be followed by technical assistance involving training and exposure to best practices and new techniques for rural and microfinance as implemented elsewhere in the world to help convince government officials of the usefulness of embarking on significant reforms of the current system.

For Cambodia, the study's recommendations are specific and narrow: technical assistance to develop the deposit mobilization capabilities of MFIs that decide to move in that direction, with the expectation that the best-performing ones will be the most interested. Such technical assistance, based on international best practice experiences, is likely to emphasize the advantages of focusing on current clienteles—and the marketing techniques needed to do this successfully. Financial support for major upgrades of management information systems and information technology systems of MFIs may be needed for their operations and enhanced risk management. Of course, other activities could beneficially be undertaken such as a comprehensive rural finance survey to measure outreach and to support marketing of deposit services, along with further development of credit bureau capabilities.

For the Lao PDR, recommendations focus primarily on monitoring the major reforms recently begun (e.g., restructuring the Agricultural Promotion Bank, setting a proper course for the new Nayoby Bank, and implementing the recent decrees for credit cooperatives and MFIs) and especially strengthening these reforms as needed. In addition, a variety of other improvements could be promoted, including training and technical assistance for MFIs on best practices (provided in part through developing a strong coordinating entity), making credit bureaus more inclusive, strengthening and refocusing central bank regulatory activities (e.g., promoting risk-based supervision), and enhancing basic infrastructure such as accounting and auditing capabilities.

Introduction and Background

Objective

This study sought to examine the progress being made in rural and microfinance operations in the three Lower Mekong Region countries of Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam, using as a basis the standards set by international best practices. Particular attention was paid to the policy environment within which these operations existed, including regulatory norms and their implementation, as well as the existing financial infrastructure (e.g., credit bureaus, microfinance associations, a framework for the use of collateral to reduce the risks of lending, and the presence of international rating agencies). Special attention was also focused on the impact of this environment on the development and performance of rural and microfinance institutions. It was hoped that, ultimately, this examination would provide useful guidance to government officials and international development agencies on which types of interventions can be most supportive of an array of efficient and sustainable institutions that can provide financial products and services that are particularly attractive to the poor, especially those living in rural areas.

Methodology

The study reviewed recent literature (mainly since 2004) on rural and microfinance in the three countries, most of which had been produced by international development agencies, including the Asian Development Bank (ADB) and various components of the World Bank Group, such as the International Finance Corporation (IFC) and Consultative Group to Assist the Poor (CGAP). The authors also reviewed recent contributions to the literature on micro, rural, agricultural, informal, and small and medium enterprise finance in developing countries pertinent to understanding the situations in the three countries.

The authors then visited the three countries, each for an intensive period of 4 to 6 days, working with the assistance of a local partner in each of the three countries. These local partners arranged various meetings, first with the most relevant government agencies (central banks, finance regulatory agencies, and finance ministries) and then with the main rural and microfinance institutions, including public and private banks, microfinance institutions (MFIs), and cooperatives involved in finance. In addition, a brief standardized questionnaire was distributed to all rural and microfinance service providers in each of the countries. The questionnaire requested basic information on the entity (e.g., size as well as the extent of collaboration with institutions such as local governments and mass organizations) and detailed data on its deposits and loan portfolio. Overall, 17 rural and microfinance institutions in Cambodia, 13 in the Lao PDR, and 19 in Viet Nam responded to the survey questionnaire, a copy of which is attached as Appendix 1.

Based on the information gathered through the review of literature, interviews, and the survey, draft chapters covering each of the three countries were prepared and then reviewed by the local partner, government officials (e.g., from central banks) and by staff from some of the rural and microfinance institutions surveyed. The chapters were then reviewed and edited by the authors. At the same time, the two introductory chapters were written and reviewed. Finally, the concluding chapter was drafted. This chapter not only provides a summary of the study's findings and recommendations but also highlights similarities and differences among the three countries, including their causes.

Scope of the Study

Microfinance in the context of this study is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households, and their microenterprises.[1] Microfinance services are provided by three types of sources: (i) formal institutions, such as rural banks and cooperatives; (ii) semiformal institutions, such as nongovernment organizations (NGOs); and (iii) informal sources, such as moneylenders and shopkeepers. Institutional microfinance is defined to include microfinance services provided by both formal

[1] ADB. 2005. *Finance for the Poor. Microfinance Development Strategy*. Manila.

and semiformal institutions. MFIs are defined as institutions whose major business is the provision of microfinance services.

In microfinance, the importance of financial infrastructure for most operations is less obvious than for most types of formal finance because of the closeness of microfinance to informal finance in many aspects.[2] More specifically, microfinance rarely relies on formal collateral to enforce loan collection because of the relatively high costs of formalization, although informal arrangements involving physical collateral can often be quite important. In addition, microfinance typically involves the use of cash rather than bank accounts. Thus, neither bank payments systems nor collateral registries are dealt with to any extent in the following chapters.

Meanwhile, in some countries, the presence of credit bureaus that cover a full range of financial operations has proven to be quite an important aspect of financial infrastructure in allowing microlenders to detect the extent of client indebtedness. In addition, specific infrastructure such as associations of microfinance entities or networks to provide training and technical assistance can facilitate more rapid development of the rural and microfinance sectors.[3] Thus, discussions of financial infrastructure in subsequent chapters focus primarily on credit bureaus, along with associations and networks of entities providing specific support for rural and microfinance institutions, rather than infrastructure for collateralization or for the payments system. In the case of finance in rural areas, physical infrastructure such as roads, schools, and even health facilities can be far more important than financial infrastructure. However, any specific discussion of physical infrastructure is beyond the scope of the study.

The other two main issues dealt with are institutional development and market outcomes—specifically, the extent to which the development of rural and microfinance has contributed to the deepening of financial systems in general, especially since these two

[2] It must be emphasized that basic infrastructure such as transport facilities (and even the availability of health care and schooling) can be more important in promoting sustainable rural finance than infrastructure specific to financial operations. In particular, in the "agricultural credit" approach to rural finance, there are implicit assumptions that subsidized lending for agricultural purposes could somehow overcome inadequacies in basic rural infrastructure.

[3] Rating agencies, although typically international rather than being an infrastructure specific to a country, can also be helpful in attracting investment capital and commercial lending in support of rural and microfinance institutions that are shown to be viable.

components of finance are typically seen as the most challenging. Thus, the study examines in some detail the extent to which various types of institutions (e.g., public and private banks, MFIs, and cooperatives) are reaching out to poor clients in rural areas.

Among the major issues in rural and microfinance that emerged are the policy environment and government interventions in financial markets; the development of the subsector at the macro, infrastructure (meso), and micro levels; and the key characteristics of successful institutions, including the design and delivery of their products and services. The most important findings of the study are the substantial differences in the development of rural and microfinance that have resulted from significant differences in the policy frameworks in the three countries and their impacts on the development of the institutions that provide micro and rural financial services. The study concludes with recommendations on the challenges to, and opportunities for, rural and microfinance in Asia, based on common trends and key differences among the rural and microfinance operations in the three countries studied.

Recent Developments in Rural and Microfinance

This chapter characterizes the different approaches that the governments of the three Lower Mekong Region countries have taken for the development of rural and microfinance. It emphasizes how current best practices in rural finance have come to differ from the traditional focus on agricultural credit and how certain elements of microfinance have come to be incorporated into rural finance. It then examines briefly some best practices in rural and microfinance that have emerged in Asia, with particular emphasis on the often contentious issue of the appropriate role for government-owned rural development banks. As an illustration of what can be achieved from the application of international best practices, three of the most successful government-owned rural development banks in Asia are examined for the lessons that can be learned.

Traditional and New Approaches to Rural and Microfinance

The traditional approach to rural finance, which is limited to agricultural credit, is based on seemingly plausible assumptions that have been proven to be incorrect because they neglected individual incentives and market forces. The basic premise of the agricultural credit approach is that subsidized credit (that is, credit with below-market interest rates) targeted to increasing agricultural output, and often to assisting the poor as well, could achieve both these objectives. As a further attraction, agricultural credits appeared to be an easier, quicker, and less costly way of dealing with some relatively intractable problems facing the agriculture sectors of most developing countries. Those problems include low prices for agricultural products, especially at the farm gate, lack of adequate materials such as improved seeds and fertilizers, and, perhaps most of all, inadequacies in rural infrastructure—not only rural roads but also health and education facilities for rural inhabitants.[4] Agricultural credits continued to be the basis for most rural finance activities of developing country governments and international development agencies for at least 20 years, until undermined by some important work beginning in the 1970s, both in academia and in the field, which called into question crucial assumptions of this approach to rural finance.[5]

The agricultural credit approach largely failed because it neglected two crucial aspects of individual incentives and market forces, namely fungibility and transaction costs, which apply with particular force to finance. Money is particularly attractive because it is fungible, that is, it can be used for whatever purpose the holder wants. Thus, attempts to target credit to agriculture proved difficult, and two concepts were coined to explain this: *substitution* and *diversion*. Substitution happens when a farmer, after receiving a loan designed to help produce more of the crop, e.g., rice, produces the same amount of rice as without having received that loan. Instead, the farmer uses the proceeds of the loan for some other activity that may be considered more important, which could range from educational expenses for the children to vacationing in a foreign country. Because the farmer indeed produces rice, this substitution would be very difficult to detect. On the other hand, diversion happens when the farmer takes the rice loan and produces no rice, which could of course be detected. However, inspections to detect diversion are costly and are also subject to bribery, which has given rise to the well-known rhetorical question of "Who inspects the inspectors?"[6]

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4 In fact, some international development agencies recognized the importance of these other factors and initiated rural development projects that attempted to incorporate most or all of these other elements. However, in addition to the difficulties of coordinating these diverse components, technical assistance was typically based on an assumption that poor farmers do not understand how to farm correctly and need the types of approaches to farming developed in advanced countries without taking into account the need to understand why poor farmers behave as they do, which is often based on their crucial need to minimize risk.

5 Three books, all from 1973, were particularly important in this respect: E. Shaw. 1973. *Financial Deepening in Economic Development.* Oxford University Press; R. McKinnon. 1973. *Money and Capital in Economic Development*. Washington, DC: The Brookings Institutions; and United States Agency for International Development (USAID). 1973. *Spring Review of Small Farmer Credit*. Washington, DC.

6 In the 1970s in Colombia, where diversion was initially not thought to be a problem, rumors of diversion caused the World Bank to institute a costly audit of all the agricultural loans that it had financed, with the audit finding that diversion was present in some 50% of these loans.

The fact that these targeted loans were subsidized made them attractive to anyone, not just to the farmers for whom they were intended. Lenders were thus expected to institute screening devices to ensure that the targeted loans went to the intended beneficiaries. However, screening devices imply additional transaction costs for potential borrowers. In fact, concerns had arisen regarding the possible importance of transaction costs in agricultural lending, as it had been widely observed that poor farmers often continue to borrow at high interest rates from moneylenders in spite of the availability of subsidized loans targeted at them at very low interest rates. Thus, in the 1970s and 1980s, researchers in the Agricultural Economics Department at Ohio State University began to study transaction costs intensively as a major part of their fieldwork on agricultural credit in Honduras. Various interesting results emerged, the most important of which was that the "normal" transaction costs of securing a loan from a formal lender such as a bank (for example, travel by the borrower to the office of the lender, and securing the documentation necessary for the loan) were much higher than anticipated. Such transaction costs thus helped to explain why poor farmers preferred high-interest loans from moneylenders over subsidized low-interest loans from banks. Furthermore, because transaction costs for obtaining a loan are largely fixed in amount based on the procedures adopted by the lender, they were relatively much more important than interest rates for smaller loans with shorter maturities. In fact, the Ohio State University researchers found that the increase in transaction costs on targeted and subsidized loans served as the key rationing device for such loans, with transaction costs rising to the point where demand was reduced to equal supply, thereby systematically driving away the poor farmers who were supposed to benefit most but who, with their smaller loans of shorter duration, found the interest rate subsidy relatively less attractive.[7]

Beyond fungibility and transaction costs, the lack of sustainability has been another key factor undermining the traditional agricultural credit approach, as ongoing funding from governments or international development agencies is required to support the subsidized lending using the agricultural credit approach. The most

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[7] See D. Adams, D. Graham, and J.D. Von Pischke, eds. *Undermining Development with Cheap Credit*. Boulder, CD: Westview Press, especially C. Cuevas and D. Graham. Agricultural Lending Costs in Costa Rica (Chapter 8), as well as C. Gonzalez-Vega. Credit-Rationing Behavior of Agricultural Lenders: The Iron Law of Interest Rate Restrictions (Chapter 7) and Cheap Agricultural Credit: Redistribution in Reverse (Chapter 10), and R. Vogel. The Effect of Subsidized Agricultural Credit on Income Distribution in Costa Rica (Chapter 11).

significant barrier to sustainability is that the provision of low-interest funds to lenders to support their subsidized lending undercuts these lenders' incentives to mobilize deposits from the public. Moreover, not only does subsidized funding undercut sustainability, but it also deprives the rural poor of deposit services, which are now considered as important for the rural poor as is access to credit. Subsidized lending also creates unfair competition for lenders that want to operate on an unsubsidized, sustainable basis. In fact, in many cases, subsidized borrowers apparently come to believe that, because they have been specially selected for favorable treatment, they do not need to repay their loans, especially if these loans are made with government funds, thereby leading to a "pollution" of rural credit markets with an ethic of non-repayment that makes sustainability all the more difficult for all lenders.

The new rural finance paradigm has evolved not only by learning from the errors inherent in the agricultural credit approach but also by recognizing some important aspects of microfinance, especially after the mid-1990s when it was recognized that microfinance was not based simply on charity but could itself be sustainable.[8] What follows are some key lessons from micro and informal finance operations that have driven the development of the new rural finance paradigm:

- While microfinance appears to be focused on providing credit for small enterprises, a crucial element in the development of best practices for microfinance has been the recognition that, in order to deal with risk, these enterprises should operate in the context of a diverse array of economic activities carried out by the whole family. The microloans need to be built primarily on the cash flows of the whole family and not on those of the enterprise alone, an approach that recognizes the importance of fungibility. This, of course, applies directly to rural families engaged in small-scale farming.
- A key lesson from the failure of the traditional agricultural credit approach is the greater importance of transaction costs relative to interest rates, especially for small loans with short maturities. This is reflected in the operations

[8] R. Christen, E. Rhyne, and R. Vogel. 1995. *Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs*. USAID. The basic principles of the new paradigm under the leadership of the Consultative Group to Assist the Poor are summarized in Appendix 2.

of successful microfinance institutions (MFIs) that have developed methods to keep transaction costs as low as possible while keeping interest rates high enough to achieve sustainability. Because of the distances often involved between lender and borrower in rural finance, the challenge of keeping transaction costs low is greater, but the principle remains the same.

- Intensive field studies of economic and financial activities in rural areas have reinforced these basic principles: first, that nonagricultural economic activities are typically important and often predominate in rural areas; and, second, that informal finance is virtually always present in rural areas and often predominates over formal finance, especially because the advantage of the very low transaction costs that characterize informal finance outweighs for the borrowers the disadvantage of high interest rates. Furthermore, informal financial activities in rural areas reveal the demand for financial services that inevitably include the demand for deposit services as well as for credit.

There are also some operational lessons from microfinance that are likely to be widely applicable to rural finance as well:

- The head office of lending institutions cannot be fully aware of conditions in the field, especially in rural areas that are often characterized by different customs and languages, so that substantial decision-making powers need to be delegated to local branches. Such delegation, to ensure effectiveness, must include incentives for good performance together with strong internal audit and financial control systems.
- To develop estimates of cash flows and form judgments about a potential borrower's character, it is usually necessary to visit the borrower's place of business (which fortunately is typically very close to the borrower's home, thereby reducing lenders' costs) to (i) gauge how serious the borrower is in making the enterprise work, (ii) witness the operations firsthand, and (iii) gauge the borrower's character by talking to neighbors and close-by businesses with whom the borrower deals.
- Due to the cost of visiting potential borrowers and developing estimates of cash flow and character, an initial loan to a borrower is rarely profitable even with high

interest rates. Thus, retention rates for good borrowers are almost as important as loan recovery rates in determining the success of the lender.

- To reduce the costs of formalizing and acting on formal collateral (such as real and personal property mortgages), alternative approaches to guarantees have been developed, including especially the requiring of co-signers, which can be even more effective in rural areas than in cities because of greater residential stability, as well as creating informal claims over a borrower's property (e.g., televisions, bicycles, appliances, and especially cattle and farm equipment in rural areas).
- Informal finance can also provide specific operational lessons beyond the importance of transaction costs relative to interest rates. For example, in agricultural finance, even in countries with highly developed finance and agriculture sectors, informal credit sources—providers of inputs and purchasers of outputs in particular—often predominate so that formal lenders wanting to reach small-scale farmers might try to work through these informal agents.

Of course, learning from the errors of the agricultural credit approach and from the successes of microfinance does not address all the challenges that arise in providing adequate financial services in rural areas and especially to the rural poor. Providing microfinance faces similar challenges such as how to provide attractive deposit services when most microlenders are not licensed and regulated to take deposits from the general public, while most commercial banks do not see taking small deposits from the rural poor as a profitable activity. While regulatory lenience for microlenders is not to be recommended because of the resulting risks for depositors, a more thoroughgoing application of risk-based supervision can be helpful, especially in the case of rural finance, where costly regulatory requirements that seek to avoid rather than manage risks are sometimes arbitrarily imposed on branching and can affect rural branches in particular. Furthermore, credit unions, which are often highly active in rural areas and sometimes among the poor and are almost universally allowed to take deposits from members (and in which typically almost anyone can readily become a member), are often left in regulatory limbo as bank regulators do not want to get involved with dozens or even hundreds of very small entities that are seen to be marginal to the overall stability of the financial system.

Another major challenge that is encountered by entities involved in rural finance, whether micro or small and medium-sized enterprises, is the concentration of risk in virtually any rural area because of the relatively narrow range of economic activities in these small localized areas. For example, the loss of the rice crop in an agricultural area devoted mainly to rice would hurt not only rice producers but also any entity doing business with rice producers, their employees, and the entities that they deal with. The needed product diversification could seemingly be achieved easily by financial entities with broader range, such as larger commercial banks with activities throughout a country or, perhaps even better, international banks. However, because intimate knowledge of the local community is required for good client selection, such a bank would have to be able to delegate effectively, and only a few large banks have shown the ability to do this. For a local lender to be sustainable when confronted with a local crisis, it would have to maintain very high levels of liquidity, thereby forgoing local lending opportunities, or to have assured access to liquidity. Very few developing countries have such liquidity mechanisms.

One element in successful microfinance operations that has not yet been mentioned is frequent loan repayments, monthly at least, in order for the lender to maintain close contact with the borrower and thereby detect potential repayment problems early on before these become likely to lead to default. In the traditional agricultural credit approach, repayment is often delayed in its entirety until the harvest of the crop being financed, thereby exacerbating any potential loan recovery problems. However, as already argued, small farmers, like microentrepreneurs, must be diversified in order to survive in the presence of risk and can thus be required to make full interest payments monthly at the very least. This problem does exist, nonetheless, moving up from small farmers to medium-sized farmers who are no longer so diversified, as their commercial farming activities are likely to completely dominate their other economic activities, which thus fail to provide sufficient liquidity for frequent repayments before the harvest.[9] Taking a more formal approach to

[9] Loss of diversification in the process of growing also presents a problem for small and medium-sized enterprises (SMEs) in the urban sector, as their lack of diversification exposes lenders to greater risks. Facing greater risks, lenders need more detailed and costly studies of the enterprise itself, which is compensated for by seeking greater revenue through larger loans to larger enterprises, thereby restricting loans to SMEs and resulting in what is often called the "gap" or "missing middle" in loan amounts.

collateralization, though more costly, can help reduce lender risk sufficiently to justify lending, but only if formal collateralization systems are modernized to make them reasonably efficient. Risk can also be reduced by the existence of adequate credit bureaus, which can be important for microlending as well as for larger loans.

International Best Practices in Asia: Microfinance Institutions, Cooperatives, Private Commercial Banks, and Government-Owned Banks

To find examples of best practices, this study used the Microfinance Information Exchange (MIX) database covering entities that provide microfinance services, extracting the hundred institutions worldwide that have mobilized the most deposits.[10]

About one-third of the 100 entities are concentrated in Asia and the Pacific. Furthermore, the four largest are all located in this region, two in Bangladesh and one each in Indonesia and India. However, only one is in a study country, the Association of Cambodian Local Economic Development Agencies (ACLEDA) Bank in Cambodia. While many of these entities are banks, a substantial number instead are MFIs operating where deposit mobilization is allowed for MFIs that fulfill the country's regulatory requirements. Relatively few are credit unions or other types of financial cooperatives, perhaps reflecting the regulatory limbo for this type of entity in many countries.

Some other characteristics are worth mentioning. First, these entities have low-income depositors. For 96 of them, the average deposit size is less than the per capita income in the country where they are located, with more than half having average balances below one-third of per capita income.[11] More than 80% of the total (including Cambodia's ACLEDA Bank) have significantly larger numbers of depositors than borrowers, which is often typical of sustainable financial institutions that focus on the poor. On the other hand, some 40% have average loan sizes greater than the per capita income in their respective countries, which is not surprising

[10] The 2007 MIX data set was used for almost all the entities on the list.

[11] Of the four that appear to focus on a different, more up-scale clientele, two are financial cooperatives in Latin America, one is a bank in Ukraine, and the other is ACLEDA Bank in Cambodia.

given the universal tendency for loans to be concentrated in larger amounts as well as in fewer hands than deposits. Lastly, of the three successful government-owned rural development banks analyzed in this chapter, two are in the top 10 (first and seventh) of the MIX list, and the one not listed does not consider itself a microfinance entity.

Government-owned rural development banks cause problems in most countries, including the crowding out of potentially sustainable private-sector entities through their subsidized interest rates and poor loan recovery. It is important to have a menu of alternatives for dealing with such problematic banks. Some examples from Latin America show the range of approaches that have been taken:

- One of Alberto Fujimori's first actions as the newly elected president of Peru in the early 1990s was to order a thorough analysis of the substantial losses that Peru's government-owned agricultural development bank was incurring and, based on this analysis, to order its liquidation. However, because Peru's agricultural bank had been so successful in crowding out potentially sustainable private competitors, the Peruvian countryside was left with almost no providers of financial services after this liquidation. Due to the resulting political clamor, the government found it necessary to offer alternatives, including initial subsidies to create private *cajas rurales*, which are nonbank entities in rural areas that carry out financial intermediation (both lending and deposit services), are typically much smaller than banks, and are often not subject to as strict a regulatory regime as banks. However, only a few of these entities survived after the owners exploited the initial subsidy. Ultimately, the government created a new agricultural development bank, but its role has so far been severely limited, as international development agencies have opposed funding it, while the government's own fiscal resources have been limited.
- In Nicaragua, on the other hand, when the post-Sandinista government liquidated the country's agricultural development bank, it took great care to sell its branches to private banks, even offering subsidies for taking over branches in towns where there were no other bank offices.
- In Guatemala, rather than being liquidated, the government's poorly performing agricultural development bank was partially privatized, with shares in the bank being sold to a variety of nonprofit institutions. Although the governance

structure was problematic, the bank had the good fortune of having an aggressive management that understood, among other things, the importance of encouraging effective local decision making in rural branches (in a country with more than 20 different Mayan languages) and of deposit mobilization for funding and for attractive client service. Consequently, the bank has been able to expand significantly and become profitable.

- In both Honduras and Trinidad and Tobago, government-owned agricultural banks have shrunk to the point that they have become marginal players in the finance sector, even in rural areas, but continue to saddle their respective government with significant losses.

In Asia, three success stories illustrate different viable paths for government-owned agricultural development banks: a major reform followed by privatization, a major reform but without subsequent privatization, and a strong governance structure that could largely prevent misguided government interventions (interventions like those that had bankrupted the other two banks before the reforms).

Khan Bank: The Agricultural Bank of Mongolia, Successfully Reformed and Privatized

Providing adequate banking services is clearly a major challenge in Mongolia, a country with fewer than 3 million people living in an area more than three times the size of France, and with over 60% of its inhabitants living in rural areas. Ever since the initial reforms in 1991 that created it, the Agricultural Bank of Mongolia (Ag Bank) had been the major provider of rural financial services, with a staff of 2,600 and a network of 326 rural branches. However, because of nonperforming loans, most of which were politically directed and often to government-owned entities, it went into receivership in 1996—and again in 1999 as a result of ineffective reforms following the first receivership. Because of the overwhelming importance of the Ag Bank in rural areas, another reform was attempted in 2000, but this time with support from international development agencies. The reforms included in particular a management contract that excluded any government intervention in the operations of the bank, with the only exception being prudential supervision by the Central Bank.

The non-intervention of government in Ag Bank operations allowed the bank's new management to pursue an independent and creative strategy that sought, instead of the typical approach of closing unprofitable branches, to make branches profitable, including even the smallest ones in the most remote areas. This strategy included, first of all, the design and implementation of financial products targeted specifically at the types of clients found in the local areas covered by each branch. Among the loan products were herder loans, reflecting Mongolia's predominant traditional rural activity, together with loans for other agricultural activities, micro and small businesses, and pensioners, as well as loans based on payroll deductions and on mortgages. Moreover, to ensure optimal implementation built on the particular characteristics of each local branch, ample decision-making discretion was given to local branch managers, supported by incentives for the manager and for branch staff based on performance. Of equal importance was management's complementary creation of a strong internal audit and financial controls division to ensure that such discretion was not abused.

Within a few months, Ag Bank operations reached the break-even point. By 2002, the bank achieved a rate of return on equity (ROE) of over 50%, which is over twice the average for Mongolia's banking system, and with a rate of return on assets (ROA) of almost 3%. By the end of 2003, Ag Bank had expanded to cover 98% of Mongolia's rural communities, with 350 branches.

Ag Bank's diverse range of loan products was the result not only of an intimate understanding of each local area's characteristics but also of learning from the types of informal financial arrangements that could be observed and from best-practice lessons of micro-lending in other countries (e.g., the importance of a family's overall cash flow rather than the specific activity being financed as a basis for the schedule of frequent repayments, and the predominance of character over formal collateral in lending decisions). Furthermore, particular attention was paid to deposit mobilization, so that by early 2004, deposits exceeded $75 million, 50% more than the amount of loans outstanding of just under $50 million. Moreover, because of high-quality deposit services, aggregate deposit balances of private individuals more than doubled on average each year from 2000 to the end of 2003 to reach 80% of total deposits. Government deposits declined in importance, from over 50% of total deposits in 2000 to less than 10% at the end of 2003. These successes allowed the government to privatize Ag Bank in 2003, awarding ownership to the highest bidder, H. S. Securities of Japan, for $6.85 million. At about this time, Ag Bank became known as Khan Bank, but with the original management team being retained by the new owners.[12]

Under its new ownership, Khan Bank continued to show outstanding performance. At the end of 2007, MIX ranked it among the top 10 MFIs worldwide in deposit mobilization, with 1.5 million deposit accounts with an average balance of under $300, or about 25% of Mongolia's per capita national income, thereby showing the bank's continuing focus on low-income individuals.[13] Its total deposits of over $400 million continued to exceed its loan portfolio, which by then consisted of almost 300,000 borrowers with an average loan size of approximately $1,500. According to its 2007 annual report, Khan Bank's network had expanded to 466 branches, with 403 in rural areas and 318 "online," that is, connected directly to Khan Bank's headquarters in Mongolia's capital.[14] Furthermore, after-tax earnings for 2007 reached almost $20 million, or a 4% ROA and a 46% ROE, with nonperforming loans remaining at their low level of less than 2%.

The latest figures for Khan Bank, as of the end of September 2008, show that deposits continued to exceed loans, with both being in the neighborhood of $600 million. Clients consisted of almost 900,000 depositors with savings accounts (out of 2.2 million total accounts) and some 335,000 borrowers. Furthermore, after-tax earnings for the first 9 months of 2008 exceeded earnings for all of 2007. Khan Bank also continued to be aggressive in using information communication technology to improve its financial services, establishing 55 automated teller machines, of which 26 were in rural areas, as well as 13 internet cafés, all in rural areas. In addition, mobile phone banking services were launched at the end of 2007, making Khan Bank the first bank in Mongolia to offer such a service.

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[12] The foregoing information on Khan Bank comes primarily from J. Gutin and R. Young. 2005. *Khan Bank: The Agricultural Bank of Mongolia*. Washington, DC: USAID.

[13] Based on the information provided by MIX to the authors of this study in November 2008.

[14] Khan Bank. *Annual Report 2007.* Ulaanbaatar.

Bank Rakyat Indonesia and Its Unit Desas: Successful Reform Followed by Remarkable Growth

Like many government-owned banks in the early 1980s, the Bank Rakyat Indonesia (BRI) offered at its rural branches, the Unit Desas, mainly subsidized loans to promote agricultural production, specifically rice. The results were also typical of such banks: losses that mounted due not only to the interest-rate subsidies themselves but also to the subsidy-seekers drawn to these loans who increasingly saw little need to repay. These losses, coupled with the low oil prices of the 1980s, led to a deteriorating fiscal situation for Indonesia's government and a decision to discontinue such lending, which by itself would have meant the closure of the Unit Desas. However, advice from fiscal advisers from the University of California at Berkeley and rural finance advisers from Harvard University, together with visionary leadership from the BRI's management, led to a decision to attempt a revolutionary reform for the BRI's Unit Desas. Under this initiative, the branches would be required to be individually sustainable by discontinuing subsidized lending and simultaneously focusing on deposit mobilization. As important as the objectives themselves was the system of incentives implemented to realize them: Unit Desa managers and their staffs would be rewarded with complementary incentives based on branch profitability, in part through promoting deposit mobilization. The incentives included high interest rates "paid" to branches for transfers of funds to other branches and to the BRI's head office. Harvard advisers and the BRI leadership also paid particular attention to market research to design loan and deposit products that would be attractive to potential clients in the diverse rural areas served.[15]

A consultant's report from the late 1990s records the remarkable progress that was then being made by the BRI's Unit Desas in their deposit mobilization activities:

> "The deposit liabilities of the 475 BRI Unit Desas in West Java, for example, increased 53 percent during the first nine months of 1989, for an annual growth rate of over 70 percent. At some units the rate of increase is necessarily much greater than the average rate. The BRI

[15] See R. Patten and J. Rosengard. 1991. *Progress with Profits: The Development of Rural Banking in Indonesia*. San Francisco, CA: ICS Press.

> Unit Desa in Lembang, for example, has seen its Simpedes liabilities grow so fast in the past several months that it has transferred more liquidity to its branch office than it has in loans outstanding. An established BRI Unit Desa visited in West Sumatra (Batusangkar) has seen its Simpedes liabilities increase an incredible 2600 percent since the beginning of the year."[16]

More recently, 2007 MIX data show the BRI to be, by far, the leader among all MFIs in mobilizing deposits.[17] It had more than 21 million accounts, while the second-most successful MFI, the Grameen Bank in Bangladesh, had fewer than 7 million. And the BRI deposits totaled more than $5.6 billion, compared with less than $2.5 billion for the second-ranking institution, Colombia's Banco Caja Social. The resulting BRI average deposit balance of $267, some 17% of average per capita income, shows the extent of its focus on low-income clients. The BRI was likewise the leader among MFIs in lending, its loan portfolio totaling almost $3.5 billion. The second-most successful institution in this respect, again Colombia's Banco Caja Social, had less than $2.4 billion. A remarkable aspect of the BRI's dominance in deposit mobilization, attributable to its highly favorable image as well as its attractive deposit products and services, was that it accumulated deposits during the Asian financial crisis at the end of the 1990s when most other banks in the region were losing deposits.

The BRI's annual report for 2007 shows clearly just how far the bank had come since the early 1980s when its approach to rural finance focused on handing out subsidized loans to promote agriculture and to assist the rural poor.[18] Its loans grew by 27.9% per annum, from 47.6 trillion rupiah (Rp) in 2003 to Rp114 trillion in 2007. Its nonperforming loans stayed at an average of 4.6% while its

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[16] J. Gadway. 1989. *Savings Mobilization in Indonesia's FID-I Project: Findings and Recommendations*. November. p. 6. Washington, DC: Development Alternatives, Inc. Simpedes are the BRI's liquid deposit product targeted to the rural poor, among others. Gadway also emphasizes the greater aggregate stability of Simpedes deposits compared with time deposits, despite the greater liquidity of Simpedes deposits.

[17] Based on information provided by MIX in November 2008.

[18] BRI. *Annual Report 2007*. Jakarta.

Table 1: Bank Rakyat Indonesia's Audited Data, 2003–2007

	2003	2004	2005	2006	2007	Average Annual Growth Rate (%)
Loans (Rp billion)	47,599	62,368	75,533	90,283	113,973	27.89
Nonperforming (%)	6.03	4.19	4.66	4.91	3.45	
Allowance (%)	5.19	5.26	4.86	4.80	4.05	
Deposits (Rp billion)	76,316	82,400	97,046	124,468	165,600	23.40
Demand	14,112	13,364	17,722	27,864	37,162	32.67
Savings	35,803	44,569	49,372	58,308	72,300	20.39
Time	26,401	24,467	30,290	38,297	56,138	22.53
Income after Taxes (Rp billion)	2,579	3,633	3,809	4,258	4,838	17.52
Return on Assets (%)	4.11	5.77	5.04	4.36	4.61	
Return on Equity (%)	44.73	42.76	38.00	33.75	31.64	
Capital Adequacy (%)	19.64	16.19	15.29	18.82	15.84	

Rp = rupiah.

Sources: BRI Annual Reports, 2003–2007.

allowance for loan losses averaged slightly higher, at 4.8% (Table 1).[19] Meanwhile, its deposits grew from Rp76.3 trillion to Rp165.6 trillion during the same period, growing by an annual average of 23.4%. Savings deposits represented the biggest share—an average of 48.5%—while time deposits accounted for 32%, with demand deposits making up the remainder. The structure of its deposit base shows a focus on lower-income clients, and this focus and reliance on savings deposits has kept its cost of funds well below that for the overall banking system.[20]

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[19] Details in the audited financial statements show that loans rated as "loss" are far exceeded by those in the "special mention" category. Moreover, the non-performing ratio for microloans is just over 1%. With respect to risk management in the current era, it is also interesting to note that investments in "derivatives" were less than Rp25 billion as of the end of 2007, compared with more than Rp112,407 billion in loans outstanding.

[20] Simpedes deposits were initiated shortly after the transformation of the BRI's Unit Desas and are by far the single most important category of deposits for the BRI.

The BRI's income after taxes grew from Rp2.6 trillion to Rp4.8 trillion, an annual growth rate of 17.5%. Meanwhile, its ROA averaged 4.8%, and its ROE averaged 38.2%. Although these ratios, especially that on equity, have tended to decrease over the past 5 years because of increased competition, they are still well above the average for the banking system. Meanwhile, the bank's capital adequacy ratio averaged 17.2%. This ratio has also shown some volatility, but it remains well above the required ratio, even after the decline in 2007 due to a substantial increase in lending.[21]

Because of these remarkable accomplishments, the BRI received a large number of awards in 2007. Among these awards were "Best Bank" from *Investor Magazine*, "Best Bank 2007" from *Finance Asia*, "Best Bank in Indonesia" from the *Alpha South East Asia*, and "Best Domestic Bank" from *Asia Money*.

Land Bank of the Philippines: Surviving and Prospering in a Changing and Often Difficult Environment

The Land Bank of the Philippines (LBP) provides an unusual example of a government banking institution that was able to survive during a very difficult period when two other large government-owned banks became insolvent at a very substantial cost to the government. It subsequently prospered in an era of financial liberalization, becoming as large and successful as the leading private commercial banks.[22] These achievements came in spite of the LBP's wide-ranging non-banking responsibilities in the agriculture and rural sectors beyond simply providing banking services, including providing support for major government programs in the areas of agrarian reform, agriculture and fisheries modernization, livelihood support, and, more recently, biofuels, as well as its own programs in agricultural marketing and watershed protection, among others. The LBP is also responsible for various subsidiaries and other agencies, some

[21] The initial sale in 2003 of 30% of the BRI's equity in the market led to private sector holdings of 46% of the BRI's equity by 2007, showing the highly favorable valuation of the BRI's performance. It is thus especially interesting to observe how possible future increases in private holdings might influence the BRI's performance and its continuing dedication to a low-income clientele.

[22] The LBP had capital adequacy ratio 19.8% in 2006. Moreover, its nonperforming loan ratio improved to 5.6% in 2006 from 6.6% in the prior year, compared with a 2006 average of 7.0% for the entire commercial banking industry. Meanwhile, its reserve ratio for nonperforming loans was 153% in 2006, compared with an industry average of 79%.

of which (e.g., its Countryside Development Foundation and its Insurance Brokerage) are largely unrelated to banking while others (e.g., LBP Leasing and the People's Credit and Finance Corporation) are complementary. In addition to providing wholesale funding for rural financial institutions, the LBP offers technical assistance and capital investments for rural banks and especially for cooperatives. Finally, the LBP is heavily involved in providing loans and other financial services to local governments and government corporations, especially in the priority areas of agricultural infrastructure for the governments and agricultural projects for the corporations.

The LBP's mandate reaches far beyond simply providing financial services to promote agriculture and the overall rural sector, and this has undoubtedly reduced its potential profitability. Despite this mandate and the constraints it imposes on its profitability, the LBP's main burden in the 1980s consisted of government policies that made it one of the primary channels through which subsidized and directed credit flows. These policies threatened its sustainability while bankrupting the other two major government banks.[23] In particular, funding for rice production on subsidized terms channeled through the LBP led many rural banks to neglect deposit mobilization and to become excessively dependent on LBP funds.[24] This dependency, augmented by subsidy-seeking borrowers who saw little need to repay, ultimately reached crisis proportions in the mid-1980s, leading one-third of the 1,200 rural banks existing at that time to bankruptcy and another third so weakened that they could be salvaged only by a massive government recapitalization program through the LBP. Over the same period, the LBP experienced even more serious difficulties with its lending operations channeled through cooperatives, as overdue and defaulted loans were even more problematic for credit cooperatives than for rural banks, and worst for agricultural production and marketing cooperatives.

In spite of these unfortunate experiences, the LBP not only survived but also dramatically changed its approach to rediscounting—

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[23] Both the Development Bank of the Philippines and the government's commercial bank were overwhelmed by the loans forced on these banks by President Marcos and his business friends who had no intention of ever repaying.

[24] While most rural banks are small and located in rural areas, this is not necessarily true for all, as the defining characteristic that makes a bank a rural bank is the much smaller amount of capital required to establish a rural bank (in comparison, thrift banks, commercial banks, and universal banks have successively larger minimum capital requirements).

a reflection of the dramatic changes in the 1990s in the Philippine government's financial policies. Programs of subsidized credit were abandoned, and the role of government entities became primarily to support the expansion of private sector participation in finance.[25] As a consequence, the LBP began lending directly at market rates to its larger agricultural and rural clients. For its smaller clients, however, it sought to operate more at the wholesale level by providing discount funds to various types of financial intermediaries. More important, it changed its approach to these intermediaries based on the dramatic change in government financial policies as well as on its own negative experiences in the 1980s with rediscounts at subsidized interest rates. The LBP is now focused primarily on ensuring that the intermediaries it uses are financially sound and are focused on the market niche that it wants to serve: small-scale rural producers in particular. Although rural banks continue to be the LBP's lowest-risk intermediaries, the greater reliance of sound rural banks on deposits has made them less interested in LBP rediscounts. Consequently, the LBP has increased its rediscounting to cooperatives while strengthening the technical assistance it provides to improve these entities' financial and managerial performance.[26]

One of the most important elements in the LBP's success—and what separated it from the other two major government-owned banks, the Philippine National Bank and the Development Bank of the Philippines, which experienced very expensive bankruptcies in the 1980s—appears to be its governance, both in structure and implementation.[27] Specifically, the board that governs the LBP has always been legally constituted with a majority of members serving because of their government positions and only a minority being appointed directly by the Philippine president. The secretary of finance is the LBP board chairperson, which in the Philippines is an

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25 Government nonfinancial institutions were forbidden to lend, while government financial institutions were required to operate with market-based interest rates.

26 This technical assistance to improve the performance has also included LBP participation in programs to promote cooperative transparency through standardized accounting and performance indicators. In addition, the LBP has become, along with the Department of Finance and the National Credit Council, a major supporter of improved regulation for credit cooperatives, for which supervision has historically been very weak because the Philippine government agency in charge of cooperatives has an inherent conflict of interest as it is tasked with promoting cooperatives as well as regulating them.

27 See USAID. 2006. *Successful Experience of Government-Owned Banks in Rural and Microfinance: The Case of the Land Bank of the Philippines.*

especially powerful position. This has allowed the finance secretary to resist outside interventions in LBP operations that could lead to excessive risk taking or costly endeavors that would become a fiscal problem. As in any country, the primary goal of a finance secretary is fiscal stability.[28] Indications of continuing attention to good governance are the substantial discussions in the annual report for 2006 of various aspects of risk management and ongoing efforts to meet Basel 2 standards.

The success of the LBP in isolating its operations from outside interventions translated into remarkable achievements. One of the more notable ones is the increase in net income after taxes each year, averaging 22.6% per annum. Another is the increase in the ROE, which grew from 8.2% in 2002 to 12.4% in 2006. The capital adequacy ratio was 14.4% in 2005 and then 19.8% in 2006. All these indicators compare favorably with the performance of the country's overall banking system. Furthermore, LBP deposits, which increased from 179.5 million pesos (P) to P267.7 billion or 9.8% per annum during 2002–2006, exceeded loans by a substantial margin. Loans increased from P105.4 billion to P159.3 billion or by 10.2% per annum during the same period. Savings deposits—always of primary importance for low-income individuals—were the largest component of deposits and increased significantly each year, by an average of 13.2%. In contrast, time deposits rose 1.8% and demand deposits 7.4% (Table 2).

From the LBP 2006 annual audit report, it is worth noting that the LBP had increased lending for its priority sectors from 36% in 2000 to 68% in 2006. The breakdown of priority lending for 2006 showed further the focus of the LBP: rural microenterprises and small and medium-sized enterprises, 19%; farmers and fisherfolk, 17.4%; agribusiness and local government infrastructure for agriculture, each between 14% and 15%; and government corporations' projects related to agriculture, 12.5%, with each other priority categories (e.g., environment related) accounting for less than 5%. The performance of the LBP is further highlighted by donor support, with more than a dozen projects as of 2006 being supported by the World Bank, Asian Development Bank, and bilateral development agencies from Japan and Germany.

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[28] Even President Marcos, well known for his devotion to crony capitalism, did not dare to dismiss his finance secretary, who carefully protected the solvency of the LBP.

Table 2: Land Bank of the Philippines' Audited Data, 2002–2006

	2002	2003	2004	2005	2006	Average Annual Growth Rate (%)
Loans (P billion)	105.4	119.8	139.0	143.2	159.3	10.2
Deposits (P billion)	179.5	184.9	214.9	242.8	267.7	9.8
Demand	69.8	68.8	74.3	81.1	95.7	7.4
Savings	91.8	96.7	118.6	135.2	152.5	13.2
Time	17.9	19.4	22.0	26.3	19.5	1.8
Income after Taxes (P billion)	1.7	2.0	2.7	3.0	3.5	22.7
Return on Assets (%)	4.1	5.8	5.0	4.4	4.6	
Return on Equity (%)	8.3	9.3	12.7	12.1	12.4	
Capital Adequacy (%)				14.4	19.8	

P = peso.

Sources: LBP Annual Reports, 2002–2006.

A Comparison of the Three Banks

The reforms undertaken in the three government-owned banks discussed in this chapter took different paths: One was reformed and later privatized, another had a major component of the bank totally reformed, and the third survived largely intact but with substantial changes that reflected major changes by the government in its finance sector policies (Table 3). However, all three reform initiatives were built around eliminating subsidies and moving to market-based interest rates in order to make each of the banks potentially sustainable. Ad hoc interventions by government officials in lending decisions were likewise largely eliminated. Another specific aspect of improved governance was the strengthening of internal audit and financial control functions that, in turn, allowed lending decisions to be delegated to local officials—often at rural branches far away from headquarters—who knew far better how to judge the character of local borrowers and the potential of their economic activities within the local environment. A final key element was successful deposit mobilization as, without access to subsidized funding, being sustainable required that lending be largely supported by deposits, which came to exceed loan portfolios in all three banks and by very substantial margins in two. This success in deposit mobilization had further collateral benefits as it required that the bank have a favorable image, which in turn drew serious borrowers who were more likely to repay.

Table 3: Comparison of the Reforms Undertaken in the Khan Bank, Bank Rakyat Indonesia, and Land Bank of the Philippines

	Major Reform Actions Taken	Bank's Condition before Reform	Bank's Condition after Reform
Khan Bank: Agricultural Bank of Mongolia	Donors financed a new independent management team and funded recapitalization. This management team focused on profitability by giving autonomy and incentives to branches, introducing financial products and services attractive to local clientele, and establishing strong internal audit and financial control systems in order to achieve sustainability.	The bank had become insolvent for the third time in 10 years. These recurring insolvencies had resulted from lending directed by government officials, primarily to state-owned enterprises, along with no effective incentives for loan recovery or profitability.	The bank became increasingly profitable through attractive new financial products and services, coupled with incentives for branches and strong internal audit and financial control systems. The bank also increased its focus on low-income clients and expanded its rural branch network. In 2003, the bank was privatized through an auction. It has continued its strong performance since then, including its focus on low-income clients and rural areas, with the same management team kept in place.

continued on next page...

Table 3 *continued*

	Major Reform Actions Taken	Bank's Condition before Reform	Bank's Condition after Reform
Bank Rakyat Indonesia (BRI)	The traditional Bimas program of subsidized credit for rice was terminated in 1984. At the same time, the Kupedes lending program was introduced to consolidate and expand other credit products with interest rates set at levels to achieve profitability, along with performance-based incentives for Unit Desa staff. In addition, Simpedes deposit products were introduced to fund Kupedes lending and to provide a full range of essential financial services for Unit Desa clients.	BRI Unit Desa losses had expanded dramatically beginning in 1979 as amounts lent and numbers of borrowers served under the Bimas subsidized rice credit program fell from their peak in 1975–1976. Neither the government nor the BRI could continue to finance the program at prior levels, which in turn caused borrower defaults to increase to over 50% by 1982. In 1983, the decision was made to terminate the Bimas program, thereby leaving the Unit Desas in an unsustainable situation.	By 1986, the Unit Desas were already profitable. By the end of the 1980s, Simpedes deposits were more than sufficient to fund Kupedes loans, while the number of Unit Desa depositors far exceeded the number of borrowers. Most recent data show the BRI with over 21 million depositors, mostly at the Unit Desas, and more than \$5.5 billion in deposits. The BRI's loan portfolio shows excellent loan recovery (1% for microloans) while the ROA is almost 5% and ROE is over 30%.
Land Bank of the Philippines (LBP)	With the change in the government's financial policy environment, the LBP quickly moved toward market-based interest rates, with rediscount funding more effectively supported by technical assistance for rural banks and various types of cooperatives.	While through its good governance the LBP was able to resist most lending pressures, subsidized rediscounting for rice in particular weakened the LBP and undermined many rural banks and cooperatives.	Since the reforms that began in the late 1980s, the LBP has improved its overall performance, showing increased profitability in recent years along with more effective technical support for its client rural banks and cooperatives, while maintaining its focus on the agriculture sector and rural areas in general.

ROA = return on assets, ROE = return on equity.

Source: Authors.

Cambodia: Broadening Services and Expanding Outreach

Overview of the Financial System

The essence of Cambodia's financial system is its private-sector and market-based orientation, which is perhaps due to Cambodia's earlier unhappy experiences with anti-market regimes based on overwhelming government involvement. This has resulted in a sector composed of 17 private commercial banks with a mix of foreign and domestic ownership; seven specialized banks, one of which is government owned; 17 licensed microfinance institutions (MFIs); a number of registered but unlicensed MFIs; and a large number of nongovernment organizations (NGOs) that undertake limited financial operations, most often in support of certain other poverty alleviation activities. Although it seems largely adequate for Cambodia's relatively unsophisticated economy, this structure lacks many of the elements of a modern financial system. It lacks securities markets and has very limited insurance and pension services. It also lacks the elements that perhaps are most relevant to providing adequate financial services to the poor and in rural areas, namely, a money market and an interbank market. It also has only an ad hoc payments system. The lack of these markets and arrangements can be a serious barrier to adequate liquidity management facilities, to building connections between the banking system and the MFI sector, and moving money in and out of rural areas, all of which increases the costs of liquidity management, especially in relatively remote and undiversified rural areas.

Approach to Rural and Agricultural Finance

Cambodia's approach to rural and agricultural finance reflects the government's approach to the overall finance sector in giving predominance to the private sector and allowing market forces full play. There are thus no government-owned agricultural or rural development banks of any significance, no controls over interest rates except for the requirement that these be transparent, and few, if any, subsidies. Government's role is largely limited to promoting macroeconomic stability, providing a legal and regulatory infrastructure that facilitates financial operations and the management of inherent risks, and encouraging competition by ensuring transparency in ownership and operations.

There are, of course, always threats to the continued implementation of this approach, the most serious of which is the temptation of "quick fixes" to provide subsidized credit to disadvantaged groups or to activities seen to be underappreciated by private markets. It is to be hoped that the government, with support from international development agencies, will maintain its current approach and focus on providing a legal and regulatory infrastructure for a competitive and efficient private finance sector, rather than trying to pick winners and compensate losers through direct interventions in financial markets. Nonetheless, this infrastructure needs to be enhanced significantly as the economy becomes more sophisticated, particularly to address the added costs of providing an adequate array of financial services in relatively remote (and often undiversified) rural areas.

Status of Key Rural Financial Institutions

The main entities involved in rural and microfinance in Cambodia as of September 2009 were the Association of Cambodian Local Economic Development Agencies (ACLEDA) Bank and the 21 MFIs that are members of the Cambodia Microfinance Association (CMA). In addition, microfinance services were also provided by the government-owned Rural Development Bank (RDB) and a large numbers of NGOs that provide financial services as part of their overall strategies to assist the poor. To have a more complete picture of the rural finance subsector in Cambodia, the commercial ACLEDA Bank, three leading MFIs, one NGO, and the RDB will be discussed.

The three MFIs and ACLEDA Bank have achieved remarkable growth and impressive outreach to the poor and into rural areas. ACLEDA Bank has added nonpoor and non-rural clients as it competes with other commercial banks, but it continues to serve large numbers of its traditional clients with both loan and deposit services. The three MFIs on the other hand remain untested in their abilities to mobilize significant amounts of deposits. Until 2007 when the *Financial*

Box 1: Cambodia's Microfinance Institutions (as of September 2009)

- **Number of members**: 21
- **Total loans of all members:** $276 million
- **Number of borrowers:** 860,000 (two member MFIs have more than 200,000)
- **Loan portfolios of nine largest members:** $15 million to $50 million (90% of all loans)
- **Portfolio at risk over 30 days of nine largest members:** 5% of total loans

Source: Cambodia Microfinance Association.

Sector Development Strategy 2006–2015 was installed, MFIs were not allowed to take deposits from the general public.[29]

The NGO may be of special interest if it can become a model of the potential of small, locally controlled entities to evolve into more significant providers of financial services to the poor in remote rural areas. Meanwhile, the RDB faces the question of what role a government-owned bank might play in a finance sector that is market based and almost totally private.[30]

ACLEDA Bank

At the end of 2007, ACLEDA Bank accounted for 212 of 310 commercial bank branches in Cambodia and covered every province in the country. It employed 4,401 or some two-thirds of all commercial bank staff members. By mid-2008, its staff complement had increased to over 5,300, of whom some 2,000 were loan officers. The bank also ranked fourth in total assets with $473 million, third in loans to clients with $310 million, third in deposits with $344 million,

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[29] National Bank of Cambodia. 2007. *Financial Sector Development Strategy 2006–2015*. Phnom Penh. www.adb.org/Documents/Others/Financial-Sector-Development-Strategy/CAM/CAM-FSD.pdf

[30] Except for a brief mention by a Lutheran World Federation staff member, the lack of attention to cooperative financial institutions (credit unions) is notable, suggesting that few if any exist. Whether this is due to the lack of an appropriate legal infrastructure is unclear. A second possible cause—that Cambodians do not like to work together in this way—seems unlikely, since group lending methods are popular in Cambodia.

third in after-tax profits with $9.7 million, and first in equity with a significant addition at the beginning of 2008. Among the long-standing investors in ACLEDA Bank were the International Finance Corporation (IFC), the ACLEDA staff association, and the ACLEDA NGO, which was the bank's largest shareholder, and German and three Dutch entities that invest in sustainable activities that are socially oriented.

Because loans and deposits play a central role in providing essential financial services, ACLEDA Bank's performance in these respects warrants further analysis. The National Bank of Cambodia (NBC) reports that ACLEDA Bank's nonperforming loans were 0.1% of its loan portfolio at the end of 2007, compared with 3.5% for the total banking system. Further information provided by staff of the CMA indicates that, as of mid-2008, ACLEDA Bank had $140 million in loans outstanding to more than 175,000 small borrowers for an average loan size of $800. ACLEDA Bank staff reported 134,392 loans to micro-business clients totaling $46.5 million for an average loan size of less than $350. While it lent far more to other categories of clients, medium enterprises in particular in terms of loan amount, it had clearly not abandoned its micro clients, who accounted for 70% of its borrowers. Similarly on the deposit side, ACLEDA Bank appeared to serve not only large depositors—344,657 of them in mid-2008, with $466 million or an average deposit of $1,350—but also micro depositors. These depositors had $223 million in 329,512 savings deposits, with an average deposit half as large as those of large depositors. Given the typical preferences of the poor for liquid savings deposits for emergencies and the fact that the vast majority of accounts will be far below the average, ACLEDA Bank was probably serving a very large number of poor depositors.[31]

Angkor Mikroheranhvatho Kampuchea

Developing rapidly after receiving its MFI license from the NBC in 2004, Angkor Mikroheranhvatho Kampuchea (AMK) is now among the most successful of the 17 licensed MFIs operating in Cambodia. At the end of 2007, it had 16 offices (third largest in Cambodia), 347 staff members (fourth largest), over $12 million in total assets (seventh largest), over $2.5 million in share capital (largest), and

[31] Typically, the smallest depositors hold less than 20% of the total amount of deposits while accounting for more than 80% of the number of depositors. Using a conservative 20/80 ratio, the average deposit balance for this group would be $170 spread over 275,000 small depositors.

more than $1.1 million in accumulated profits. For 2007, it had over $800,000 in after-tax profits (fifth largest), according to the NBC's Banking Supervision Department.

In the same year, the AMK's total loan portfolio amounted to more than $10 million (seventh largest), with a delinquency ratio of less than 0.01% as it had only 23 nonperforming loans. This ratio was, by far, the lowest of any of the significant MFIs in Cambodia. Three of Cambodia's very smallest MFIs had no nonperforming loans, while the average for all 17 was 0.19%. Furthermore, this loan portfolio was spread among more than 120,000 borrowers, 80% of them women. This borrower base placed the AMK among the top 100 worldwide. (By mid-2008, the number of borrowers had risen to 150,000, the vast majority of whom were apparently well satisfied, given the extremely high loan repayment rate and a retention rate of over 80%.) The average loan size in 2007 was less than $90, the lowest of any MFI in Cambodia and substantially lower than the average of over $250 for all 17 MFIs. Its loan portfolio was heavily rural, with 67% of its lending being for agricultural purposes, lower than the 45% for all 17 MFIs.

In contrast to its loan portfolio, the AMK's deposit portfolio in 2007 was among the smallest, amounting to less than $30,000 in voluntary deposits (all of which were savings deposits) and less than $25,000 in mandatory deposits from borrowers. However, with the new opportunity accorded by the NBC in the *Financial Sector Development Strategy 2006–2015* for MFIs to become licensed and authorized to accept deposits from the general public, the AMK has developed plans to move quickly in that direction. It is especially well-positioned to do so with its presence in some 4,000 Cambodian villages. In spite of this favorable positioning, AMK management does not underestimate the challenge of attracting depositors on a massive basis, recognizing in particular the need to upgrade its management information system and strengthen its financial controls to handle deposits. It also recognizes the need to perfect the design and marketing of attractive deposit products and services.

Amret

In 1991 a French NGO, Groupe de Recherche et D'Echange Technologiques (GRET), set up an experimental project to deliver microcredit to the rural population in Cambodia. The experiment was successful and became known in 1995 as Ennatien Moulethan Tchonnebat (EMT). EMT became a private limited company in 2000.

It received an MFI license from the NBC in 2001 and was renamed Amret in June 2004.

Through the years, it has been able to attract several foreign investors, mainly French, interested in making financial services available to the poor. Because of the equity infusions from these investors, it grew to be among the largest MFIs in Cambodia. As of the end of 2007, according to NBC figures and its own audited financial statements, Amret was fourth among Cambodia's MFIs in the number of branches with 88, second in staff size with 611, first in total assets with over $38 million, first in after-tax profits at just under $2.5 million, second in loans at over $30 million, and third in deposits at just under $900,000. None of its deposits was compulsory, but most were term rather than savings deposits.

Like other leading MFIs, Amret plans to obtain a license from the NBC to take deposits from the public and sees no significant barriers to complying with the NBC's requirements. While it expects that this change will improve its deposit performance dramatically, it nonetheless recognizes the challenges, especially in shifting its emphasis from term deposits to liquid savings deposits, which it sees as most important for its poor clients. One of its major advantages in seeking to expand its deposit mobilization is its current base of borrowers. Just from the end of 2007 until mid-2008, its loan portfolio expanded from $30 million to $39 million, and the number of its borrowers reached 184,400, by far the largest of any MFI. Over 80% of its borrowers are women, who are typically much better savers than men. Furthermore, the NBC reported that Amret's delinquency ratio was 0.11% at the end of 2007, compared with an average of 0.19% for all MFIs.[32] Amret's loan portfolio was two-thirds agricultural, which showed its continuing focus on rural areas. In terms of value, 60% of its loan portfolio went to group loans, 40% to individual loans. In terms of numbers, however, 85% went to groups, thus leaving individuals with just 15% of total loans. Amret's client retention rate was over 60% for individual borrowers and over 80% for group borrowers.

[32] Amret's audited final statements for 2007 likewise show that substandard, doubtful, and loss loans taken together are only 0.11% of its loan portfolio.

Sathapana Limited

Sathapana Limited was originally established as a Cambodian NGO in 1996, under the name of Cambodia Community Building (CCB), to offer financial and health education services to poor communities. In late 1999, it adopted a minimalist microfinance approach, offering savings and loan services only. Its lending operations then shifted gradually from predominantly group lending to a mix of group and individual lending. In 2001, the CCB was registered with the NBC as a microfinance operator. From 2000 to 2003, the organization transformed itself from a humanitarian to a profit-oriented organization. In February 2003, it was incorporated as a private limited company, registered with the Ministry of Commerce under the new name of Cambodian Entrepreneur Building (CEB) Limited, and it obtained a license from the NBC in April 2003 to operate as a regulated MFI. From July 2008 CEB was renamed Sathapana Limited.

Sathapana Limited has been very successful over the past 5 years in expanding its portfolio and increasing its outreach. As of August 2008, it had a staff of 650 working in 34 branches with 32,360 borrowers and a portfolio of $34.6 million. Sathapana Limited's total assets came to just under $38 million. Despite this impressive expansion, it was able to maintain its on-time repayments ratio at 99.8%. It is also in the process of launching new products for savings mobilization, which it believes to be the appropriate long-term funding strategy. As of December 2007, Sathapana Limited (CEB at the time) ranked first among MFIs in savings mobilization, second in share capital, and third in loan portfolio and in earnings after tax, its return on equity being 31%. Sathapana Limited plans to keep expanding each year and to continue to be among the leading MFIs in the country over the long term.

Lutheran World Federation

While the Lutheran World Federation (LWF) is far from being an MFI and does not wish to become one, focusing instead on a variety of activities to support rural development in general, its approach to making financial services available to the poor in rural areas nonetheless provides some interesting lessons, specifically in the importance of local ownership and commitment. Working currently in about 400 villages, the LWF has set up some 270 village banks (comparable to credit unions) with grants of $30 on behalf of each member to start a loan fund to which members must provide a savings counterpart. LWF staff initially explain carefully to prospective members of the village bank how the system is designed to work but thereafter try to minimize technical assistance, in effect leaving the operations of the banks almost entirely to their respective members. Very few of these village banks have failed, with most growing in both capital and membership. Interest rates on loans are typically set at 3% per month but are often higher in the early stages of a village bank's existence as members seek to ensure sustainability through a more stable financial resource base.

The LWF is currently considering a push to formalize these village banks by combining several of these entities into credit unions at the commune level.

Rural Development Bank

Although this entity is small compared with Cambodia's commercial banks and MFIs just discussed, it is the largest of the country's specialized banks in most respects (e.g., in total assets, loans, deposits, and total revenue) but not in profits. The key question is whether at some point it might interfere with Cambodia's currently market-based financial system by offering targeted loans at subsidized rates of interest, as government-owned banks have done in many countries.

Summary

ACLEDA Bank and the three MFIs examined in detail have all grown very rapidly and shown outstanding performance in both profitability and outreach to the poor. While ACLEDA Bank has added nonpoor and non-rural clients as it competes with other commercial banks, it continues to serve large numbers of its traditional clients with both loan and deposit services. Meanwhile, although the three MFIs have been highly successful in their outreach in lending to the poor and in remote rural areas, they remain untested in their ability to mobilize significant amounts of deposits from their traditional clients, although this is clearly their intent. The LWF may be of special interest if it can serve as an example of the potential of small, locally controlled entities to evolve into more significant providers of financial services to the poor in remote rural areas. For the RDB, the question is what role a government-owned bank might play in a finance sector that is market based and almost totally private.

Outreach and Sustainability

Meetings with these entities revealed that the CMA, ACLEDA Bank, and the three MFIs in transition to be licensed to take deposits from the general public understood what was needed for them to engage in profitable micro and rural lending: a focus on borrower cash flow and character rather than formal collateral as basis for decision to extend loans or not, as well as the delegation to loan officers of the decision of whether to extend loans, with the officers being motivated to perform well while being effectively controlled by strong internal audit and financial control systems. Moreover, figures from the Banking Supervision Department of the NBC and the audited financial statements of the entities confirmed that they are clearly sustainable (showing consistent profitability and very low rates of loan delinquency) and are expanding their outreach rapidly, currently reaching at least a million families throughout rural Cambodia with attractive lending services.[33]

Although difficult to give a precise measure of outreach, it is clear that these successful institutions are not abandoning the rural poor as their clientele. A detailed credit demand survey at the household level could uncover other initiatives worth investigating for the very poorest and for the most remote rural areas, such as building on the type of informal but apparently sustainable local entities being created by the LWF to see if these can be formalized into credit unions (savings and credit cooperatives).

Deposit Mobilization

Cambodia's MFIs are only now beginning the process of securing a license from the NBC to be able to take deposits from the general public. Not surprisingly therefore, the total amount of deposits mobilized by all 17 MFIs in mid-2008 was extremely small, amounting to just $5 million in 25,000 accounts, much of which was required counterparts for loans. In comparison, ACLEDA Bank had $466 million in 344,657 deposit accounts. Thus, there is great scope

[33] A fairly recent publication of the NBC, *Microfinance of Cambodia: 2007*, is already out of date in seriously underestimating the world-class performance of many of Cambodia's MFIs as a result of their staff being well-trained and clearly understanding international best practices.

for the Asian Development Bank (ADB) and other donors, as well as domestic and international NGOs, to assist in transforming MFIs as deposit collectors.

ACLEDA Bank's deposit mobilization has been conducted mainly in rural areas, suggesting that there is a large potential pool of depositors there for these MFIs to exploit.

The main question for the future will be the ability of Cambodia's transforming MFIs to build on ACLEDA Bank's example and to be as successful in deposit mobilization as they have been in lending. It might be helpful for donor assistance to focus on the kinds of improvements in management information systems, information technology, and internal control systems that have proven so important for successful lending. A rural survey like that carried out by ADB in the Lao People's Democratic Republic could also be extremely helpful for MFIs in designing deposit products and services.

In addition, certain specific barriers may need to be lowered or removed. The most significant barrier is probably the withholding for taxation purposes of part of the interest paid on deposits, which will impose relatively greater administrative costs on MFIs in dealing with small deposits. Great care must be taken to avoid imposing similar barriers with anti-money laundering rules and requirements for knowing the client. Furthermore, having readily accessible branches is crucial for small depositors, who typically want quick and easy access to liquidity to deal with emergencies (or sometimes to take advantage of opportunities). This implies that the fee that the NBC collects on each bank branch could seriously inhibit or undo branching by MFIs if applied to them. Likewise, regulatory requirements that the NBC might place on branch infrastructure in order to control risks when MFIs are taking deposits could raise the costs of branching significantly.[34]

[34] In addition to suggesting tighter rules for branching, the NBC's *Microfinance of Cambodia: 2007* takes a rather pessimistic view of the potential of MFIs to mobilize substantial deposits in rural areas, thereby encouraging a self-defeating reliance on external funds, whether from donors or banks and other commercial lenders. Recognizing the experience of Indonesia's BRI Unit Desas in deposit mobilization, together with the rural survey being recommended, may help to overcome these views.

Deposit mobilization will bring in cheaper sources of funds to support the sustained growth of MFIs. However, this could be a challenge for many MFIs. Meeting the challenge could involve the same level of promotion given to lending operations, such as the 3-day national forum on microfinance technology conducted by the NBC in January 2006 and the prime minister's declaration that 2006 was to be the year of microfinance, with three regional microfinance workshops. In 2007, there were two regional microfinance workshops on the important role of microfinance in poverty reduction. A similar approach involving high-ranking officials could bolster deposit mobilization.[35]

Informal Finance

No recent reliable information was available on informal finance in Cambodia at the time of the study.[36] However, despite the increasing reach of the rural and microfinance operations of MFIs and ACLEDA Bank, it is unlikely that informal finance is no longer important in Cambodia, especially in rural areas. Even in the United States, at least half of agricultural credit is supplied informally by marketing agents (i.e., those who sell inputs and purchase outputs). It could thus be highly useful to carry out a detailed microfinance survey of households in Cambodia to ascertain the nature and extent of this operation, especially since the infrastructure (a survey instrument and a sampling methodology) already exists. Identifying the lending services that are provided informally in rural Cambodia could help MFIs decide what new credit products and services to introduce. Such a survey could also illuminate how rural households make decisions with respect to the sources and uses of income and

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[35] Certain MFIs are recommending the issuance of a "microfinance bank license" to allow them to offer the same deposit services as commercial banks. The use of the term "bank" could increase the confidence of the public. In addition, because they support rural economic development, MFIs or their offices in rural areas might be treated differently from normal commercial bank branches by reducing some requirements, such as capital requirements, license and branch fees, and other obligations.

[36] A 2004 World Bank report by O. Torres, *Rural Finance and the Microfinance Sector in Cambodia*, contains the most recent information, compiled from a number of sources and summarized in Appendix 3. An interesting point, although it is not emphasized in the Torres report, is that rotating savings and credit associations (known by their French name *tontines* in Cambodia) are prevalent in Cambodia's urban areas but appear to be largely absent in its rural areas, despite their ubiquitous nature in many, if not most, developing countries.

the resulting cash flows that, because of diversification to deal with risk, almost inevitably extend beyond agricultural production.

Financial Crises

The heavy dollarization of Cambodia's economy exposes those that are not perfectly hedged to potentially serious risks—in particular, MFIs that typically lend in local currency to their micro clients and often find it cheaper and more convenient to borrow in dollars (or in some other foreign currency). Of course, most financial institutions and the NBC itself are largely aware of exchange rate risks and of the importance of maintaining careful control over such risks, most often through matching liabilities with assets that are both in the same foreign currency. However, this is not always as easy as it appears on the surface, as many lenders discovered during the Asian financial crisis of the late 1990s. Specifically, these lenders lent heavily to the then highly attractive real estate sector, hedging by making these loans in dollars as an offset to their dollar deposits. When major depreciations of local currencies occurred, borrowers in non-tradable-goods sectors such as real estate could not pay their dollar obligations because their cash inflows in local currency did not increase with the change in the exchange rate.[37] The risks faced by Cambodian MFIs in lending in local currency in an economy that is so heavily dollarized should thus receive further attention. ADB might consider bringing in international experts, particularly those knowledgeable about countries that have replaced their own currencies with the dollar (such as Panama many years ago and El Salvador and Ecuador more recently).

Current Potential of and Constraints on Rural and Microfinance

Most donor involvement in Cambodia's finance sector is bilateral, except for ADB and the IFC's investments in, and technical assistance for, specific institutions. The positive aspect of these interventions

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[37] Indeed, in its 2007 Annual Report, the NBC's Banking Supervision Department (pp. 8–9) highlights the risks not only of the major increase in lending for real estate, which may be part of a "bubble" in that sector, but also the heavy reliance on real estate as collateral for loans. Of course, microlending is rarely for real estate, nor does it rely significantly on such collateral, but this nonetheless illustrates the risks inherent in an economy that relies heavily on a foreign currency.

is that they have largely focused on supporting commercially sustainable rural and microfinance operations. However, the danger exists that donors may be tempted to subsidize "poverty-reducing" finance in ways that undermine sustainability, such as offering credit lines for selected groups of target borrowers or encouraging financial institutions to offer other services as complements to finance. Donor help for the transforming MFIs is likely to be more needed in improving poverty reduction performance than in improving lending activities, which appear to be well taken care of in Cambodia. Indeed, the major issue impacting the current potential of, and constraints on, rural financial markets in the country is the ability of MFIs to transform successfully into deposit-taking institutions that aggressively serve the poor, including those in remote rural areas. The impressive accomplishments of MFIs in lending, together with the record of ACLEDA Bank in deposit mobilization, provide a basis for optimism, but external assistance is likely to be very important, if not essential, for success in deposit mobilization.

Creating the Policy Environment

NBC officials charged with supervision of MFIs indicated many of the reasons for the highly successful development of private-sector microfinance operations in Cambodia. One is the government's recognition of the importance of a for-profit ownership structure under which the owners are clearly identified and foreign and domestic owners are treated equally. Another key is flexibility, which allows the rules to vary for different levels of operation. Upon reaching a certain number of clients and amount of loans, a microfinance entity is required to register with the NBC and, at a higher level, to obtain a license, also from the NBC. Ultimately, an MFI can achieve a level at which it can take deposits from the general public, which several MFIs are currently in the process of doing, or even become a commercial bank as in the case of ACLEDA Bank. A third element stressed by NBC staff is transparency, which involves a standard chart of accounts for licensed MFIs that is essentially the same as that which is required for commercial banks, monthly reporting to the NBC, and publication of audited financial statements.[38]

[38] As noted elsewhere, ADB has been involved in supporting improvements in accounting and auditing toward the attainment of international standards.

Also important is the quality of governance over the sector. The NBC's MFI supervision staff has achieved high levels of relevant education and relatively lengthy tenure in the MFI supervision unit, in contrast to regulatory bodies in many other countries, where supervisory personnel assigned to smaller entities have decidedly lower stature so that such units are avoided by those seeking serious careers in supervision. The NBC's Banking Supervision Department currently has a staff of 57, with 44 assigned to banking sector supervision (30 to off-site inspections and 14 to on-site inspections), 6 to an administrative unit, and 7 to the MFI unit. ADB has supported the improvement of this department, providing not only training for its personnel but also technical assistance directed at refining pertinent laws and regulatory norms. With the likely major expansion of NBC responsibilities if many MFIs opt to mobilize deposits from the general population, ADB may need to consider providing substantial additional support to strengthen the supervisory capacity of the NBC.

Creating and Strengthening the Financial Infrastructure

For rural financial services for low-income people, little financial infrastructure is required. Since microlending in Cambodia is—correctly—not based on formal collateral, there is no need, for that purpose, to focus on developing registries for land and moveable collateral or the related judicial systems and expertise.[39] Attention should be paid, however, to developing an information gathering and retrieval system for borrowers and their credit behavior because of the overriding importance of information about "character" in microlending decisions. This requires careful analysis of the current legal situation of credit bureaus in Cambodia, which is in some dispute. Whereas the 2007 Annual Report of the Banking Supervision Department of the NBC states that "according to the *Financial Sector Development Strategy 2006–2015*, the credit information system established for the commercial bank sector can be extended to the microfinance sector," other experts argue

[39] However, these elements may be important for lending to SMEs. ADB has assisted in establishing other important elements of financial infrastructure to facilitate lending such as the Secured Transactions Law, a registry to accompany the foregoing law, the Commercial Enterprises Law, and the Insolvency Law. It also assisted in the implementation of the laws.

that laws currently in place clearly prohibit the circulation of any information about borrowers.[40]

Institutional Development

The CMA has played a major role in the institutional development of Cambodia's MFIs. It was established in 2002 by several leading MFIs and, in 2004, was formalized and registered with the Ministry of Interior as an NGO. However, since Cambodian law allows for only one professional association related to banking services, the CMA became a subsidiary of the Association of Banks in Cambodia in 2007. This arrangement has allowed the CMA to retain its operational autonomy while also being able to deal directly with the NBC on issues relating to MFIs and to microfinance in general. In addition to working to improve the legal and regulatory environment for microfinance, the CMA provides various services to its member MFIs, including organizing and conducting training, workshops, and exchange visits with MFIs in other countries. In 2007, its activities focused on enhancing the availability of management information system and information technology to its members.[41]

A significant number of multilateral and bilateral international development agencies have provided aid for developing the finance sector in general, and the microfinance subsector in particular, as well as individual MFIs. ADB has been a leader in supporting the formulation and implementation of a number of laws, including the Secured Transactions Law and a registry to accompany it, the Commercial Enterprises Law, and the Insolvency Law. Particularly important was the support it provided for the implementation of

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40 There are several other countries that seem to interpret "banking secrecy" as applying to loans when, in fact, it is meant to apply only to deposits. This definition, however, has routinely been circumvented by lenders by inserting into loan contracts the right to share this information.

41 The NBC's *Microfinance of Cambodia: 2007* fails to acknowledge the important role being played by the CMA in supporting the institutional development of the MFI sector, perhaps because the NBC's publication dates from early in 2007, while many of the CMA new contributions began later in that year after it received formal recognition as an autonomous subsidiary of the Association of Banks in Cambodia. On the other hand, the CMA is careful to acknowledge the support it has received from various multilateral and bilateral international development agencies, the Agence Française de Développement (AFD) of France and the Appui au Developpement Autonome (ADA) of Luxembourg in particular in 2007.

the Accounting and Auditing Law and the requirement for regulated financial institutions to publish their audited financial statements with regularity. ADB has also given assistance to the NBC and to the training institute attached to the organization. Meanwhile the IFC has been a major supporter of specific MFIs as well as the CMA. Beginning in 2002, it has provided technical assistance to help Cambodian Entrepreneur Building transform itself into a formal MFI. It is currently recruiting consulting firms to assist MFIs that want to be licensed to mobilize deposits from the public.

Lao People's Democratic Republic: Continuing Reforms and Capacity Building to Create a Robust Sector

Overview of the Financial System

Historical Background

At its Fourth National Party Congress in 1986, the Lao People's Revolutionary Party adopted the New Economic Mechanism as the foundation for the current financial system in the Lao People's Democratic Republic (Lao PDR). Since then, the government has focused on ensuring macroeconomic stability and establishing a market-oriented regulatory framework. Sustained economic growth has been achieved, and inflation has been both stable and low, interrupted only by the Asian financial crisis. Moreover, the finance sector has been restructured, with support from international development organizations, from one characterized by the direct and exclusive provision of financial services by the state to one where market forces are allowed full play. This has resulted in a small banking sector, predominantly catering to large state-owned businesses and wealthy individuals in urban areas, and monitored by a central bank, the Bank of the Lao PDR (BOL).

The Formal Finance Sector before 2007

At the end of 2007, the domestic banking market of the Lao PDR, in addition to being small, with just over $1 billion in total assets and some 2,600 employees, was dominated by state-owned banks. In addition to three state-owned banks, it consisted of two state joint-venture banks, a private joint-venture bank, and seven foreign commercial banks.[42] Together, the state-owned banks accounted for over 50% of loans, almost 60% of total assets, and over 60% of deposits.[43] The foreign-owned banks, subsidiaries of five Thai, one Malaysian, and one United Kingdom–based bank, all operated a single branch office in Vientiane and serviced only home-country clients with operations in the Lao PDR.[44]

Although there was a large unfulfilled demand for credit from both individuals and enterprises, banks had huge excess liquidity, as indicated by very low loan-to-deposit ratios. Banks relied heavily on collateral, but their ability to seize and liquidate collateral in the case of default was weak and had not been helped by the postponement of the promulgation of the Law on Secured Transactions. For those banks willing to lend based on cash flow, enterprises often could not supply audited financial statements (or any financial statement) or well-designed business plans. Even adding nonbank financial institutions, the formal finance sector included until 2007 only a single insurance company, a small social security system, and 28 pawnshops, altogether accounting for just 3% of all assets of the finance sector.

This low level of development was reflected in the ratios of money and bank credit to gross domestic product. The Lao PDR's ratios were among the lowest in Asia and lower than other countries with similar levels of development.

The Rural and Microfinance Sector by the End of 2007

Of all the banks, only the state-owned Agricultural Promotion Bank (APB) had been involved in delivering credit to rural areas for agricultural purposes, using a group-guarantee lending technology. APB had been given the government's mandate to support rural economic development with subsidized and targeted lending. In the process, it had built up a huge portfolio of nonperforming

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[42] The government has a 30% minority stake in one joint venture bank and a 50% stake in another (*Financial Sector Strategy 2008*, BOL).

[43] BOL. 2007. *Lao Financial Statistics (3rd and 4th quarters)*; BOL. 2008. *Financial Sector Strategy.*

[44] Technically, the United Kingdom–based Standard Chartered Bank has only a representative office in the Lao PDR.

loans, along with negative capital, while still focusing its lending operations on large accounts and in urban areas. As a consequence, according to a 2003 survey, it had met only 2% of existing demand for credit in the rural areas where 80% of the population and 90% of poor households reside.[45] According to this survey, the main suppliers of financial services in rural areas, specifically credit, were groups of semiformal providers that were satisfying 5% of demand for credit by the lower-income segment.[46] Informal finance filled the gaps left by banks and the formal and the semiformal microfinance sector.[47]

The importance of semiformal providers of microfinance services play was confirmed in 2006 when a survey showed that this group lent to 85% of the 206,000 low-income rural clients served by formal and semiformal credit institutions and lent out 72% of the total loan amount disbursed to the segment during that year. The same survey, conducted by the National Economic Research Institute (NERI), found that APB served only 14% of all these clients and provided just 28% of the total loan amount. The contribution of other formal lenders, consisting of a group of seven small microfinance institutions (MFIs) and savings and credit unions (SCUs), most of which had only recently been established, was marginal.

Clearly, the unmet demand for rural financial services in the Lao PDR was huge. In 2003, the unsatisfied demand for credit amounted to $500 million (at the current exchange rate). At that time, only 7% of total demand for credit was met by all formal and semiformal

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[45] B. Coleman and J. Wynne-Williams. 2006. *Rural Finance in the Lao People's Democratic Republic: Demand, Supply, and Sustainability (Results of Household and Supplier Surveys)*. Manila: ADB and Financial Reform and Strengthening Initiative (FIRST).

[46] Semiformal entities are those recognized by local authorities or mass organizations but not licensed or monitored by the central authorities responsible for the finance sector.

[47] Numbers in this section, in particular on the activities of semiformal providers, are typically "best estimates" based on existing survey reports and interviews with implementers of projects containing rural financial market components. Nonetheless, these numbers suggest the scale of rural financial market services. Much information on the semiformal and informal sectors was taken from: NERI, Committee for Planning and Investment, Microfinance Capacity Building and Research Project. 2004 and 2007. *Rural and Microfinance Statistics in the Lao PDR*. Vientiane.

providers together, including APB. In 2006, the same group of providers served only 6.5% of the population between 15 and 64 years old and reached only 46% of all villages in the country.[48]

In the Lao PDR rural financial market sector, the level of interest rates had been the dominant focus of attention. However, Lao rural households put a higher value on sustained and easy access to a credit provider and the "certainty that a loan will be made" than on the level of interest rates. Successful credit delivery was also challenged by the multi-functionality of rural households, with more than one motive for borrowing. Almost all rural households in the Lao PDR combine farming (predominantly of rice, poultry, and pigs) with other forms of business activity. And the poorer a household is, the less it is inclined to borrow for production purposes. To be successful, therefore, credit needs to be flexible enough to fund both farming and non-farming activities, and to satisfy various non-productive and emergency purposes.

The demand for savings services was staggering. Based on the 2003 survey by Coleman and Wynne-Williams, rural households had savings assets totaling $987 million (at the current exchange rate), 73% of which was in nonmonetary forms, predominantly livestock. Savings in monetary form, either deposited in a bank or in cash, amounted to $263 million. Of this, 55% ($144 million, or 31% of total deposits in the Lao PDR banking system) had been deposited in a bank by only 5% of all rural households, thus leaving $119 million in cash "under mattresses." These figures suggest a huge market for savings deposit services as yet untapped by the finance sector as a whole.

Semiformal providers, so important for delivering credit, played a less central role in the delivery of savings facilities. Deposits in village savings and credit groups (VSCGs) amounted to just $1.3 million in 2003, $8.4 million in 2005, and $7.7 million in 2006. These deposits were brought in by a constant number of about 167,000 people. In an interview with the Lao Women's Union (LWU) conducted in 2008 for this study, it was found that savings by a core group of 104,000 participants in VSCGs were estimated to be at least $15 million, indicating that significant amounts of money had sometimes been deposited with them. It is normally deemed advisable to restrict such

48 No correction was made for the cases in which more than one provider would operate in the same village, so that the percentage of villages reached was overestimated.

sizable collections to institutions that are not licensed by financial-monitoring authorities. This has been the case in the Lao PDR since the issuance of the Microfinance Regulations in 2008 (discussed in detail below). Before then, there were no prohibitions against semiformal providers taking large deposits.

The Approach to Micro-, Rural, and Agricultural Finance

The main elements of the current approach to rural financial markets in the Lao PDR can be found in the Policy Statement for Sustainable Rural and Microfinance Sector, which was endorsed by the Prime Minister in 2004 and is standing policy.[49] The statement gives clear support to the creation of an enabling environment based on the principles of sustainability and market orientation.[50] The Rural Finance Sector Development Program 2006–2010 (RFSDP), which was designed to institutionalize the policy statement from the Prime Minister's Office (PMO), determines much of today's financial environment. It includes restructuring the APB into a bank operating on market principles and limits future policy lending to a newly created "policy bank." Part of the process of restructuring the APB has been the transfer of its existing portfolio of subsidized loans to this policy bank.

Under the RFSDP, the PMO has explicitly mandated that the BOL regulate and supervise the rural finance sector, and a Microfinance Division has been created for this purpose.[51] Since then, the BOL has issued "good practice" microfinance regulations, enabling the establishment of a diverse set of licensed, formal, and independent microfinance service providers that are intended to be self-sufficient.[52] The government has also prohibited foreign ownership of MFIs.[53]

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49 The policy statement was created by the interministerial Rural and Microfinance Committee, led by the BOL.

50 The principles and goals of the policy statement are also found in the government's poverty reduction strategy. *National Growth and Poverty Eradication Strategy 2003*. pp. 1, 43, 59, and 108. Vientiane.

51 PMO. 2007. Order 05/PMO. 4 April. Vientiane.

52 The final regulations were issued in June 2008.

53 PMO. 2005. Notice 1634 (subjects 2 and 3). 21 October. Vientiane.

There are exceptions to the general market-oriented policies on microfinance, however. The approach to delivering rural and microfinance services to the 47 poorest districts identified by the government is distinctly different. In these districts, subsidized and targeted lending is to be used as a means to alleviate poverty and is to be funded by the state budget. Distribution is done through village revolving funds (VRFs), which have been created for this purpose by the Rural Development and Poverty Eradication Committee of the PMO and through a state-owned policy bank, the Nayoby Bank.

The involvement of commercial banks in the Nayoby Bank is less clear. Foreign equity investments in private commercial banks in the Lao PDR are permitted. All commercial banks are allowed to lend in small quantities and use group guarantees as a means to secure a loan.[54] This opens up the microfinance segment for any bank to enter, particularly in light of Article 6 of the Law on Commercial Banks that secures a level playing field.[55] Moreover, banks are required to report to the BOL on their microfinance portfolio, and the Prime Minister, at the closing ceremony of the annual BOL meeting on 14 June 2007, even urged banking officials around the country to look to village banks for inspiration on how to encourage rural people to use bank services. However, a BOL notice currently limits the spread between interest rates on deposits and loans to 5%, effectively restricting the commercial viability of entering this segment because of its cost structure (see further discussions on this notice below).[56]

A final important element of the approach to rural financial markets is the policy (and practice) of creating community-managed loan funds (CMLFs) or village banks, which are often referred to in the Lao PDR as "village development funds."[57] The government promotes the creation of CMLFs as a way to provide "improved or better

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[54] BOL. 2007. Notice No. 277. 16 October. Vientiane.

[55] Article 6 on Equality in Business Operations of the Law on Commercial Banks states, "Commercial banks established and operate banking business in the Lao PDR shall be equal under the laws to cooperate and complete with each other in order to expand production and business operations. The State uniformly regulates commercial banks based on laws and regulations and the State protects the rights and legitimate benefits of commercial banks."

[56] BOL. 2006. Notice No. 111. 28 April. Vientiane.

[57] A wide range of terms is used for various CMLFs, with the definition depending on the user, thereby making it imperative to ask the user for the exact meaning to avoid misunderstanding.

access to microfinance and affordable micro-credit facilities."[58] The many multisector programs that are designed by the international development community and are implemented in cooperation with various government entities, or mass organizations, almost always contain CMLFs as a credit component. This explains the relative dominance of these semiformal suppliers, particularly in the delivery of credit. Basic self-sufficiency, transparency, and accountability, as demanded by the principles outlined in the PMO's policy statement on rural financial markets, are often not adequately followed by either international development organizations or local counterparts in the way that the CMLFs are set up or operated.[59]

Recent Developments in the Finance Sector and the Current Status of Key Micro and Rural Financial Institutions

The finance sector in the Lao PDR, although still in its infancy, seems to have acquired a strong momentum toward development, largely as a consequence of the improved enabling environment. Most notable are the promulgation of laws on the promotion of foreign investment (2004), on enterprises (2005), and on commercial banks (2006), as well as the PMO decree on the promotion and development of small- and medium-sized enterprises (2007) and the BOL's regulations for the microfinance sector (2008).

Since January 2007, no less than nine private investments have been made in the banking sector. Eight of these investments are of predominantly foreign origin and have led to the establishment of eight new commercial banks with total investment in capital alone of reportedly over $100 million. As a consequence, new technology, knowledge, and experience are being imported, boosting the finance sector. Of all the newly established banks, at least three have explicit strategies to create large networks of branches and service units and ultimately to achieve outreach. In 2009, despite an international

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[58] Decree on the Compensation and Resettlement of Development Projects (PMO/192, 7 July 2005) and Regulations for Implementing Decree 192/PM on the Compensation and Resettlement of People Affected by Development Projects (PMO STEA/2432, 11 November 2005), STEA technical guidelines (pp. 25, 52, 116, and 117).

[59] J. Murray and R. Rosenberg. 2006. Community-Managed Loan Funds: Which Ones Work? *Focus Note* No. 36. May. Washington, DC: CGAP. www.cgap.org/gm/document-1.9.2577/FN36.pdf

financial crisis, the total outstanding loan portfolio of the domestic banking sector was expected to grow by 26%, after growing 70% year-over-year in August 2008.[60]

Some of the investments in the Lao PDR banking sector have been made by international financial groups that are experienced in supplying financial services to low-income segments including micro-, small-, and medium-sized enterprises in developing countries. The impact of such groups on the Lao PDR rural financial markets is still to be seen, as the room for cost recovery in delivering financial services to low-income segments is currently limited by the prescribed limit on bank spreads. In the case of state-owned banks, it will be important to see the consequences of their internal restructuring programs, especially in the face of potential new competition.

The number of formal microfinance service providers licensed by the BOL had grown from 3 at the start of 2004 to 16 as of June 2009, while the number of semiformal providers had doubled. Currently, it is estimated that there are at least 5,000 CMLFs in the country's 10,552 villages. At least 50% of all villages therefore have either a village bank or a village development fund.

As a consequence of the RFSDP, the rural finance sector is likely to become rapidly formalized. The new microfinance regulations both allow for and require the creation of a number of independent, formal service providers. They will need professional staffs in larger numbers than are currently unavailable. The staffing situation is made worse by the expansion of the banking sector, which is hiring large numbers of workers from formal and semiformal providers of microfinance services.

For the BOL, the task of licensing and regulating the formal finance sector along with the rural finance sector, with its expected rapid expansion, is probably beyond its current resources. To deal with this greatly increased workload, the BOL needs to expand its capacity, in particular its human resource base.

For the semiformal providers, the near future is likely to bring a continued growth in the number of development projects with credit components and of financial compensation packages stemming from

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60 World Bank. 2008. *Lao PDR Economic Monitor*. Washington, DC.

human dislocation for hydropower and mining projects.[61] To deal successfully with these developments, support for the rural finance sector should focus not only on improving microfinance regulations but also on implementing the recently created laws and regulations, building the required human capacity and financial infrastructure, improving coordination within the sector and between the sector and the relevant authorities, and, most important, raising awareness of the policies and strategies of the central government of the Lao PDR (including the "good practice" principles on which these are based) among decentralized units of government, mass organizations, and international development agencies and development banks.

In addition to the APB, the various entities involved in rural and microfinance can be sorted into deposit-taking MFIs, savings and credit unions, and non-deposit-taking microfinance institutions (NDT MFIs), including credit cooperatives and village banks (Table 4).

Table 4: Profile of Rural Financial Institutions in the Lao People's Democratic Republic (as of the end of 2009)

Institution	Number	Number of Accounts	Products and Services	Main Funding Sources
Agricultural Promotion Bank	17 branches, 42 service units	100,972 borrowers; 93,000 depositors	Short- and medium-term credit, time deposits, savings, money transfers	Government
ACLEDA Bank[a]	6 branches, 12 service units	3,530 borrowers; 6,395 depositors	Short- and medium-term credit, time deposits, savings, money transfers	Private investors, clients

continued on next page...

[61] For details, please refer to the project documents of: ADB Nam Ngum River Basin Development Project, ADB/IFAD/SDC Northern Region Sustainable Livelihoods through Livestock Development Project, World Bank/Finnish and Lao PDR government in Sustainable Forestry and Rural Development Project, existing (Nam Theun 2, Nam Theun Hinboun) and future hydropower and mining projects (www.poweringprogress.org), (visited 30 August 2009.) GTZ/IFAD Access to Finance for the Poor, World Vision Local Area Development Program.

Table 4 *continued*

Institution	Number	Number of Accounts	Products and Services	Main Funding Sources
Deposit-taking MFIs	7	44,932	Short-term credit, time deposits, savings	Shareholders, donors
Non-deposit-taking MFIs	8	7,713	Short-term credit, time deposits, savings	Government, shareholders, donors
Savings and credit unions	11	9,593	Short-term credit, time deposits, savings	Member shares, donors
Credit cooperatives	Circa 5,000	More than 200,000	Short-term credit, savings	Government, donors, members

ACLEDA = Association of Cambodian Local Economic Development Agencies, MFI = microfinance institution.

[a] As of November 2009. *Vientiane Times*, 16 November 2009.

Sources: The Bank of the Lao PDR and the Agricultural Promotion Bank.

The Agricultural Promotion Bank

Subsidized lending has resulted in mediocre performance among state-owned banks in many developing countries. Worldwide experience has shown that policy lending at below-market interest rates not only draws subsidy seekers but also creates a disincentive for successful borrowers, who manage to deal with the rationing devices, to repay their loans.[62] Furthermore, the presence of these loans crowds out private lenders that seek sustainability but cannot compete with subsidized interest rates and a culture of non-repayment. The role and performance of the APB and the likelihood

[62] This issue has been discussed in several studies for the USAID, the World Bank, and the Inter-American Development Bank as early as the 1970s and 1980s in Bolivia, Colombia, various Central American countries, and the Philippines. For example, D. Adams and R. Vogel. 1986. Rural Financial Markets in Low Income Countries: Recent Controversies and Lesson. *World Development*. April; World Bank. 1989. *World Development Report 1989.* Washington, DC; R. Buckley and R. Vogel. 1999. *The World Bank and Microenterprise Finance: From Concept to Practice*. Operations Evaluation Department, World Bank. November; and R. Vogel. 2006. From Agricultural Credit to Rural Finance: In Search of a New Paradigm. In M. Lamberte et al. eds. *Beyond Microfinance: Building Inclusive Rural Financial Markets in Central Asia.* Manila: ADB.

of success in the ongoing reform efforts thus receive significant attention in the remainder of this chapter.

In an August 2008 meeting with APB officials conducted for this study, it was reported that some 58% of APB lending was for agriculture (including forestry) and some 37% was for commerce and services. About 70% of loans had maturities ranging from 6 to 12 months, and virtually all lending was to individuals and private enterprises. APB loans totaled some $44 million, ranging in size from $1,000 to $1 million, with about 40% being loans of more than $5,000. This confirmed the findings of the 2003 survey by Coleman and Wynne-Williams that limited attention was being given to the low-income segment. APB loans were also said to take about 2 weeks to process for new clients and to require, in most cases, land or houses as collateral. Interest rates on loans ranged from 12% to 15% per year, depending on an assessment of the risk involved. Repayments were a lump sum at maturity for seasonal loans, but interest was paid monthly and principal quarterly for most other loans. These interest rates are below those offered by private commercial banks and thus likely to be problematic. At the same time, the repayment schedules would also be considered risky according to microlending best practices, or even according to small and medium enterprise lending practices.[63]

The APB has had serious performance problems with a high percentage of nonperforming loans and substantially negative net worth. As a result, ADB and various international development agencies have been involved in major efforts to reform and restructure the APB, including substantial injections of capital and the transfer of policy loans, most of which are nonperforming, to the newly created Nayoby Bank.[64] The APB's restructuring follows the governance agreement signed among the Ministry of Finance,

63 Microlenders that do not require payments at least monthly and often weekly find that lack of continuing close contact with borrowers leads to repayment problems. While some argue that agricultural loans must conform to the agricultural production cycle, it should be noted that most small farmers engage in a number of economic activities in order to diversify risks and to achieve relatively constant cash inflows. Such diversification is clearly confirmed in the rural finance survey by Coleman and Wynne-Williams discussed in this chapter.

64 The Nayoby Bank will continue policy lending, confined to a geographically area that has been identified to contain the most urgently poor people in the Lao PDR, based on poverty alleviation objectives and other non-economic criteria, funded from the state budget without a for-profit orientation.

the BOL, and the APB that allows more fundamental reforms in the APB's corporate governance. These reforms include strengthening the APB's autonomy, human resources management, and portfolio quality management.[65] As of the time of the study, APB performance had started improving, but it was too soon to comprehensively assess the effectiveness of the governance agreement (Table 5). Experiences in other countries, however, show that successful reform of a state-owned bank requires a strong mechanism to eliminate political interference.

Table 5: Agricultural Promotion Bank's Financial Performance, 2005–2009 (% unless otherwise indicated)

Indicator	2005	2006	2007	2008	2009
Asset growth rate	—	8.7	38.6	44.1	54.9
Nonperforming loan to gross loan[a]	39.7	32.8	18.2	4.3	3.2
Nonperforming loan to net loan	64.4	57.0	25.9	20.8	3.3
Net loan growth rate	—	(0.7)	9.7	147.6	80.2
Return on assets	(0.9)	(9.8)	(2.3)	4.0	1.6
Return on equity	—	—	—	—	169.8
Net interest margin	6.4	6.9	9.7	8.6	6.4
Cash and due from banks to total liabilities	17.7	21.1	34.4	19.9	11.8
Cash to total deposit liabilities	8.7	8.4	9.5	8.4	17.8
Borrowed funds to total assets	37.3	21.2	13.6	13.3	19.8
Deposits with the BOL to total deposit liabilities	15.7	20.0	30.0	14.9	5.4
Customer loans to customer deposits ratio	95.2	84.2	48.6	78.2	103.3

continued on next page...

[65] Governance Agreement of the Ministry of Finance and the BOL with the Board of Directors and Management of the APB. 30 March 2007. Vientiane.

Table 5 *continued*

Indicator	2005	2006	2007	2008	2009
Customer deposit growth rate	—	20.6	56.5	15.5	22.4
Total equity (KN billion, year end)	**(106.2)**	**(164.1)**	**(175.0)**	**(52.3)**	**15.4**
Net income (KN billion, year end)	**0.0**	**(42.7)**	**(14.2)**	**35.2**	**26.3**

— = not available, ( ) = negative, BOL = Bank of the Lao PDR, KN = kip.

[a] A nonperforming loan is defined as a loan with principal or interest overdue by 180 days or more.

Sources: Agricultural Promotion Bank audit reports for 2005–2008. The 2009 data are unaudited.

Nonbank Microfinance Providers under the Jurisdiction of the Bank of the Lao PDR

The collection of nonbank financial institutions serving the rural and microfinance sectors can be seen as a pyramid, with the village banks forming a base that is broad but may not be sustainable, and with the much smaller number of formal, deposit-taking MFIs at the top (see Nonbank Microfinance Institutions in the Lao PDR).

The first two groups discussed below, deposit-taking MFIs and SCUs, are licensed and formalized rural financial service providers supervised by the Microfinance Division of the BOL. They are predominantly active in urban and semi-urban areas, where they make short-term loans to individuals, with collateral in the form of land titles or motorbikes. The farther from the city their clients are located, the smaller the average loan size becomes and the more that group guarantees, rather than collateral, are used to secure a loan.[66] Such group loans form only a small percentage of loans issued by these providers. Funding for loans is predominantly savings-based for both institutions, as is required by BOL regulations, which stipulate that borrowings may not exceed 30% of the concerned MFI/SCU's total outstanding loan portfolio at any time.[67] While borrowing from foreign sources is subject to prior BOL approval,

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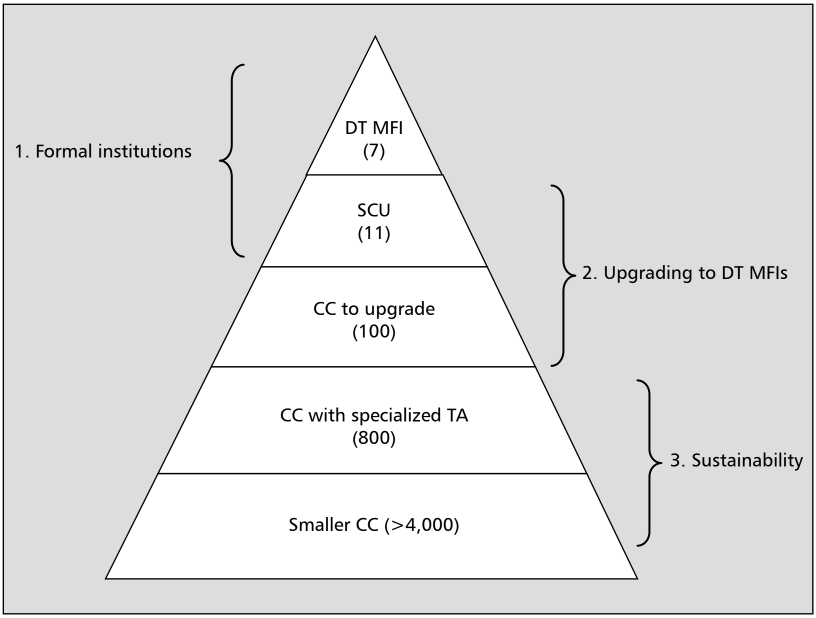
[66] Interviews conducted by the authors for this study with formal MFIs and the Microfinance Center and Microfinance Working Group in 2008 and 2009.

[67] Article 38 of Deposit-Taking MFI regulations and Article 40 of SCU regulations.

Nonbank Microfinance Institutions in the Lao People's Democratic Republic (as of the end of 2009)



CC = credit cooperatives, including village banks, village development funds, village savings and credit group, and village revolving funds; DT MFI = deposit-taking microfinance institution; SCU = savings and credit union; TA = technical assistance.

Source: Authors.

foreign grants are not. Portfolio risk ratios are nonetheless generally high by international standards.

Deposit-Taking Microfinance Institutions

As of end 2009, there are seven microfinance entities that have been licensed by the BOL as deposit-taking MFIs. Of these, four were surveyed for this study, namely, the Lao Postal Savings Institute (established in 2000), Ekphatthana MFI (established in 2006), Newton MFI (established in 2007), and Saynhai Samphanh deposit-taking MFI (established in 2007). The Lao Postal Savings Institute had already been established and licensed before any regulations for MFIs had been issued and is in many ways a hybrid between a deposit-taking MFI and a state-owned commercial bank. It also differs in that salaried government employees make up 95% of its clientele, with these employees receiving loans using salary guarantees. It is also often used for national money transfers because of its extended network.

As of mid-2008, the four surveyed deposit-taking MFIs altogether had an outstanding loan portfolio of $3.550 million lent out to some 6,450 borrowers. They had a staff of some 50, half of whom were credit officers. Saynhai Samphanh differs from the rest in that it is engaged almost entirely in longer-term lending, with maturities of more than 1 year, while the others are exclusively in short-term lending. It also provides loans mainly to teachers and other government officials, using salary guarantees and making heavy use of mass organizations and local government officials for client selection and loan recovery. In contrast, the Ekphatthana MFI and Newton make no use of these methods.

Funding for deposit-taking MFIs is predominantly based on savings, in the form of liquid savings and time deposits. Liquid savings, totaling $3.1 million, were brought in by 15,200 savers while just 66 people placed a total of $700,000 in time deposits. These deposit patterns are not unlike those of the two larger SCUs, showing that these institutions serve mainly small, presumably poor, depositors with their liquid deposits. However, it also shows that funding and liquidity management depend heavily on a small number of individuals with relatively large deposits, exposing the institutions to risks of nonrenewal or premature withdrawal.

Savings and Credit Unions

As of June 2009, there were 11 SCUs licensed by the BOL, 6 of which were licensed after October 2008 when the data collection for this study ended.[68] Being member-based, SCUs have a lower initial capital requirement than deposit-taking MFIs, and their financial services are to be delivered only to their members. Most of the 11 SCUs have only one main office and just four or five staff members, with one or two being loan officers. One savings and credit union, Rural Development Cooperative (RDC), is somewhat larger, having two offices, nine staff members, and five loan officers. None of the SCUs

[68] Because of the timing of the survey, no data are reported for the SCUs that were licensed after October 2008. Data on one small cooperative, Credit Cooperative for Promotion of Small Producers (CCSP), originally licensed in 1996 under a BOL regulation that is no longer in effect, are also not included.

are engaged in any term lending (more than 1 year). Altogether, they have accumulated assets of $750,000, of which $657,000 was being lent to 2,140 borrowers. Their total savings portfolio totaled $460,000, brought in by 5,100 members. Only 3% of the savers made time deposits, but they accounted for 50% of all savings. SCUs are therefore subject to the same types of liquidity risks mentioned above.

Non-Deposit-Taking Microfinance Institutions

Since the issuance of the Microfinance Regulations in 2008, all organizations that have not been licensed by the BOL and are carrying out microfinance activities have been categorized as NDT MFIs. This group, including at least 5,000 semiformal entities, is made up of five different types of MFIs: (i) a handful of former project-based microfinance initiatives that are now run as parts of different provincial governments; (ii) a few apex-like associations of village banks; (iii) community-managed loan funds (CMLFs) or village banks; (iv) about 1,000 village savings and credit groups (VSCGs); and (v) around 4,000 village revolving funds (VRFs).[69] Of all of these, only seven have so far registered with the BOL's Microfinance Division, as required by the NDT MFI regulation.[70] Each of these types is discussed below.

Institutionalized Former Donor-Funded Microfinance Projects

There are four known examples of donor-funded microfinance projects that have been institutionalized as part of various provincial governments, while a fifth one is currently being implemented.[71] Institution Financière de Développement de Phongsaly, a former project funded by the Agence Française de Développement, is now part of Phongsaly's provincial government. It was the first semiformal MFI to register with the BOL as an NDT MFI and is also the only MFI

[69] In reality, there is a spectrum of CMLFs rather than clearly distinct groups, the group of 1,000 being a combination of large, savings-based entities that have received specialized technical support for a long time. In the group of 4,000 VRFs are also smaller VSCGs, mainly without significant specialized technical support.

[70] BOL website. www.bol.gov.la (accessed in June 2009)

[71] The fifth project of this kind is the Rural Finance Services Component of the Oudomxay Community Initiatives Support Project, implemented with support from the International Fund for Agricultural Development (IFAD) and Lux-Development.

in the Lao PDR that has registered in the Microfinance Information Exchange (MIX) database.[72] Saiyaboury (Province) Microfinance Office, Oudomxay (Province) Microfinance Office, and the Sihom Project Savings and Credit Scheme are what remain of a former United Nations Capital Development Fund microfinance initiative.[73] The Sihom scheme is now part of the government of Vientiane Capital. Institution Financière de Développement de Phongsaly and the microfinance offices of Oudomxay and Saiyaboury together have 37 staff members, of whom about half are loan officers. Taken together, these entities have a loan portfolio of $518,000 in 1,920 loans or an average loan size of $270. Deposits are compulsory for members and amount to only $44,600 contained in 2,550 accounts, making the funding for the entities' operations mainly externally based. Thus, with respect to lending patterns in particular, these entities behave much like the MFIs just discussed.

Apex-Like Village Bank Associations

Even though these associations are not directly involved in delivering microfinance services, three of them have already registered under the NDT MFI regulation.[74] A great many others have been created and are still being created in various forms and under various names in almost all projects that have set up VSCGs.[75] They are quite different from NDT MFIs, being apex institutions channeling donor funds from the associations to individual village savings and credit groups and village development funds. The associations charge interest, which is their most important source of income. The associations also monitor and provide technical support to their constituent VSCGs/ village development funds.

[72] See www.themix.org (accessed on 15 May 2009).

[73] After registration, Oudomxai became Oudomxay Development NDT MFI.

[74] Bokeo Village Development Fund Association, Hongsa Credit and Savings Association, and Khop Credit and Savings Association have registered.

[75] The BOL undoubtedly has the authority to register them and could have registered them on an individual basis, since the NDT MFI regulation is applicable only to direct providers of microfinance services, rather than to apex-like structures.

Community-Managed Loan Funds

The Consultative Group to Assist the Poor (CGAP) defines a community-managed loan fund as an entity providing "credit to members (that) is managed by the members themselves with no professional management or supervision of the approval, disbursement and collections of loans."[76] It is estimated that at least 50% of all 10,552 villages in the Lao PDR have a CMLF. Realizing that there is a whole spectrum of CMLFs with variations in their respective modus operandi, the descriptions here are focused on analyzing their sustainability. Village savings and credit groups are CMLFs in which funding is predominantly based on internally generated savings from members. Almost always, VSCGs are supported with long-term, specialized technical assistance from development institutions. Village Revolving Funds, on the other hand, are those CMLFs in which loans to members are primarily externally funded. Mostly, they lack long-term specialized technical assistance. The terms village bank or CMLF are used for both groups together.[77]

Most CMLFs have been created through cooperation between an international development agency, a development bank or nongovernment organization (NGO), and a counterpart within the government—often the Ministry of Agriculture and Forestry or the Ministry of Planning and Investment—or the Lao Women's Union (LWU). A smaller number of CMLFs are created and funded only by the government, mainly by various rural development and poverty reduction funds, or by the LWU or Lao Front for National Construction, and are mainly in the 47 poorest districts. The CMLF model as developed in the Lao PDR is closely linked to the structures of mass organizations and governments at the provincial, district, and village levels. The main elements of the model have been developed by the LWU and two Thai NGOs and have been disseminated in guidelines to noncentral governments and mass organizations.[78]

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[76] J. Murray and R. Rosenberg. 2006. Previously cited.

[77] A whole range of different terms are used for CMLFs in the Lao PDR. The terms "village development fund" and "village bank" are used to describe VRFs by some, VSCGs by others, and VRFs and VSCGs together still by others. When discussing it, it is an imperative to know the definition that the user has in mind in order to prevent misunderstandings.

[78] The Thai organizations are the Community Organizational Development Institute and the Foundation for Integrated Agriculture Management.

Village Savings and Credit Groups

Village savings and credit groups (VSCGs) start when those villagers who save become members and elect a management team from within themselves. The team organizes the village bank and keeps the books. Bookkeeping is performed in writing in at least monthly cycles when savings are collected and loans are disbursed, with some larger village banks having up to three cycles per month. There are no term savings or term lending, with loans for trade purposes having maturities of up to 4 months and loans for agricultural purposes having maturities of up to 6 months. Lending is based on various forms of group guarantees or group recommendations. There is an "advisory committee" of local authorities that monitors management, audits the books, promotes the VSCG, and helps solve conflicts or problems such as the non-repayment of loans. The village bank offers simple savings and loan products similar to those found in savings and credit unions. The loan and savings products are decided upon at the yearly general meeting of all members. No interest is paid on members' savings, but the village banks' profit is shared annually as dividends according to pre-determined rules among the members, the management team, and the advisory committee, often with some reserves for "development funds" and auditing costs.

The collaboration among the LWU and two Thai NGOs, mentioned earlier, has been supported with long-term technical assistance from external specialists. This arrangement has set up a group of some 600 of the most successful VSCGs, which are based solely on member savings and involve only women. Even though each is located in a single village, often with fewer than 1,000 members, many are very large, sometimes having multiples of $100,000 in voluntary savings, 80% of which is lent out, on average. Other development organizations that are known to set up VSCGs with long-term technical assistance include the GTZ, the International Fund for Agricultural Development, Lux-Development, the International Labour Organization (ILO), and the Stone Family Foundation. In addition, hydropower and mining projects in the Lao PDR are strictly obliged to create a socioeconomic plan for villagers who are affected by their activities in order to compensate for any loss of livelihood. Decrees from the PMOs, as well as international agreements, require microfinance as part of the compensation plan, which in the Lao PDR occurs through the creation of CMLFs. The large sums provided to compensate villagers are deposited as savings in these CMLFs, making them effectively VSCGs. Given the scale and number of current and expected hydropower and mining projects, already including Nam Theun 2 and Theun Hinboun Power Companies (together currently responsible for over 120 village banks), this is developing into a significant group.[79]

Two factors with regard to VSCGs are most relevant for rural finance sector reforms. The first is Article 20 of the NDT MFI regulation, which states that an VSCG with voluntary savings in excess of $23,000 "shall be required to convert to a DT [deposit-taking] MFI or SCU, shall apply for a license, and shall be subject to regulations for DT MFI or SCUs as applicable." It is estimated that a minimum of 200 VSCGs are subject to this requirement. The process of transformation to a more professional, formal structure requires an investment in human and technical capacity well beyond the scale of training and support organizations that are currently available. The processes of monitoring compliance and of regulation will also put an enormous strain on the BOL, which does not have adequate staff. Nonetheless, formalization and monitoring should help in the development of transparency and accountability, as well as in the protection of depositors, if done well. It should also open the door to a whole range of professional support organizations and funders that deal only with formalized institutions.

The second factor is the initiative of a core group of development organizations to promote sustainability by creating apex-like associations or networks of village banks, which are to be guided by these organizations' bylaws. The associations intend to provide the necessary technical assistance to their constituent village banks, to monitor them, and to function as a channel for distribution of funds. So far, a patchwork of different bylaws has been created by NGOs and development institutions to support these village banks. These bylaws, however, often do not adhere to basic "good governance" principles.

Village Revolving Funds

Each year, many multisector projects are implemented in the Lao PDR with funding support from international development banks, donors, and NGOs. Often, a microcredit component is added to the program without a plan for making it sustainable. These microcredit

[79] See www.poweringprogress.org for dozens of projects that are ongoing, under construction or planned, with feasibility studies being done for even more (accessed on 10 September 2009).

components, called village revolving funds (VRFs) currently number some 4,000, and many more are likely to follow in coming years.

VRFs appear inconsistent with the principle of sustainability embedded in the PMO's Policy Statement and too often do not adhere to "good practice" as defined by generally accepted standards such as those of the CGAP. The new Microfinance Regulations could help address this concern as the lack of sustainable outcomes becomes more apparent with increased transparency. The regulation that requires MFIs to register with the BOL, use a specified chart of accounts, and submit yearly balance sheets and income statements offers an opportunity to have a set of comparable data for semiformal rural finance entities.[80] This could help identify approaches that work and thus to steer the sector toward an appropriate direction. Registering all village revolving funds and those VSCGs that do not require a license will, however, be a major effort that demands strengthening the capabilities of the BOL.

Outreach

The outreach to borrowers of all formal SCUs and MFIs surveyed is quite limited. As of August 2008, less than $3.9 million in short-term loans had been lent by these entities to fewer than 9,000 borrowers. Two of these entities provided loans with maturities of more than one year and reached 5,000 borrowers with loans totaling less than $1.3 million. The majority of these rural finance entities, however, have only recently been established.

Recent and accurate (audited or externally checked) data on semiformal entities, which compose the largest group of providers of credit to the lower-income segment, are hard to obtain. The 2003 Coleman and Wynne-Williams survey counted almost 100,000 low-income borrowers, 17% of whom borrowed from the APB and the rest from semiformal entities.[81] These rural and microloans totaled just under $20 million. Overall, the average loan size was about

[80] Article 3 of the BOL's NDT MFI regulations. The 2008 Financial Sector Strategy of the BOL suggests, however, that NDT MFIs can instead be administered by the agency that created or financially supports them.

[81] The dominant government counterparts for international development organizations setting up CMLFs are the Ministry of Planning and Investment, and the LWU.

$200, with the average for APB loans being well over $300, about $200 for mass organizations, and just over $150 for government agencies. For all groups of entities, amounts lent were predominantly (80%) for agriculture, with trade and then handicrafts the only other significant categories, accounting for more than 5% each. Borrowers were almost equally divided between the genders, but men received slightly bigger loans. By region, the central and north regions received substantially more and larger loans than the south.

Sustainability

The sustainability of the nongovernment rural and microfinance entities that existed as of mid-2008 in the Lao PDR is difficult to predict and is dependent on a variety of external factors as well as the behavior of these entities themselves. Nonetheless, there are several positive signs. First, among the 15 entities for which extensive data were collected under this study, at least two or three appear well along the road to sustainability, having grown rapidly in relatively short periods and showing various positive indicators (such as reasonable loan processing times, good client retention rates, and adequacy of interest rates to cover costs).[82] Still, portfolio-at-risk percentages are generally high and higher than international norms. Furthermore, future growth toward sustainability depends heavily on improved deposit mobilization, with the contributions of international development agencies and NGOs ideally coming more in the form of supporting effective training and technical assistance in this and other respects than in monetary donations.

Internationally, as in the Lao PDR, the success rate of semiformal providers is dependent on the extent to which funding is based primarily on internally generated savings as well as on the quality and duration of technical support these entities receive.[83] For VRFs that are merely credit components of multisector development projects, this suggests that, without a change in strategy by the main supporters, which are predominantly large international

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[82] From the Coleman and Wynne-Williams 2003 survey of rural finance in the Lao PDR, it is interesting to note that private MFIs and SCUs have significantly lower arrearage rates, less than 8%, compared with 14% or 15% for donor and NGO programs and even higher rates for the APB.

[83] J. Murray and R. Rosenberg. 2006. Previously cited.

development banks and NGOs, there is little to be expected in long-term sustainability.[84]

VSCGs have much more scope for reaching operational self-sufficiency. Based on these organizations' existing knowledge, experience, network, and performance, supporters of sustainability may want to consider focusing particularly on this group. It ought to be noted, however, that to upgrade an estimated minimum number of 200 VSCGs to the formal level would require intensive on-the-job and classroom training and institutional capacity building for the most advanced VSCGs.[85] For the remaining 800 VSCGs and for the minority of VRFs that have some basic structural form, sustainability strategies would need to be developed and supported; otherwise, survival may not be a realistic expectation. Forming supporting associations and linking these to the formal sector could be a possible solution, since such linkages are often sought in the international context and, as seen earlier, associations already have some basis in the Lao PDR.[86]

As already discussed, the actions of the APB and, to a lesser extent, the Nayoby Bank will affect the ability of nongovernment rural and microfinance entities to become important players in providing sustainable financial services to the rural poor. While ADB and other international development agencies and NGOs are making serious efforts to rein in policy lending and improve loan recovery efforts, low interest rates on loans from the APB remain an important constraint to the growth of nongovernment rural and microfinance entities. Furthermore, although new rules governing the operations of nongovernment financial entities mark a major improvement in the regulatory environment, the effectiveness of these rules (e.g., will they be risk-based and emphasize transparency, thereby providing a basis for improvements in deposit mobilization?) as well as the ability of government to implement them, remains to be seen.

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[84] See also CGAP. 2006. *Good Practice Guidelines for Funders of Microfinance. Second Edition*. October. Washington, DC. www.cgap.org/gm/document-1.9.2746/donorguidelines.pdf

[85] Estimates based on figures provided to the authors by reports and interviews with the main creators of VSCGs, namely, the ILO, Stone Family Foundation, Lao Community Sustainable Development Promotion Association, Women and Community's Empowering Project, Non-Profit Association of Lao Development, Foundation for Integrated Agricultural Management, the LWU, GTZ, Nam Theun 2, Theun Hinboun Power Company, and Lux-Development.

[86] As above, interviews with the main creators of VSCGs.

Deposit Mobilization

In meetings with APB officials conducted by the authors of this study, it was reported that the APB had the equivalent of some $73 million in deposits, of which more than 70% was liquid deposit. No information was provided about the number of depositors.[87] The SCUs and MFIs examined in this study together had less than $4.3 million in deposits, mainly in voluntary rather than compulsory deposits. Almost a quarter of these deposits consisted of time deposits in fewer than 200 accounts. The 30,000 liquid deposit accounts amounted to just three-quarters of total deposits. However, a survey by NERI reported that as of 2006, semiformal entities had accumulated savings deposits of more than $7.65 million in just under 163,000 accounts for an average savings of $47 per saver. And interviews by the authors for this study suggest large increases in accumulated savings within this group, perhaps more than doubling the foregoing numbers.[88]

There are significant regional and gender differences in savings patterns, probably caused by the ways that different savings programs have been designed and set up. The programs that focus on generating short-term savings and do not have long-term technical support for borrowers show low amounts of accumulated savings and much lower participation rates for women.[89] As the funding of deposit-taking MFIs and SCUs is based to a large extent on savings, the ability to mobilize savings is crucial for outreach in lending as well. Depositor protection, a priority identified by the BOL in its 2008 Financial Sector Strategy, could help overcome hesitance to depositing in cash in formal nonbank entities that are seen as less solid than banks. However, great care must be taken, due to moral hazard considerations, not to introduce deposit insurance before prudential regulation and adequate supervision are fully in place.

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87 For the total number of deposits, no segregated data are reported on deposit sizes and locations (urban or rural), thus effectively limiting any understanding of rural and microsavings at the APB.

88 NERI, Committee for Planning and Investment, 2006. Microfinance Capacity Building and Research Project. Rural and Microfinance Statistics in the Lao PDR. The APB, also covered in this survey, did not provide data on savings.

89 Women have larger amounts of savings on average. Moreover, average amounts are greater in the south than in the north.

Informal Finance

Given the limited outreach of formal and semiformal financial entities, it is not surprising that most financial services are supplied by the informal sector. The 2003 Coleman and Wynne-Williams survey found that loans came primarily from friends and relatives, although rotating savings and credit associations, and even moneylenders charging annual interest rates of more than 100%, were far more important than banks or semiformal sources of credit. The characteristics that rural households want in a lender help explain why informal sources of credit are so important. Confidence that a loan will be made—cited as a key factor by almost 60% of rural households—is far more important than the interest rate charged, especially for poor rural households. The ongoing relationships that are typical between informal lenders and their clients, especially in the case of the rural poor, thus provide a major advantage for informal lending over the services offered by many formal financial institutions.[90] The other characteristics sought in a lender are convenience of location, low collateral requirements, and simple loan procedures, all of which are components of transaction costs and, taken together, are likely to be the most important factor favoring informal over formal lenders. Furthermore, rural borrowers need to be able to use their loans for many purposes, not just for agriculture and not just for other productive purposes such as transport, trade, and services. They also use credit for health, housing, education, marriages, and funerals. Informal lenders allow that flexibility, in contrast with many formal lenders that insist that loans be used for some specific productive purpose.

The rural finance survey also found that noncash savings accounted for over 70% of total rural savings, exceeding savings in financial form in all wealth groups. Livestock was by far the most important form of savings for rural households, held by 98%, but precious metals, jewelry, and building materials are also important savings vehicles. Thus, for all financial services, savings as well as credit, the informal sector is far more important than banks or other institutions, not only because of access but also because of the quality of informal financial services that can more than compensate for the higher interest rates found in some (but not all) informal cases.

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[90] Indeed, for MFIs, the retention rate for clients is almost as important in explaining success in lending as the repayment rate.

Financial Crises

Although not as extreme as in Cambodia, the dollarization of the Lao PDR economy has resulted in 72% of deposits, 66% of loans, and 75% of total banking sector assets being denominated in foreign currencies as of 2006.[91] This exposes those not perfectly hedged to potentially serious risks. Most financial institutions and the BOL itself should already be largely aware of exchange rate risks and of the importance of maintaining careful control over such risks, most often through the matching of liabilities in foreign currencies with assets in the same currencies. However, this is not always as easy. For example, many lenders during the Asian financial crisis in the late 1990s lent heavily to the real estate sector in dollars to offset their dollar deposits. When local currencies depreciated, borrowers in non-tradable goods sectors, such as real estate, could not pay their dollar loans. Dealing with exchange rate risk in an economy that is so heavily dollarized might thus need to receive further attention. The government is urging its people to use the kip instead of foreign currencies, but this policy is not likely to be effective without specific incentives.[92] To deal with this potential problem, it might be worthwhile to bring in international experts familiar with the experiences of countries that have encountered similar situations.

Current Potential of and Constraints on Rural Finance

Implementing the needed reforms will require a large number of people to be trained in the various aspects of running new and enhanced rural financial institutions. The current lack of a well-trained workforce is a major hindrance to the development of the finance sector. Second, the PMO's policy statement, the principles on which it is based, and the content of the ensuing regulations need to be disseminated more widely and explained more fully to all stakeholders, including international development organizations, mass organizations, ministries, and local governments. International development organizations should also be pressed to adhere more closely to the policy and to "good practice" principles, which they themselves have often identified as crucial. Then, consensus ought

[91] BOL. 2008. Financial Sector Strategy. Draft of 25 February, especially pages 14–16.

[92] E. Phouthonesy. 2008. Central Bank Governor Campaigns on Use of Kip. *Vientiane Times*. www.bol.gov.la/english/Central%20bank%20gorvernor.pdf (accessed on 20 July 2008)

to be forged among the parties, public and private, on how to ensure that much-needed rural and microfinance services are made available to the poor and dispossessed.

There is clear potential for the banking sector to become more involved in the sustained delivery of these services. If the regulation that currently limits interest rate spreads were formally withdrawn, banks could increase their interest income to compensate for the higher costs involved in serving clients with lower incomes, especially in rural areas. As more financial service providers enter that market, competition should follow that could ultimately lower interest rates and improve the quality of the services provided, as seen in more mature financial markets in nearby countries such as Cambodia and the Philippines.

An important constraint to the expansion of rural finance found elsewhere in the world is a failure to understand the basic elements of the sector. More specifically, there is a lack of understanding that rural finance is not equivalent to agricultural credit. One of the most important findings from the 2003 Coleman and Wynne-Williams survey of rural finance in the Lao PDR, which conforms closely to what has been found elsewhere in the developing world, is the high degree of diversification in the economic activities of rural households at all levels of income. According to this survey, only 38% of rural income comes from agriculture, broadly defined to include livestock and fishing. To be successful, rural financial service providers should understand the multiple uses for credit, including supposedly "non-productive" uses such as health, education, and funerals.

Among all the reforms implied by the Prime Minister's Policy Statement for the Development of Sustainable Rural and Microfinance Sector and the National Growth and Poverty Eradication Strategy, the most important is the phasing out of policy lending, so that the Agricultural Promotion Bank make loans on a commercial basis and with genuine autonomy. Another important issue is implementation of the new MFI regulatory regime within a framework of risk-based supervision and policies that support the private sector.

Creating the Policy Environment

The government's ongoing finance sector reforms should continue to focus on improving the policy environment and the legal and regulatory infrastructure for the expansion of a market-based rural and microfinance sector, as well as on strengthening the supervisory capacity of the BOL. In addition to the updated action plan for the PMO's policy statement, adopted in 2008, another important step was the issuance of revised regulations for MFIs and SCUs that same year.[93] The new regulations divide MFIs into two types, those that can take deposits and those that cannot (except in very limited ways), with much more strict supervision for the former and for the savings and credit unions that can take deposits from their members.

Reform efforts have also focused on strengthening the capacity of BOL staff to supervise MFIs and SCUs, including the conduct of both off-site surveillance and on-site examinations. These activities have identified significant difficulties in several of the supervised entities in the areas of portfolio performance, accounting, and internal controls, along with inadequacies in the BOL's supervisory capacity due to the lack and inexperience of staff members and, in particular, inappropriate staff rotation. The significance of adequate supervision will increase substantially with the expected formalization of many rural financial service providers and the resulting increase in workload.

Given the large numbers of village banks in need of technical support and monitoring, as well as the practice in the Lao PDR of setting up village bank associations, the creation of an enabling environment in the form of specific BOL regulations and strategies for those associations based on the new PMO Decree on Associations could be beneficial.[94] Associations supported with a uniform, appropriate legal structure and oversight are more likely to come up with ways to help village banks survive. A special "good practice" regulation could prevent many organizations from "reinventing the wheel," while ensuring better governance and enabling the registration of apex-like associations based on more pertinent regulations rather than those intended for MFIs. Monitoring of associations by the BOL would be easier, and a critical mass of knowledgeable people could be created much sooner. Finally, the creation of apex-like support structures could also lessen the pressure on the BOL to register individual village banks.

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[93] The action plan is available at www.bol.gov.la/english/microfinanceeng.html (accessed on 25 August 2009)

[94] PMO. 2009. Decree on Associations, No. 15/PM. 29 April.

Inadequacies in the supervision of MFIs and SCUs may nonetheless be due to a more basic problem of securing sufficient government resources and allocating them effectively among different types of financial institutions. The current predominance of government-owned banks takes major BOL resources away from the potentially more effective supervision of private-sector financial institutions. In addition, the demanding requirements to supervise government banks may have promoted the frequent staff rotations observed in and out of the BOL, thereby further weakening the BOL's supervisory capacity, as mentioned in reports on experiences worldwide.[95] Focusing on private institutions, including not only banks but also MFIs and SCUs, with special attention to those not performing well, could speed up corrective actions and thereby improve overall performance.

Meetings with BOL officials conducted for this study revealed some promising government trends in the supervision of MFIs and SCUs: a greater focus on the risk management capacity of supervising institutions, more transparency in record keeping, and greater attention to the characteristics of the people running the microfinance institutions and savings and credit unions. The officials also asserted that there were no effective government controls over interest rates on loans and that institutional sustainability was a major objective of the BOL.

Regulations recently issued by the BOL should for the most part provide an excellent policy environment for the development of the MFI and SCU sectors. A careful reading indicates some shortcomings, however.[96] Among the main problem areas are fee structures for SCUs and deposit-taking MFIs that contain disincentives on the registration of institutions with large initial capitalizations; the requirement that branch openings be pre-approved by the BOL, which could potentially be used to stifle competition; and confidentiality with respect to loans that could impede the creation of credit bureaus. There are

[95] Worldwide experience with the supervision of government-owned banks by the central bank has shown that such supervisory efforts are often largely ineffective because of the governance structure. When the bank is "owned" by the Ministry of Finance, hoped-for policies supportive of sustainability and efficient management are more likely to be implemented because the Ministry of Finance must ultimately pay the bills resulting from bad performance.

[96] Bank of the Lao PDR Regulations for Non-Deposit-Taking Microfinance Institutions, Deposit-Taking Microfinance Institutions, and Savings and Credit Unions. www.bol.gov.la/english/microfinanceeng.html

some areas where improvements are vital: The qualifications for MFI and SCU officials should be standardized across the different types of institutions, and individuals who are merely considered of questionable character (but not actually convicted of any crime) should be given the right of appeal. Moreover, transparency could be enhanced if the names of nonbank financial institutions indicated the types of institutions these are and did not use the word "bank" or any other word suggesting some other type of financial institution. Transparency could also be enhanced if the financial statements of NDT MFIs were the same as those for deposit-taking MFIs and if those statements were all publicized. This regulation would also facilitate conversions to deposit-taking status should this be warranted.

The following specific aspects of MFI and SCU regulations could benefit from attention:

- The statements "If loans are extended in foreign currencies, the approval of the Bank of the Lao PDR is required" and "If deposits are taken in foreign currencies, the approval of the Bank of the Lao PDR is required" are unclear as to whether MFIs wishing to engage in such operations need BOL approval for a general application of such transactions or for each transaction. Furthermore, these requirements should be focused on the foreign exchange risks involved, that is, to require not only matching liabilities in foreign currency with assets in foreign currency but also consideration of the ability of borrowers to pay in foreign currency when confronted with a major devaluation.
- The 5% general loan loss reserve seems excessively high especially when compared with the requirement for commercial banks.
- The requirement that a "Savings and Credit Union shall maintain a ratio of capital to risk weighted assets of at least twelve (12) percent or as determined by the Bank of the Lao PDR from time to time" should be reviewed. International best practice for SCUs differentiates between member shares and institutional capital (reserves, accumulated surpluses from operations, etc.) with only the latter being counted as capital, since the former belongs directly to the member and not to the SCU. In the Lao PDR, the shares of "founding members" are also included as part of capital as there are restrictions on their withdrawal

if such withdrawal causes the capital to dip below the required percentage.[97]

- Reconsideration should be given to the requirement that "the regulatory reserve shall be accumulated by the transfer to the reserve of at least five (5) percent of the annual profit after tax until such time as the value of the regulatory reserve reaches twenty (20) percent of the capital of the Savings and Credit Union. Thereafter the regulatory reserve shall be maintained at twenty percent of the capital of the Savings and Credit Union." A narrow definition of capital makes these reserves crucial, so that the rules for accumulation of such reserves/capital should be much more aggressive.
- At various places in the SCU regulation, there are references to their taxation, but standard practice is for cooperatives to be considered nonprofit and thus tax exempt (although members are required to pay taxes on the benefits they receive, such as dividends on shares and interest on deposits).[98]

Creating and Strengthening Financial Infrastructure

The financial infrastructure that needs strengthening the most is the area of local microfinance training and consulting. The rural finance sector is on the brink of formalization, which will demand large-scale, intensive, and high-quality training and technical support. For example, just the process of upgrading the more than 200 VSCGs is estimated to require a minimum of 50,000 training and advisory days.[99] Currently, only two companies employing some five full-time advisory staff are in place to support this process. Furthermore, the expanding banking sector has been siphoning off trained MFI staff, and the need for well-trained staff in village bank associations only adds to demand.

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[97] This limit might instead be applied proportionately to all members so as not to discriminate among members.

[98] According to an unofficial source, as of early 2009, Ministry of Finance and BOL officials are in discussions on tax exemptions for SCUs.

[99] This estimate is based on project documents of the only project of this kind currently active in the Lao PDR, a cooperative arrangement among the Lao Microfinance Center, the Dutch Rabobank Foundation, and the SNV Netherlands Development Organization. However, the SNV may no longer be involved in microfinance.

Aside from a strengthened human resource pool, the Depositor Protection Fund (DPF) could play a significant role in the development of the rural finance sector because of the importance of savings as a source of funding. The DPF has recently received its first application for membership from by a licensed microfinance entity.[100] This request has yet to be processed, partly because of a lack of knowledge and understanding of the DPF on the part of rural financial entities and partly because of a lack of sufficient development of the DPF itself. Since formal rural financial entities have a different profile from that of banks (e.g., loans issued by such entities tend to be much smaller), technical support to the DPF could be beneficial, particularly if it helped build a joint strategy with deposit-taking MFIs and SCUs.

Because of the overriding importance of information about the character of the prospective borrower in microlending, special attention should be paid to developing a systematic information data bank on borrowers and their behavior. A credit bureau can answer this requirement. All banks are required to report monthly to the BOL on all loans over the equivalent of $3,000, and all regulated institutions have access to this information. However, BOL officials reported some shortcomings in the information technology facilities required for full electronic reporting. In addition, the floor limit of $3,000 for reporting can limit the ability of the BOL to check the accuracy and completeness of what banks report. If all loans must be reported, then the BOL simply needs to compare what banks report to its "credit bureau" with the loan balances reported in bank balance sheets. Moreover, most microloans fall well below this $3,000 limit, thus limiting the utility of the existing BOL system for MFIs and SCUs.

Institutional Development

As consistently highlighted in various reports by international development agencies, institutional development is crucial for progress in the Lao PDR's rural and microfinance subsectors, as well the finance sector in general. Institutional development requires the strengthening of the capacities of the staffs of relevant institutions, both providers and regulators. Also needed is an incentive structure that would motivate well-trained individuals to serve the institutions where their competence is required. For the BOL, this means the

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[100] Deposit-taking MFIs and SCUs are required to become members of the DPF, as stipulated in BOL MFI regulations.

creation of a strategic human resource development plan for both its needs and those of the rural and microfinance institutions. With its present staff complement and its heavy focus on the supervision of government banks, the BOL is unlikely to accomplish what rural and microfinance requires most: effective, prudential regulation and supervision of private institutions (i.e., banks, MFIs, and SCUs) so that these are transparent and secure.[101]

Improvements in the DPF should also be given high priority, along with improvements of the credit information bureau to include microfinance institutions and savings and credit unions and even the Agricultural Promotion Bank, and the development of the payment system, with more active private sector participation if the policy environment comes to favor that. Institutions required for the effective use of collateral guarantees, such as a secured transactions registry, may be important for other segments of the finance sector. However, from the perspective of rural and microfinance, these are far less important because microloans are often extended without collateral.

Finally, because of its importance in the provision of financial services to the public, especially in rural areas where most of the Lao PDR's poor reside, particular attention must be paid to the institutional development of the APB. Specifically, the APB needs to be run on a more commercial basis, focusing more strongly on loan recovery and avoiding interest rate policies that encourage subsidy seeking by borrowers and crowd out private-sector financial entities that could provide financial services to these target groups sustainably in the long run. The policies already agreed to by the government and international development agencies, including the Asian Development Bank, could go a long way in this respect if appropriately implemented.

[101] There is no worldwide consensus on how to regulate nonbank institutions that take deposits. Putting SCUs under a different entity dealing with cooperatives has often led to a conflict of regulatory objectives with those that support SCUs. The case for a specialized department within the bank regulatory agency can be stronger for both SCUs and MFIs if regulatory staff can be convinced that they can advance professionally dealing with these nonbank entities.

Viet Nam: Reducing Government Dominance and Formalizing Microfinance

Overview of the Rural and Microfinance Sector

The formal rural and microfinance sector in Viet Nam consists of two state-owned banks, the Vietnam Bank for Agriculture and Rural Development (VBARD or AgriBank) and the Vietnam Bank for Social Policies (VBSP); the state-owned Vietnam Postal Savings Company; and the network of nearly 1,000 People's Credit Funds (PCFs) that operate as credit and savings cooperatives. Despite the existence of these institutions, access to formal finance in rural areas is low with less than 25% of the rural population having some kind of access to financial services.[102] Viet Nam's overall financial depth is likewise rather shallow, although this has deepened sharply in more recent years; in 2007, the ratio of credit to gross domestic product reached 82.5%, and the ratio of M2 money to gross domestic product hit 112.1%.[103] Furthermore, targeted policy lending with subsidized interest rates remains substantial in the country's microfinance sector through the operation of government poverty-reduction funds under the VBSP.

The other participants in rural microfinance in Viet Nam are the semiformal microfinance institutions and the informal sector. Limited available literature often refers to the informal sector as being composed of moneylenders and savings and credit groups informally organized by and among community members, friends, and relatives and similar to rotating savings and credit associations,

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[102] Banking with the Poor Network. 2008. *Vietnam Industry Assessment. A Report on the Vietnamese Microfinance Sector.* August. Ha Noi.

[103] Asian Development Bank Institute. 2008. *Managing Capital Inflows: The Case of Viet Nam.* May. Tokyo.

with members contributing periodic savings and receiving credit on a rotating basis.[104]

Although it plays an active role in the delivery of rural microfinance services, the government does not have a clear strategy to develop a sustainable microfinance industry and integrate this into the mainstream finance sector. The delivery of microfinance services is still widely perceived among government officials and the public as a social mission to be financed and carried out by the government rather than as a sustainable financial business geared toward the poor. The dominance of the state-owned banks and the popularity of targeted lending at subsidized interest rates have effectively kept levels of non-state microfinance lending (i.e., those engaged in by nongovernment organization (NGO)–type microfinance institutions [MFIs] and private-sector entities) insignificant. Furthermore, the existing non-state MFIs are almost always heavily involved with mass organizations, the most important of which is the Vietnam Women's Union (VWU), that are intertwined with the government and are also subject to interventions by local government officials. Government's direct involvement in the provision of microfinance services and the lack of a supportive legal and regulatory framework have deterred non-state microfinance entities from operating as formal MFIs. The good performance (e.g., in loan recovery) of some of the non-formal MFIs may be due to pressure from the mass organizations to which these institutions are associated rather than to economic incentives. Indications of sustainability may likewise be due to the mass organizations absorbing the major costs of the lending operations of these MFIs. In addition, while customers, especially the poorer among them, demand a wide variety of products and services, especially more flexible loan structures, small-balance liquid savings products, and low-cost insurance services, most providers are relatively supply-driven, providing typically Grameen Bank types of credit with mandatory savings. Products such as voluntary savings and microinsurance are largely nonexistent.

[104] In Vietnamese, these rotating informal savings and credit schemes are called *Ho* in the North and *Hui* in the South.

The Status of Key Rural and Microfinance Institutions

The Vietnam Bank for Agriculture and Rural Development is by far the largest rural financial institution and provides the fullest range of financial services in rural areas in Viet Nam. It reports a customer base of 10 million farmers, 47% of whom are considered poor. Of its total deposits 45% are mobilized in urban areas, while 55% are lent out in the rural areas.[105] According to the State Bank of Vietnam (SBV), about 50% of VBARD's outstanding loans are for rural clients, with its loans averaging about $1,300. The bank's main clientele consists of average-income households and rural small- and medium-sized enterprises (SMEs).[106] VBARD, however, is going upmarket to concentrate more on rural SME loans and expanding its urban branch network to capture more urban clients and SMEs. Its clients are therefore considered outside the scope of this study, which will focus on the important role of the Vietnam Bank for Social Policies, the People's Credit Funds, and the semiformal MFIs in providing financial services to the poor in rural Viet Nam (Table 6).

Table 6: Profile of Viet Nam's Microfinance Service Providers

Institution	No. of Clients (million)	Loans Outstanding ($ million)
VBSP	6.8	3,000
VBARD	3.2	3,500
PCFs	1.3	1,000
MFIs/NGOs	0.6	75

MFI = microfinance institutions, NGO = nongovernment organization, PCF =People's Credit Fund, VBARD = Vietnam Bank for Agriculture and Rural Development, VBSP = Vietnam Bank for Social Polices.

Sources: VBSP Annual Report 2008; VBARD report, as of 31 October 2009; Central Credit Fund Annual Report 2008; and *Viet Nam Microfinance Bulletin*, No. 13, July 2009, data as of end 2008.

Vietnam Bank for Social Policies

The Vietnam Bank for Social Policies was created in 2003 as a result of the separation of the poverty reduction policy lending body,

[105] Banking with the Poor Network. 2008. Previously cited.

[106] SBV. 2008. *Proposal for Awareness Raising and Developing the Microfinance Sector to Enhance Its Role in Poverty Reduction.* Sent to ADB in May 2008.

called the Bank for the Poor, from VBARD. It currently serves five main target groups: poor households, disadvantaged students, job creation programs, migrant workers, and economic entities and households in remote areas under the Reforestation Program 135.[107] By far the most important of its target groups is poor households, which alone receive over half of its loans. About half of VBSP's funding comes from capital, including donor funds (e.g., the International Fund for Agricultural Development, the Organization of the Petroleum Exporting Countries, and the World Bank) and a mandatory contribution of 2% of the deposits of the state-owned commercial banks. The other half of its funds comes from savings deposits, most of which are required deposits against loans. Mass organizations, especially the VWU, play a major role in the bank's lending decisions since these organizations make the initial screening of potential borrowers, who are then verified by the local government to which the borrower belongs and finally approved by the VBSP itself. Groups of 30 to 50 members are formed by the mass organization and a formal structure is created, complete with a group charter and a management board composed of the group head, an accountant, and a cashier. The loans themselves are made to individuals without any group liability. If the borrower is more than 3 kilometers from the nearest VBSP branch, business is conducted by the VBSP staff visiting the borrower rather than having the borrower go to the branch.

As of end-2008, the VBSP had a network of 64 provincial and municipal branches, 601 district-level transaction offices, and 8,740 mobile posts, covering 100% of the communes in Viet Nam. Its 7,500 staff members served 197,500 groups, with over 6.8 million borrowers and a loan portfolio totaling $3 billion. Loans were almost exclusively in the range of $200–$500, averaging $245, and typically for short terms of 1 to 3 years. Repayment was reported to be excellent, with the average delinquency amounting to less than 1.5% across all target groups. An exception was the youth group (ages 20 to 35). Their repayment rate was slightly below 5%, which is not surprising given their greater mobility. (It must be noted, however, that the trends depicted by these numbers may understate potential problems because the VBSP has been operating for only about 5 years and has a growing loan portfolio.) VBSP officials believe the bank's program of evaluating and rewarding local staff based largely on interest collections may explain this good performance. However, although VBSP's credit programs have probably helped reduce the

[107] VBSP. 2008. *Introduction to Vietnam Bank for Social Policies, May 2008*. Ha Noi.

national poverty rate, the evidence of leaks and the opportunity cost of funds have given rise to public debates regarding the efficiency of this use of public resources.[108]

The VBSP is planning to focus more on remote areas with high concentrations of ethnic minorities and less on poor households since it already has established its presence in 100% of Viet Nam's communes. In doing so, it hopes to achieve its goal of allotting 8% of its lending operations to newly included communes. Among its other goals are to increase operational efficiency, introduce new products and services, and reduce government intervention, the government subsidy in particular. In addition, the VBSP plans to reinforce its internal audit capabilities, offer improved savings services focused on voluntary deposits, and increase wholesale lending to MFIs.

People's Credit Funds

The network of PCFs is the second-largest rural microfinance provider in Viet Nam in terms of outreach and capital. It was established in 1993 under both the cooperative law and the credit law. It is modeled after the community savings and credit cooperatives of the Canadian group Desjardins, which assisted in organizing it. Up until 2000, the network grew very rapidly and was structured in three tiers: the Central Credit Fund (CCF), the Regional Credit Funds, and PCFs. From 2000 to 2003, the network was drastically consolidated when problematic PCFs had their licenses to operate revoked, those at risk were strengthened, and the network was restructured into two tiers: the CCF and PCFs. In 2005, the Vietnam Association of People's Credit Funds was established to provide general technical support to PCFs. The CCF continues to intermediate surplus internal funding among the PCFs and to mobilize and allocate external funding for the network as a whole. Furthermore, PCFs and the CCF continue to receive some limited technical assistance from Desjardins.

Some 90% of PCFs are in rural areas, with 70% of their funding coming from their members, 10% from their equity, and the remainder from external sources, including other PCFs, but mainly from the domestic

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[108] For example, a recent study shows that over 67% of VBSP's clients are nonpoor and that nonpoor clients have larger loans than the poor (see Cuong, 2008). VBSP officials, however, explained that the study used data from the 2004 Vietnam Living Standards Survey, which were collected at a time when VBSP loans were channeled through VBARD and therefore might not reflect the true quality of VBSP loans.

market. As of mid-2008, there were almost 1,000 PCFs with about 1.3 million members and nearly $800 million in loans outstanding.[109] PCFs are permitted to have legal entities, as well as individuals, as members and can make up to 10% of their outstanding loans to poor nonmembers.

The required chart of accounts and accounting standards for the PCF system are the same as those for the banking system, with external audits mandated for every level in the system and with financial statements presented at annual meetings. To reinforce this transparency, individual PCFs send monthly reports to the CCF, and these are analyzed off-site. There are also regular CCF on-site visits at least every 2 years to even the strongest PCFs and special visits at any time when warranted. In addition, the SBV provides prudential oversight of the CCF, and the regional branches of the SBV conduct prudential inspections of individual PCFs. Given this external oversight and strong incentives for effective oversight by PCF members themselves, who provide a substantial majority of funding for their PCFs, problems have been few. CCF officials report that overdue loans are less than 1% of total portfolio and that, in recent years, only about 10 PCFs have required help with problems each year and only about 50 had to be closed over the entire history of the system, there being almost none in recent years. Most problems arise from faulty liquidity management, although there have been a few cases of fraud.

For the future, the CCF is thinking of becoming a cooperative bank to enable it to provide financial services to other types of cooperatives.

An analysis of some of the figures contained in the draft of the CCF's annual report for 2007 suggests some potentially problematic areas in PCFs that might warrant a closer look. Consolidated figures for PCFs as of the end of March 2008 show an average loan size of $1,683, considerably higher than per capita income in Viet Nam.[110] The three largest regional branches (Ha Noi, Ho Chi Minh City, and Ha Tay Province), which together account for one-third of PCF lending volume, had the average loan amount of $2,080, $2,105, and $3,275, respectively. There also seem to be some substantial inequalities among PCFs; for example, the average size of a PCF

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[109] CCF. 2007. Draft Annual Report. Ha Noi.

[110] This assumes that the number of loans refers to the lending volume of the year and not to the amount of loans outstanding; in the latter case, the average would be more than twice as high.

loan in Thai Binh Province is $824, compared with $3,275 for Ha Tay Province. The CCF's audited balance sheet for the end of 2007 also has some curious aspects that might benefit from further investigation. One such aspect is that loans to other credit institutions are higher than loans to customers. Another is that deposits from other credit institutions are larger than deposits from customers. Furthermore, the off-balance-sheet accounts in the 2004–2005 annual report show that mortgages and collateral plus valuable papers substantially exceed CCF's loan portfolio, but such figures are not shown in the subsequent annual reports for 2006–2007 and 2007–2008. Despite these questionable areas, the CCF has demonstrated rapid growth and profitability, both signs of likely sustainability.[111]

Semiformal Microfinance Institutions

The other participants in rural microfinance in Viet Nam are the semiformal MFIs. These are entities of different forms that have some association with mass organizations, mostly the Vietnam Women's Union, and/or international NGOs, to implement microfinance programs. Currently, there are about 50 MFIs. Of these, about 30 report frequently to the Vietnam Microfinance Working Group (VMWG), the MFIs' informal coordinating body. Appendix 4 contains descriptions of MFIs that were interviewed for this study.

MFIs have relatively small client bases, ranging mostly from a few thousand to 10,000, except for Tao Yeu May (TYM) Fund, with 40,000 clients, and the Capital Aid Fund for Employment of the Poor (CEP), with 80,000. Their loan portfolios are also small—an average of less than $1 million—except for TYM ($15 million) and CEP ($20 million). The loans they make available, mostly in rural areas and almost entirely (94% of total) to women, typically range from $150 to $300. The interest rates they charge range from 0.5% to 2.5% per month, for an average of 1%. These institutions also do not generally borrow from commercial sources for their capital. They have an average of 205 clients for every credit officer, with the highest ratio being 941. MFIs make loans available to about 300,000 borrowers with a total gross loan portfolio of about $37 million, far smaller than

[111] No mention is made of the VWU in these reports or in discussions with CCF officials. However, a survey conducted for this study indicated that mass organizations and local governments are often involved in PCF lending decisions and loan collections. This, as discussed elsewhere in this report, implies that long-term institutional sustainability may not as secure as numbers suggest.

either the VBSP or PCFs.[112] They are not under the supervision of the SBV, and most of them operate with the heavy involvement of nonfinancial mass organizations. Except for a few large ones, they have an average of 5,000 clients and an outstanding loan portfolio of some $300,000, giving them a smaller reach—though with more productive credit officers—than MFIs globally (Box 2).[113]

Box 2: Viet Nam's Unique Microfinance Institutions

The typical microfinance institution (MFI) in Viet Nam is different in many ways from those in Asia or the rest of the world. Eight of the most salient characteristics that set Vietnamese MFIs apart are that they

1. have **fewer clients**—half the average worldwide and one-third of that in Asia, even across peer groups;
2. have **smaller loan portfolios—**a tenth of international (world or Asian) standards;
3. have **lower (recorded) expenses** in terms of their expenses/assets ratio, which mostly reflects their lower operational expenses, although their financing costs are also lower. That they have lower expenses is the result of their receiving a number of implicit subsidies from the Vietnam Women's Union (VWU), ranging from free rent to heavy subsidies of credit officers' salaries. As these are some of largest costs of MFIs internationally, it is not surprising that Vietnamese MFIs are better able to cover their (reported) expenses than international MFIs (as measured by operational self-sufficiency);
4. are **more poor-focused** by having smaller loan sizes (relative to national per capital incomes) than their international peers;
5. lend almost entirely to **women,** unlike many MFIs outside Asia;

continued on next page...

[112] Banking with the Poor Network. 2008. Previously cited.

[113] VMWG. 2008. *Viet Nam Microfinance Bulletin*. Issue 11. Ha Noi.

Box 2 *continued*

6. generally **do not borrow,** as their foreign counterparts do, because they are funded almost entirely by equity and savings. This may reflect the absence of microfinance regulations until very recently;
7. charge **lower interest rates**, as measured by their nominal portfolio yield. As a result, their revenue/assets ratio is from a half to a third of those of their international peers. This may be the result either of the competition from the subsidized lending of the Vietnam Bank for Social Policies or the lower (reported) expenses, allowing them to charge lower interest rates while still covering costs; and
8. have **more productive credit officers,** who have higher average numbers of clients served. This might be partly explained by the fact that client monitoring is often done by VWU staff.

Source: Vietnam Microfinance Working Group. 2008. *Viet Nam Microfinance Bulletin.* July, Issue 11.

While MFIs are mandated and highly motivated to serve the poor, and in fact are doing well, their growth is constrained by their inability to mobilize funding because of the lack of legal status to allow them to take voluntary deposits or attract private-sector investment. Other difficulties MFIs face are the informal and political pressures to keep lending interest rates low; the unfair competition created by the dominance of large, state-owned microfinance providers, most importantly the VBSP; and their dependence on external concessionary funding sources from international foundations and NGOs.

MFIs may be able to advance rapidly if they can register as formal MFIs under the microfinance regulations recently issued by the SBV (Decrees 28/165 and implementing Circular 02). Although no MFI has yet applied to the SBV for a license, several MFIs that were visited and studied in this research appeared ready to meet most or all of the transformation requirements. Other MFIs seem likewise to be ready. The VMWG reports that, as of 31 December 2007, 10 MFIs have met the SBV's capital requirement of some $310,000 for transformation to a regulated MFI.[114] However, other significant MFIs that were visited

[114] VMWG. 2008. Previously cited.

were not interested in being licensed. The NGO Save the Children (Japan), in spite of its 7,450 clients, very high repayment rates, and assets of more than $3 million, expressed disinterest in registering, largely because of the high costs and other restrictions implied by transformation. The staff of CARE International (Australia), which offers loans integrated with other activities, felt severely constrained by the VBSP's very low interest rates, which make sustainable lending impossible. In addition, the French NGO Groupe de Recherche et D'Echanges Technologiques (GRET) had turned over its microfinance programs to the VWU and to local governments and now focuses on providing technical assistance and training for microfinance providers, as well as to the conduct of studies and conferences to attract potential investors into microfinance. It remains to be seen if these MFIs can expand their financial services for the poor in rural Viet Nam, especially given the constraints that exist in the current legal framework (e.g., restrictions on ownership structure) and the policy environment. Furthermore, if they are as highly dependent on the VWU and other mass organizations for client selection and loan recovery as they appear, it is unclear if they can represent an effective alternative to government-owned and controlled entities in expanding outreach.

Outreach

If one judges by the 6.8 million loans totaling almost $3 billion currently being provided by the VBSP as well as the 1.3 million members served by the PCFs (although PFC loan sizes in certain provinces suggest that many members may not be poor), outreach of financial services to the poor and in rural areas in Viet Nam seems excellent, even without considering the relatively minor role of MFIs (Table 7). However, this analysis does not take into account two aspects of outreach that are discussed later in more detail: (i) the paucity of voluntary deposit services and (ii) whether the loans delivered and recovered are based primarily on economic criteria or more on government control, including by mass organizations as well as central and local governments.

Sustainability

Institutions involved in rural and microfinance often appear to be more sustainable than they in fact are because of the understatement of nonperforming loans and the lack of recognition of subsidies,

Table 7: Key Characteristics of Viet Nam's Major Microfinance Service Providers

	Formal Sector		Semiformal Sector			
Characteristics	VBSP	PCFs	CEP	TYM	Other MFIs	Total
Number of branches	665	986	20	26	108	1,805
Number of active borrowers	5,648,140	1,230,436	74,360	31,941	183,586	7,168,463
Gross loan portfolio ($ million)	2,176.40	766.70	13.00	7.30	16.60	2,979.90
Average loan balance ($)	385	1,683	175	171	80	
Number of savers	na	na	21,157	1,586	170,000	
Savings volume ($ million)	124.60	126.50	0.57	0.13	0.03	251.83
Average savings balance ($)	na	na	27.00	81.00	6.35	
Loans per credit officer	3,402	2,051	520	288	173	
PAR (more than 30 days, %)	1.70	na	1.19	2.93	0.06	
ROA (%)	(9.60)	na	8.16	5.80	4.00	
ROE (%)	(34.60)	na	15.75	11.37	5.00	
OSS (%)	70.70	na	156.06	172.00	157.00	

( ) = negative, na = not available, CEP = Capital Aid Fund for Employment of the Poor, MFI = microfinance institution, OSS = operational self-sufficiency, PCF = People's Credit Fund, PAR = portfolio at risk, ROA = return on assets, ROE = return on equity, TYM = Tao Yeu May Fund, VBSP = Vietnam Bank for Social Policies.

Sources: VBSP Annual Report 2007; Central Credit Fund Draft Annual Report 2007; Microfinance Information Exchange, 31 December 2007; TYM Fund Brief Sheet, July 2008; Banking with the Poor Network, August 2008; and Study Survey, August 2008.

especially when these subsidies are implicit rather than explicit transfers of funds. For microloans, international best practices consider a loan to be at least somewhat problematic when any payment of interest or principal is even one day overdue. However, few supervisory entities strictly adhere to this practice, often allowing the lapse of as many as 90 days before beginning to require provisioning for non-repayment. There are, moreover, well-known practices of reprogramming or refinancing overdue loans in order to improve the apparent financial condition of lenders. In Viet Nam, the extent of such practices is not known, nor is it known how vigilant the SBV is in monitoring and recording these practices. Thus, the excellent loan repayment rates that are reported by Viet Nam's MFIs and others lenders such as PCFs and the VBSP and that contribute so much to the appearance of sustainability might possibly be overstated. This could be an important subject for further investigation.

The other element that contributes greatly to the appearance of sustainability is the widespread practice of having other entities provide services at little or no cost to lenders. The VWU, in particular, handles client selection and loan recovery for most, if not virtually all, of Viet Nam's rural and microfinance entities. This practice of providing services without any apparent explicit charges to the lenders is due not to mismanagement on the part of the VWU but rather to the benefits that the VWU receives in terms of enhanced credibility and leverage over its members (and perhaps even over non-members). In microlending operations in most countries, the costs of client selection and loan recovery are the main cost items that lenders incur. Thus, the services provided by the VWU at apparently no cost may provide an appearance of sustainability even with Viet Nam's well-known below-market interest rates on micro and rural loans. Moreover, as discussed elsewhere in this report, if current rates of inflation continue and interest rates are not substantially increased, sustainability is absolutely impossible.

Deposit Mobilization

While most MFIs and other micro and rural lenders in Viet Nam require mandatory deposits as collateral for loans, voluntary deposit mobilization appears virtually nonexistent in rural areas or among the poor. MFIs that have not been formalized are prohibited from taking in voluntary deposits. Moreover, there is no incentive for the VBSP and the PCFs to mobilize voluntary deposits since they have other cheaper sources of funds in addition to their mandatory deposits. Thus, even though deposit services are so important for people in rural areas and especially for the poor, deposits are likely to remain "the forgotten half of rural finance" as long as cheaper sources of funds from the central and local governments, as well as donors, remain available. The VBSP's stated objective of increasing voluntary deposit mobilization may be more than offset in the aggregate by its parallel plans to increase wholesale lending to

MFIs at a time when MFIs are just beginning to be allowed to take voluntary deposits.

Microfinance

After Christen, Rhyne, and Vogel showed in the 1995 United States Agency for International Development report that MFIs could be commercially profitable and hence sustainable, the microfinance industry has moved more and more in that direction and away from the concept that microfinance is primarily a charitable activity and needs to be subsidized by NGOs and/or governments.[115] In Viet Nam, however, microfinance is still seen as charity, and subsidies are considered essential to give poor people access to credit. Nevertheless, overwhelming evidence continues to mount that microfinance can be highly profitable and still reach the poor. One example is the recent experience with Banco Compartamos in Mexico. Other instances from around the world demonstrate that subsidizing interest rates is counterproductive, because rationing devices inevitably arise involving transaction costs that are most prejudicial to the poor, in addition to the superior capabilities of the nonpoor to capture such subsidies. Furthermore, interest rate subsidies have been shown to be a major cause of poor loan repayment performance, while the presence of entities offering subsidized interest rates crowds out institutions that can effectively offer financial services to the poor on a sustainable basis.

Informal Finance

No systematic information is available on informal finance in Viet Nam, particularly in rural areas. This probably reflects the government's view that the current outreach of formal finance, even into relatively remote rural areas, has eliminated the need for informal finance. However, even in the United States, at least half of agricultural credit is supplied "informally" by marketing agents (i.e., those who sell inputs and purchase outputs). It should thus be a high priority to carry out a survey in Viet Nam similar to that done in the Lao People's Democratic Republic a few years ago. The "infrastructure" already exists (e.g., a survey instrument and a sampling methodology), although contributions from experts in rural sociology and anthropology are

[115] R. Christen, E. Rhyne, and R. Vogel. 1995. Previously cited.

needed to fully reflect local culture and rituals in rural and microfinance activities. In this survey, the role and impact of the VWU and other mass organizations should also be explored.

Financial Crises

The effect of financial crises and natural disasters is not relevant for rural and microfinance in Viet Nam in recent years, except perhaps for current inflation. If inflation persists at current levels, which was above 20% in August 2008, and if interest rates are not adjusted significantly upward to compensate for inflation, financial institutions will rapidly be decapitalized. More specifically, if the annual inflation rate reaches 23%, a financial institution will lose half its capital in only 3 years.

Current Potential of and Constraints on Rural Finance

An assessment of the current potential of, and the constraints on, rural finance depends largely on one's perspective. If a rural finance subsector that is dominated by government institutions and with the private sector largely crowded out is seen as appropriate, then the potential of the rural and microfinance subsector in Viet Nam has been largely realized. There are, moreover, few constraints to its continued growth, except perhaps for the limitations to the funding that will be available to maintain such a system.

On the other hand, if what is deemed appropriate is a rural and microfinance subsector that has a private-sector orientation, there are several measures that need to be undertaken to break the constraints on, and realize the potential of, the subsector in Viet Nam. The first requirement is to totally change the government's perspective. The government must be convinced that private initiatives, supported by appropriate government interventions (e.g., prudential regulation of deposit-taking institutions, promotion of financial infrastructure such as credit bureaus, and dealing vigorously with monopolies and other barriers to effective competition), can produce more outreach and greater efficiency in the provision of financial services in rural areas. Without this shift in attitude, the piecemeal efforts toward more ample and efficient financial services in rural areas are likely to produce few benefits, especially relative to the costs involved.

Creating the Policy Environment

The major issue in the policy environment has been the restrictive regulations on private microfinance institutions, which operate predominantly in rural areas. The first regulation, Decree 28, issued in March 2005, was found to be too restrictive as no MFI moved toward being licensed. The subsequent modifications, contained in Decree 165, issued in November 2007, and its implementing Circular 02, issued in April 2008, appear to be receiving a much more positive response from MFIs, although as of August 2008, no institution had yet presented itself for licensing, largely because preparatory steps had not been completed.[116]

Nonetheless, certain constraints, especially in the areas of ownership and governance, may need to be dealt with for MFIs to achieve their potential as soon as possible. One such area is the conflict of interest among MFIs that may arise from the VWU's assuming a major, if not sole, ownership position in most—perhaps all—MFIs to be licensed because of its overwhelming predominance in microfinance operations in Viet Nam. The work involved in fulfilling transparency of ownership in all these cases would also strain the VWU's financial resources.[117] While it is understandable that the government would like to be able to identify as readily as possible those responsible for both ownership and operational control, such rules may in fact encourage non-transparency. It might be preferable to establish clear guidelines on the traits preferred in those holding board or high-level management positions (e.g., relevant experience, no link to prior bankruptcies, and no criminal record of fraud). Another problematic area is the restriction of foreign shares to 50% of capital, which may discourage potentially beneficial foreign participation given that interested foreigners with relevant expertise may want clearly transparent ownership and operational control to implement important innovations. Because of the importance and complexity

[116] As of February 2009 when it provided its comments on a draft report of this study, the SBV received applications for licensing from three institutions. The first license was issued to TYM in August 2010.

[117] There is a major definitional issue with respect to an operator, who must be the legal owner of a formal licensed MFI. The operator could be considered the central management of an MFI that sets policies and sees to key administrative issues, or it could be considered to be those who actually select clients and disburse and recover loans. This possible ambiguity needs to be clarified. This is further complicated by the fact that various types of Viet Nam's noncommercial organizations must be the largest owners of a formal licensed MFI and must own at least 25%.

of the issues of ownership and governance for the performance of MFIs, further in-depth study may be essential, possibly as part of the survey of rural finance in Viet Nam recommended in this report.

Regulations that limit the opening of new branches (e.g., the required approval by the local People's Committee) might be considered inappropriate for microfinance institutions that are in compliance with all prudential requirements. These may also be potential serious barriers to needed competition. Thus, a better option might be to require only prior notification for the opening of new branches.[118]

Meanwhile, the various quantitative prudential requirements seem reasonable, including potential limits on foreign borrowing. However, what is needed is adequate attention to the risk management capabilities of MFIs and, more generally, to risk-based supervision beyond just lending risks in the regulation of MFIs.[119] Finally, while it is clear that unlicensed MFIs should not be allowed to take voluntary deposits from the public at large, some specific attention might be paid to promoting transparency in the operations of these unlicensed MFIs, in part as a means of creating a pathway to eventual licensing for those that can demonstrate successful operations leading to compliance with the various requirements for licensing.

Creating and Strengthening Financial Infrastructure

Minimal financial infrastructure is required to deliver rural financial services to low-income people. Specifically, since microlending in Viet Nam is—correctly—not based on formal collateral, there is no need to focus on developing registries for land and moveable collateral or the related judicial systems and expertise.[120] However, a database about borrowers and their behavior is essential because of the overriding importance of information about character in microlending decisions.

[118] The regulation of the opening of new branches is a frequent point of contention worldwide, but in countries where risk-based supervision has been applied overall, the usual view is that so long as an entity complies with all regulatory norms, the opening of branches should be the entity's decision.

[119] As of February 2009 when SBV provided comments on a draft report of this study, it reported that it was drafting a circular on safety regulations (safety ratios and provisions) for MFIs.

[120] However, these elements may be important for SME lending.

The current credit bureau in the SBV, known as the Credit Information Center (CIC), appears to already be operating effectively. In particular, all entities falling under the credit law are required to report all their credit transactions to the CIC every 3 days.[121] This reporting is done electronically (except for the financial statements of borrowers), using software that is supplied by the CIC, so that these data can be processed immediately. Banks and other lenders have a contract with the CIC under which they have access to these data.[122] Although, until it is formalized, an MFI would not automatically be part of this system, there appears to be nothing in the regulations governing the CIC that would prevent the CIC from voluntarily providing information to MFIs as well as acquiring information from MFIs.[123] In any case, access to CIC data provides an additional incentive to MFIs to strive for formalization. For those MFIs that do not formalize, the MFI association can explain the advantages of gaining access to CIC data and perhaps also provide support and incentives to gain access to the CIC.[124]

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[121] The format for this reporting has been obtained from the CIC in Vietnamese, and the main elements are now being translated into English. It is important that all credit transactions be reported so that the completeness of reporting can be verified. In countries where complete reporting is not required (e.g., small loans are omitted), complete reporting of all larger loans cannot be verified by comparing reports to the credit bureau with the total amount of loans reported in the lender's financial statements. Moreover, lenders have incentives not to provide information about their largest borrowers, especially if these are "related parties."

[122] A copy of this reporting format has also been requested from the CIC and will be translated into English as required to understand exactly what information is available. In other countries where credit bureaus have been studied, it has been important to verify that only amounts borrowed, the terms and conditions of loans, and the status of repayment obligations are provided. The identities of lenders are not deemed vital and are not required to prevent opportunities from being provided to banks and other financial institutions to steal clients from other lenders.

[123] In most other countries studied, reciprocity is required by credit bureaus when the lending entity is not required by law to report. In addition to any fees required, a lending entity must provide information on all its credit transactions to the credit bureau in order to have access to information from the credit bureau.

[124] In other countries, other types of entities such as electric and water utilities and telephone companies have readily joined credit bureaus, providing information about the payment histories of their customers and, in return, receiving useful data to judge the extent to which customers need to be required to prepay or can be allowed to post-pay.

Institutional Development

A number of entities in Viet Nam, some domestic and others international, provide support for the institutional development of MFIs. Perhaps the most important is the Vietnam Microfinance Working Group (VMWG). In addition to publishing the *Viet Nam Microfinance Bulletin*, which presents important MFI data using the Microfinance Information Exchange format, the VMWG carries out and coordinates capacity-building and advocacy activities. However, it lacks the legal status that would help it obtain adequate funding. With more money for staff, it could provide more training and technical assistance for MFIs to transform themselves into licensed deposit-taking institutions. Among other supporters of institutional development, the ILO has focused its efforts in Viet Nam primarily on risk management, including the roles of savings and insurance services in helping clients manage risks. The ILO also offers a variety of training courses (e.g., on market research, product development, financial analysis, and management for performance and transformation of MFIs); study tours; and participation in international conferences, as well as supporting the VMWG's advocacy activities. The International Fund for Agricultural Development, on the other hand, works primarily with government banks (e.g., the VBARD and the VBSP, often in conjunction with the VWU), to promote outreach into remote ethnic areas and the use of a "value chain" approach to lending.[125]

[125] As noted above, GRET has also moved from direct microfinance activities to providing training and technical assistance.

Conclusions and Recommendations: Major Similarities and Differences among the Three Countries

This chapter discusses the study's findings, conclusions, and recommendations, highlighting key similarities and differences among the rural and microfinance subsectors in Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam, particularly in regard to the challenges and opportunities they face. Among the major issues that emerged are (i) the nature, extent, and impact on the policy environment of government interventions in financial markets; and (ii) the need for measures at three levels—macro (policy), meso (infrastructure), and micro (institutions)—to improve financial services to poor and rural populations. The current level of development of those services varies substantially among the three countries, primarily because of different policy frameworks. The recommended reforms, which also vary, are based partly on the characteristics of successful microfinance institutions (MFIs), including the way they design and deliver their products and services.

A Key Element in the Financial Policy Environment: Regulation and Supervision

The policy environment looms as perhaps the most important factor determining the configuration of the rural and microfinance sectors in the Lower Mekong Region countries, just as elsewhere in the world. In forming a strategy to develop the sectors, governments make a crucial decision about their primary function: They either support the delivery of financial services by private entities, or they take a leading role—even the exclusive role—in providing these services themselves. A major aspect of the strategy chosen is the regulatory and supervisory framework. Does it manage risk adequately, and does it take a neutral stance between public and private entities and between domestic and foreign ones? One area where these questions are of particular importance is government credit programs, which may either be market based or targeted and subsidized, which could make it difficult for the private sector to compete.

Viet Nam and Cambodia have followed very different paths in the development of their rural and microfinance sectors. In Viet Nam, the government is overwhelmingly predominant, not only because it is the main provider of micro and rural financial services but also because it promulgates regulatory policies that have inhibited the development of private-sector providers. Specifically, it limits the ownership of private microfinance entities to quasi-governmental and nonprofit organizations, with foreign participation restricted and with some apparent ambiguity about the definition of a microfinance operator. In Cambodia, on the other hand, ownership must be for-profit, with foreign and domestic capital being treated equally. Of at least equal importance are the approaches to licensing and regulation in Cambodia, where microfinance entities are subject to more stringent requirements as they grow and develop but are also allowed to offer more services, including, recently, even mobilizing deposits from the general population.[126] The Lao PDR, which faces a variety of more daunting obstacles, has nonetheless almost completed the Rural Finance Sector Development Program that gives predominance to the private sector in providing rural financial services. The government has recently moved to restructure its regulatory regime, issuing separate comprehensive decrees for savings and credit unions (SCUs) and for MFIs, dividing those that cannot take deposits from the public at large from those that can. However, notwithstanding the carefully targeted technical assistance from the Asian Development Bank, the Lao PDR has yet to fully develop the human resources to carry out the Bank of the Lao PDR's (BOL) expanded supervisory responsibilities.[127]

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[126] This is further supported by an excellent supervisory staff in charge of microfinance, in contrast to most countries, where the best personnel are typically drawn to dealing with the largest banks.

[127] Confusion regarding the government's limit on bank spreads also complicates the supervisory situation. There is uncertainty on whether this limit also applies to nonbank financial institutions. The situation is made worse by statements by various officials that the BOL does not enforce this limit, thereby potentially calling into question just which among all BOL regulations are to be enforced.

Government Interventions in Financial Markets and Their Impacts on Private Rural and Microfinance Institutions

By far the predominant entity in microfinance in Viet Nam is the government's Vietnam Bank for Social Policies (VBSP), which currently provides some 6.8 million loans totaling $3 billion, 50 times the amount of the next largest entity (except for the People's Credit Funds, a cooperative financial system that might also be considered to be within the public sector). It is highly subsidized by government funds, complemented by borrowing, much of which is on concessional terms. The concessional terms with which it gets its borrowings allow it to offer loans at less than 1% per month and even at no interest at all in some cases. Because of the competition it poses, private-sector microfinance entities rarely charge interest rates higher than 1.5% per month, according to a survey carried out for the study. In addition, the VBSP, together with almost all of the 19 institutions surveyed for the study, relies heavily on local governments or mass organizations for client selection and loan recovery.[128] The situation is radically different in Cambodia. With only one inconsequential government-owned bank present, almost all private microfinance entities charge between 2% and 3.5% per month on loans and almost never rely on mass organizations for client selection or loan recovery, although almost half reported relying somewhat on local government officials for help. With this, Cambodia's microfinance entities are able to rely primarily on accumulated capital and commercial borrowing for their funding, and only rarely on donations or subsidized borrowing.

In the Lao PDR, the government's Agricultural Promotion Bank (APB) is an important rural finance provider, but unlike the VBSP in Viet Nam, its performance has been clearly problematic. It has negative capital and large amounts of nonperforming loans despite some earlier attempts at reform. It is too early to predict the outcome of the current major reform effort, which is in its final stages and involves both recapitalization and restructuring. However, based on preliminary analyses, more effort is probably needed to ensure the necessary shift in focus and culture. The future performance of the

[128] This raises major questions about sustainability. With the low interest rates charged, private-sector entities must rely heavily on mass organizations and local governments for the costly activities of client selection and loan recovery, with the mass organizations willing to do this because it strengthens their control over MFIs.

APB is thus unclear, as is its impact on private rural and microfinance entities. It is possible but not definite that its poor loan recovery will continue and "pollute" the credit market and make loan recovery more difficult for private entities.[129] Also, interest rates charged by private lenders in the Lao PDR may be constrained by the lower rates charged by the government banks. Moreover, private lenders use local governments and mass organizations for client selection and loan recovery more in the Lao PDR than in Cambodia but less than in Viet Nam.

Financial Products and Services

In all three countries, loans are offered in the three major formats that characterize microfinance worldwide: individual loans, group loans with small groups and joint responsibility for repayment, and group loans with large groups and joint liability or sometimes with individual liability. However, the countries diverge in their lending services. Loans are processed fastest in Cambodia; the time varies more widely across lenders in Viet Nam and the Lao PDR, but the average is somewhat shorter in Viet Nam. The percentage of clients returning for a follow-on loan is typically very high in Viet Nam (between 90% and 100%), possibly because of the role played by mass organizations, and somewhat variable across lenders in the Lao PDR and Cambodia but generally high.[130]

Deposit mobilization is the area with the greatest differences across countries and among institutions. In Viet Nam, partly as a result

[129] The situation is further complicated by denials of officials that the government's Nayoby Bank is truly a bank because its function is only to deliver subsidized credit and only in certain regions where poverty is deemed as extreme. Notwithstanding such denials, financial services are being delivered by the Nayoby Bank—and in a way that can undermine not only private-sector entry into these poverty areas but also the sustainability of private-sector finance in other areas that the Nayoby Bank could conceivably enter.

[130] In the Lao PDR, of the six MFIs and cooperatives reporting group loans, four reported that 90% or more return for follow-on loans, while two reported less than 30%; all 15 MFIs and cooperatives surveyed reported making individual loans, with four reporting that 90% or more return for follow-on loans; another five reporting from 70% to 85%; and the other six, 40% or less. In Cambodia, of the eight MFIs engaged in group loans, four reported that from 85% to 95% return for follow-on loans; two reported just under 70%; and the other two, less than 50%. Of the 11 MFIs making individual loans, seven reported that from 80% to 100% return for follow-on loans, three reported from 50% to 70%, and one reported just 15%.

of its regulatory framework, only very limited deposit mobilization is reported by private-sector entities, and most is in the form of compulsory deposits as the counterpart for loans.[131] By far the most deposits are reported by the VBSP, but these amount to less than $25 million, and all are compulsory. Because of this limited deposit mobilization, most lending by private and government entities is funded by capital and loans, with the capital often donated and the loans almost always on noncommercial terms—all of which calls into question the sustainability of rural and microfinance operations in Viet Nam. On the other hand, two of the private MFIs visited were not only taking voluntary deposits but were also making large numbers of small loans of less than $200, with one making more than $3 million available in more than 80,000 loans. While this lending operation is very small compared with that of the VBSP, it does suggest the positive role that could be played in Viet Nam by the private sector.

In Cambodia, deposit mobilization by microfinance entities is just beginning, as mobilizing deposits from the general population has only recently been allowed and no microfinance entity has qualified as yet to do so. Nonetheless, the track record of Cambodia's microfinance bank, the Association of Cambodian Local Economic Development Agencies (ACLEDA) Bank, is impressive, with $466 million in 344,657 accounts as of mid-2008. Of its deposit base, $223 million were in 329,512 savings accounts, which are typically preferred by low-income savers. Given the performance of Cambodia's microfinance entities in lending, one may expect that their mobilization of deposits from the public in general and from low-income people in rural areas in particular will expand very rapidly once begun.

In the Lao PDR, deposit mobilization is dominated by government banks, specifically the APB. Altogether, the deposits mobilized by the 13 formal MFIs surveyed for this study, which includes SCUs and some institutionalized semiformal providers, amounted to barely $1 million. Savings in the Lao Postal Savings Institute, which is licensed and categorized as an MFI but in reality functioning as a hybrid between an MFI and a state-owned commercial bank, totaled $2.8 million. The semiformal village savings and credit

[131] Only one MFI visited as part of the study reported voluntary deposits, and these amounted to only a few thousand dollars. Two others that were not visited reported similar amounts, and one (the Capital Aid Fund for Employment of the Poor) reported about $500,000 in voluntary deposits.

groups had accumulated substantial amounts of savings, although exact numbers were unclear. Recent estimates based on interviews covering only Lao Women's Union initiatives in Vientiane suggested a deposit base of $15 million to $20 million.

An interesting pattern emerges from the formal rural and microfinance providers in the three study countries, from which two general conclusions about savings behavior might cautiously be drawn. In particular, the number of liquid savings deposit accounts exceeded 1,000 for almost half of the 49 entities surveyed, while no entity had even 100 time deposits. On the other hand, only four of these entities had liquid savings deposits of more than $50,000. As for time deposits, only one entity had more than $150,000 and another had more than $500,000. This means that time deposits are highly concentrated, implying that the entities involved must pay special attention to liquidity risk management, On the other hand, liquid savings deposits are mostly very small, indicating that several of these entities are indeed serving low-income clients.

Outreach Issues

One of the most important questions that need to be answered in the three countries is what proportion of rural residents and especially the poor have access to financial services. Unfortunately, it is only in the Lao PDR that a thorough survey and systematic analysis of the outreach of formal finance services into rural areas were undertaken.[132] Aside from showing that outreach was extremely limited in the Lao PDR, this survey revealed other financial characteristics that could be extremely useful in designing more appropriate products and services. It found that among rural households, especially poor ones, transaction costs and the likelihood of actually obtaining a loan are far more important considerations than interest rates in taking out loans. This finding explains the frequent use of informal sources of credit, even those charging high interest rates. Furthermore, the survey showed that poor rural households borrow for nonagricultural purposes and that these families depend on nonagricultural activities to diversify against risks in agriculture. These discoveries, in turn, show that it is not useful to grant loans exclusively for agricultural purposes, with

[132] B. Coleman and J. Wynne-Williams. 2006. Previously cited. Also National Economic Research Institute, Committee for Planning and Investment. 2006. Previously cited.

repayments delayed to a relatively large lump sum at harvest time. In addition, the survey revealed that livestock, not deposits, are by far the most important form of saving for rural households at all income levels, followed by precious metals, jewelry, and building materials.

Unfortunately, comprehensive analytical surveys have not been carried out in Viet Nam and Cambodia, even though the survey instrument and sampling strategy used in the Lao PDR could easily be adapted for them. In any case, data at mid-2008 suggest that outreach, at least in terms of lending, is far better in both Viet Nam and Cambodia than in the Lao PDR. The two largest entities in Viet Nam, one a state-owned bank and the other a member-based financial cooperative, reach over 8 million borrowers with $4 billion in loans. However, the semiformal (at least partly private) entities surveyed do not account for even $25 million in loans and have only about 300,000 borrowers. Their outreach in deposit services is even more limited and almost entirely in the form of compensating balances against loans.[133] This may be because government officials in Viet Nam believe that outreach is already well handled by the VBSP and other government programs. Nonetheless, a survey such as that conducted in the Lao PDR might indicate where performance could be enhanced, on the deposit side in particular, if the financial behavior of the rural poor were better understood.

The outreach of private microfinance entities in Cambodia appears to be successful in the area of loans. Of the 14 Cambodian entities that report to the Microfinance Information Exchange (MIX), five are in its top Global 100 Composite Ranking, including one in the 19th position and another ranked 39th. Moreover, according to MIX's indicator for market penetration (the number of borrowers as a percentage of the poor), these five entities account for more than 13%. However, since only one of these (ACLEDA Bank) is a bank, their overall outreach on the deposit side is negligible. A thorough analytical survey of rural finance in Cambodia would be timely, with MFIs just now embarking on deposit mobilization. The benefits of designing products and services better could include lower transaction costs for loans.

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[133] MIX lists only five Vietnamese entities that report to it, and only one of these, the Capital Aid Fund for Employment of the Poor, appears in its top Global 100 Composite Ranking, at 99th.

Building Infrastructure for a More Viable and Inclusive Finance Sector

For rural financial services for low-income people, little financial infrastructure is required. Since under international best practices microlending is not based on formal collateral, there is little need to pay special attention to developing registries for land and moveable collateral or the related judicial systems and expertise.[134] Systematic information about borrowers and their behavior is needed, on the other hand, because character (along with cash flow) is a vital determinant of lending decisions at the micro level. Rural and microfinance operations can benefit greatly from credit bureaus that are effective in obtaining and sharing information about outstanding debts and repayment histories of potential borrowers.[135]

Another important component of infrastructure is training and technical assistance. These can be most effective when provided to associations of microfinance institutions, rather than to individual clients of donors and nongovernment organizations (NGOs). Banding together in an association also allows MFIs to present a united front to government officials in advocating policy on issues such as regulation.

Cambodia and Viet Nam have active microfinance associations that focus either on providing technical assistance and training for their members or on improving the regulatory framework for microfinance. Nonetheless, an inadequate legal framework has impeded the development and effectiveness of these associations. Cambodian law allows for only one professional association related to banking services, and such a group already existed for bankers. Thus, while leading MFIs had agreed by 2002 on the importance of establishing an association, this could only be formalized and registered as an

[134] However, these elements may be important for lending to small- and medium-sized enterprises. In many developing countries, there is a gap in loan size (sometimes called the "missing middle"), often between loans of $5,000 and $100,000, depending on the average income level in the country. This is in part because of the lack of infrastructure to deal with risk, given that SMEs are typically not as diversified as microentrepreneurs.

[135] International rating agencies are also an important element of financial infrastructure as they can enhance the access of an institution to international capital markets for both debt and equity, as well as provide useful guidance for potential improvements in an institution's performance. As far as can be ascertained, only Cambodian MFIs have been rated.

NGO in 2004. Not until 2007 did it arrive at an arrangement to become part of the bankers' association while retaining autonomy so that it could deal directly with the central bank on regulatory issues and other important matters.[136] In the case of Viet Nam, the Vietnam Microfinance Working Group as an association of MFIs has been active in both capacity building and advocacy, but association staff members argue that because it is legally only a working group, it cannot so easily obtain funding support or be an effective advocate. In the Lao PDR, international development agencies, especially the Asian Development Bank and international NGOs have played a relatively more important role than in the other two countries in providing some of the more basic infrastructure (e.g., development of accounting and auditing standards, legal and regulatory frameworks, and even payment systems). It is in this country that support might have the strongest positive impact. Nonetheless, only one local organization, the Microfinance Center Lao PDR, delivers specialized microfinance training and consultancy services. Although it has the ability and experience to engage in this work, it has a small staff.

As far as credit bureaus are concerned, only Viet Nam has sufficient infrastructure. It has a Credit Information Center (CIC) within its central bank to which all entities falling under the credit law are required to report all their credit transactions every 3 days. This reporting is done electronically, except for the financial statements of borrowers, using software that is supplied by the CIC, so that these data can be processed immediately. Banks and other lenders have a contract with the CIC under which they have access to these data. Thus, until an MFI has formalized, it would not automatically be part of this system. However, there appears to be nothing in the regulations governing the CIC that would prevent the CIC from voluntarily providing information to MFIs as well as acquiring information from MFIs. In the Lao PDR and Cambodia, credit bureaus do not operate under rules as adequate as those in Viet Nam. In the Lao PDR, all banks are required to report to and have access to credit bureau data, but reporting covers only loans greater than $3,000, thus making it of little use for microlending and for Laotian

[136] Its training and technical assistance activities also increased markedly in 2007, especially in the important areas of management information systems and information technology.

MFIs and SCUs.[137] In Cambodia, there is some basic ambiguity. The 2007 Annual Report of the Banking Supervision Department states that "the credit information system established for the commercial bank sector can be extended to the microfinance sector," but others argue that current laws prohibit the circulation of information about borrowers.

Major Issues Facing the Rural and Microfinance Subsector and Its Readiness for "Take-Off"

The Lower Mekong countries face different constraints on the sustainability and expansion of rural and microfinance services. In Cambodia, the major barrier appears to be a fairly simple one that may already be disappearing: the lack of a regulatory framework to allow MFIs to take deposits. With requirements for microfinance entities to offer deposit services to the public being established, a number of MFIs appear ready to embark on deposit mobilization, and their success seems likely, given their performance in lending in rural areas and even to the poor in several cases. Nonetheless, improved knowledge of the existing state of financial services in rural areas, including such important elements as cash flows, diversity in economic activities, and the use of informal finance, could make progress more rapid and help ensure that outreach is broader.

The case of Viet Nam is far more complicated since a large fraction of key government officials appear to believe that both sustainability and outreach have already been achieved under a system in which the government takes the lead not only in setting policies and establishing infrastructure but also in the actual provision of financial services. Perhaps even more difficult to resolve is the question of sustainability. While it is clear that the low interest rates offered on loans from government banks are subsidized to some extent, the results seen in most other countries where government banks offer subsidized loans—poor loan recovery leading to insolvency—are not found in Viet Nam. The role of mass organizations, especially the Vietnam Women's Union (VWU), is key, as these groups are able to enhance their power and control by offering client selection and loan

137 In the Lao PDR, there are also concerns about more basic elements of financial infrastructure, such as the adequacy of the payments system for even simple types of transactions, especially in areas outside of the capital, and the adequacy of accounting and auditing standards and the performance of accounting and auditing professionals.

recovery services without any apparent cost, not only to government banks but also to many private lenders. The unanswered questions are whether loans are being allocated where returns are highest and whether repayment is the result of financing profitable activities or of coercion (i.e., the threat of exclusion as punishment for non-repayment).[138]

Even though the rural and microfinance subsector in the Lao PDR starts from a lower level of development, certain aspects of the situation may make its problems potentially less difficult to deal with. The comprehensive analytical survey of rural finance in the Lao PDR, which has been referred to at numerous points in this study, makes it clear that the outreach of formal financial services in the Lao PDR is very low. While the government has begun to put in place some highly appropriate policies (e.g., the recent regulations on SCUs and MFIs taking or not taking deposits from the general population), many aspects of implementation at both the governmental and private-sector levels are likely to require continued improvement. At the government level, the effectiveness of actions to improve the regulatory and supervisory activities of central bank officials is not yet clear, nor is the effectiveness of efforts to improve the performance of the APB and to set an appropriate course for the new Nayoby Bank. (One question is whether governance is adequate to deal with the inevitable temptations to direct credit in ways that benefit government officials.) At the private-sector level, a more thorough understanding of international best practices in rural and microfinance would clearly help, as would more organized technical assistance that would be sustainable and not simply ad hoc. Protection of depositors for formal rural and microfinance service providers, part of the central bank's strategy for the finance sector, would need to be formally developed within the Depositor Protection Fund as part of the regulations, since the funding of the licensed rural and microfinance service providers is dependent upon accumulated savings that will be strongly influenced by regulatory requirements.[139]

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[138] The potential importance of coercion is seen in the lower loan repayment rates for members of the Viet Nam Youth Union, as young people have greater flexibility to ignore exclusion by simply "moving on."

[139] Great care must also be taken to ensure that effective prudential regulation and supervision are in place to avoid the serious moral-hazard problems that can occur in deposit insurance operations when adequate regulation and supervision are lacking.

Recommendations

Because of the different paths taken by the three countries and the resulting market outcomes, a set of "one size fits all" recommendations would not be appropriate. Moreover, because neither donor support nor absorptive capacity within each country is infinite, it is also important to prioritize the activities to be undertaken and the donor support to be sought.

The apparently very good performance by several profitable and hence sustainable private-sector MFIs in lending in rural areas and to low-income people has put Cambodia in a position to focus relatively narrowly on the main missing element: deposit mobilization. The government has laid out what appears to be a reasonable regulatory path to allow microfinance institutions to mobilize deposits from the population at large. MFIs clearly know their borrowing clienteles and lending risks very well, but the regulatory authorities now need to focus on helping MFIs identify the new risks that arise with deposit mobilization and how to manage these risks effectively.[140] Among these tasks are the upgrading of management information and information technology systems as well as acquiring improved capabilities for liquidity risk management and financial control. All these efforts can be supported by international development agencies, and with only relatively small amounts of funding required, with the management information system and information technology upgrades likely to be the most costly. This support should focus on providing experts with international best practice experience who have demonstrated their understanding of what is required for successful deposit mobilization in specific local contexts.

For Cambodia, the main challenges are to expand lending and, especially, deposit services. One requirement is a credit bureau that provides information about borrowers, thereby making lending operations less costly and risky. Another is for MFIs and banks to take special care to manage exchange rate risks in the face of the high dollarization of finance in the country. This requires not just matching

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[140] Elsewhere in the world, MFIs introducing deposit mobilization have often abandoned their microloan clientele, believing, like traditional commercial bankers, the myth that the rural poor have no savings to be mobilized or that mobilizing them must be too costly. These institutions have instead focused on pursuing large time deposits without recognizing either the risks in such a concentrated deposit base or that MFIs are at a disadvantage compared with commercial banks in dealing with such a clientele.

dollar liabilities with loans in dollars but also the capability to deal with the volatile supply of funds, which the Asian financial crisis of the late 1990s showed to be inadequate when borrowers' business operations did not provide dollars. Finally, a survey of rural finance similar to that carried out in the Lao PDR could be very useful for Cambodia, both to verify that outreach is really as good as it appears to be and to provide marketing information for the design and implementation of the most appropriate deposit products and services.

Viet Nam, like Cambodia, could benefit greatly from a rural finance survey in order to know the actual extent of outreach of financial services in rural areas and among the poor. In fact, without such a survey, it would probably be very difficult to persuade government leaders to make some changes in direction that would allow for more private sector participation in rural and microfinance. The current system lacks sustainability because of the subsidies provided through funding and also in the form of the participation of mass organizations in the processing and collecting of loans. However, these subsidies tend to be hidden by "tie-ins" with the objectives of mass organizations, especially the VWU.[141] A thorough analytical survey is needed to clarify the financial realities, along with technical assistance and training on best practices and new techniques for rural and microfinance as implemented elsewhere in the world.[142]

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[141] Only through a sophisticated survey of rural finance that fully covers the use of informal finance (and the reasons for this use) as well as the difficult issue of whether client selection and loan recovery involve implicit coercion rather than individual choices resulting from economic incentives and market forces will it be possible to provide convincing evidence that basic reforms are required. Such a survey will require not only the usual array of experts in statistics, economics, and finance but also rural sociologists and economic anthropologists.

[142] Among the important lessons that such technical assistance and training should convey is that microfinance is not primarily concerned with financing some micro-enterprise but rather with financing a poor family that almost certainly has developed a range of diverse economic activities in order to survive. This leads to focusing on the cash flow of the overall family rather than the cash flow of the enterprise as basis for selecting clients and structuring loan repayments. Traditional commercial bank lending also needs to be observed, but in modified ways: borrower's character can often best be inferred by observing the appearance of a potential microclient's family members and talking with his neighbors, while formalizing collateral is almost certainly too costly and likely to be no more effective than informal claims over items valued by the family such as bicycles and televisions. There are also key differences between the characteristics of effective bank employees and those of MFIs, as MFI loan officers need knowledge of local communities rather than university degrees. At the same time, delegation of responsibilities and incentives for loan officer performance to local branches, coupled with strengthened internal audit and financial control functions at the institutional level, are important lessons to be imparted from worldwide MFI experience.

Although the Lao PDR already has the important advantage of having an excellent survey of its rural financial markets, more progress is required for it to have adequate financial services in rural areas and among the poor. The government has begun to see the need to reform its finance sector and state-owned banks, and the BOL has issued a series of largely appropriate regulations defining the operating requirements for private-sector MFIs and savings and credit unions. However, the implementation of these regulations and, more generally, of improvements in the central bank's regulatory capacity presents a continuing challenge that is likely to require further support from international development agencies. Improving the central bank's regulatory capacity involves, among other actions, moving toward effective implementation of risk-based supervision, significantly reducing staff rotation, and not devoting scarce central bank resources to solving the problems of government bank operations, which are essentially political problems. At the same time, unless true progress can be made now in reforming them, government banks (the APB and the Nayoby Bank) will potentially continue to pollute the market through low interest rates and poor loan recovery. The involvement of commercial banks in the provision of financial services to the rural sector could have potential, but this requires, first and foremost, that the notice on the maximum interest-rate spread be formally withdrawn by the BOL.

Currently, there are few examples of successful private-sector rural and microfinance institutions in the Lao PDR, largely a consequence of the short time that has elapsed since an improved enabling environment has been put in place, especially the regulations allowing for a more formal microfinance sector.

Future support should focus especially on strengthening the infrastructure for the finance sector, which is currently inadequate. Training, education, and consultancy facilities are needed to produce qualified staff for financial service providers. A formal local organization supporting microfinance should be established to help spread best practices tailored specifically to Lao PDR conditions. Such a microfinance entity should raise awareness of the government's policy statement and the "good practice" principles on which it is based. This entity should also provide effective advocacy and support coordination of technical assistance. Moreover, training and technical assistance should cover improvements not just in lending techniques but also in deposit mobilization, to head off the emerging pattern of a heavy concentration of money in a small number of large time deposits. This pattern is not only potentially risky but also fails to provide meaningful deposit services for the rural poor in particular. Finally, it is recommended that an enabling regulatory framework be created for an association of rural and microfinance service providers, based on the recently issued decree on associations.

Appendix 1: Microfinance Institution Survey Questionnaire

MICROFINANCE INSTITUTION PROFILE

Date of Report: .... Country: ....

Name of institution: ....

Date of establishment: ....

Number of branches: ....

Total number of staff: ....

Of which loan officers: ....

Main geographical area of service (rural or urban): ....

Interest range of loan in local currency: From ...% per month to ...% per month

Interest range of deposit in local currency: From ...% per month to ...% per month

	Number	Amount
Number and amount of loans of term less than one year		
Number and amount of loans of term of one year or longer		
Number and amount of time deposits		
Number and amount of liquid sight (e.g., passbook) deposits		

How many days it takes to process a first loan: Group Loan: ... days Individual Loan: ...days

Percent of returning clients: Group Loan: ...% Individual Loan: ...%

Loan and Deposit Sizes:

Size Range	Number of Outstanding Loans	Amount of Outstanding Loans	Number of Deposit Accounts	Amount of Deposits
Less than $100				
From $100–less than $200				
From $200–less than $500				
From $500–less than $1,000				
From $1,000–less than $5,000				
From $5,000–less than $10,000				
Above $10,000				

Note: These are suggested ranges. If you already have your own system of keeping track on loan and deposit sizes, you may use it, so long as it is not dramatically different from these suggested ranges.

From your latest balance sheet, please provide the following:

	Amount (Please indicate currency)
Amount of total assets	
Amount of compulsory deposits required against loans	
Amount of voluntary deposits	
Amount of own capital (exclusive grants)	
Amount of donated capital (grants)	
Amount of commercial borrowings	
Amount of concessionary borrowings	

To what extent do you use mass organizations (e.g., Women's Union) for client selection and loan recovery:	Not at all	Somewhat	Almost always
To what extent do you use local governments for client selection and loan recovery:	Not at all	Somewhat	Almost always

Thank you very much.
We appreciate your kind cooperation.

Appendix 2: The Key Principles of Microfinance

Good Practice Guidelines by the Consultative Group to Assist the Poor

Commitment to applying good practices in microfinance comes from the highest levels of donor countries and agencies. In June 2004, the Group of Eight (G8) endorsed the "Key Principles of Microfinance" at a meeting of heads of state in Sea Island, Georgia, United States. Developed (and endorsed) by the 28 public and private member donors of the Consultative Group to Assist the Poor,[1] the principles are now translated into concrete operational guidance for staff of donors and investors.

1. **Poor people need a variety of financial services, not just loans.** In addition to credit, they want savings, insurance, and money transfer services.
2. **Microfinance is a powerful tool to fight poverty.** Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. **Microfinance means building financial systems that serve the poor.** Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.** Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.

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1 The Consultative Group to Assist the Poor now has 33 members.

5. **Microfinance is about building permanent local financial institutions** that can attract domestic deposits, recycle them into loans, and provide other financial services.
6. **Microcredit is not always the answer.** Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
7. **Interest rate ceilings hurt poor people by making it harder for them to get credit.** Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their cost, and these choke off the supply of credit for poor people.
8. **The job of government is to enable financial services, not to provide them directly.** Governments can almost never do a good job of lending, but they can set a supporting policy environment.
9. **Donor funds should complement private capital, not compete with it.** Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products.
10. **The key bottleneck is the shortage of strong institutions and managers.** Donors should focus their support on building capacity.
11. **Microfinance works best when it measures—and discloses—its performance.** Reporting not only helps stakeholders judge cost and benefits but also improves performance. Microfinance institutions thus need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).

Source: The Consultative Group to Assist the Poor.

Appendix 3: Cambodia's Rural and Microfinance as of Late 2003

Summarized from the Torres Report and Sources Therein

A 2004 report by Olga Torres for the World Bank is the only report on Cambodia that attempts to focus specifically on rural finance, but it suffers from the severe lack of data that can be used to measure financial and overall economic activity in rural areas with any degree of precision.[1] As in other reports on Cambodia, the agriculture sector is found to be the dominant employer in the overall economy (80%) and for the poor (70%), yet agriculture accounts for only 37% of economic activity (compared with 42% for services and 20% for industry). Extrapolating from available data, the Torres report estimates that microcredit reaches fewer than 13% of total Cambodian households and probably a far smaller percentage of rural households (even if non-rural households received no micro-credit, the percentage would be only 16% for rural households). Thus, to the extent that they use credit, rural households must rely primarily on informal sources of credit. Other sources of Cambodian data for the Torres report indicate that between 25% and 60% of rural households have debts and that these debts range between $65 and $150.

Friends and relatives are the most important sources of credit, accounting for around 40% in all the studies cited, with the use of moneylenders and marketing agents at around 30%, while estimates for the use of nonregulated microfinance institutions (MFIs) vary

[1] O. Torres. 2004. *Rural Finance and the Microfinance Sector in Cambodia*. World Bank.

more widely, from 15% to 30%, leaving virtually nothing for the formal finance sector, although some of the lending attributed to nonregulated MFIs may in fact come from formal regulated MFIs. The Torres report is also useful in understanding key points about the uses of credit, specifically, that most borrowing is not necessarily for agricultural production but is rather for a wide variety of purposes, including not only nonagricultural production but also education, ceremonies such as weddings and funerals, and especially emergencies arising from sickness or accidents. Furthermore, the crucial variables for lenders are the overall cash flows of borrowing households and not just those relating to agricultural production.

With respect to the conditions for rural credit in Cambodia, even less is known, although it appears that interest rates from friends and relatives can be very low or even zero, while moneylenders and even marketing agents often charge as much as 10% per month but sometimes 5% or less when there is competition and the household is well known to the lender. In addition, loan terms are typically quite short, just 3 to 6 months, and are rolled over when funds are needed for longer periods, thus adding further to lending risks. The Torres report also discusses the formal finance sector, noting that, with Cambodia's economy largely dollarized, there is significant foreign exchange risk either for the borrower or the lender depending on whether lending is in dollars or local currency. The few larger loans in rural areas from formal financial institutions are typically in dollars, but this applies mainly to the Association of Cambodian Local Economic Development Agencies (ACLEDA) Bank; as of late 2003, 16 of Cambodia's 24 provinces had no bank branch except for ACLEDA Bank, and 9 provinces had no bank branch at all.

Appendix 4: Viet Nam's Microfinance Institutions Visited for This Study

Capital Aid Fund for Employment of the Poor, Ho Chi Minh City

Among Viet Nam's semiformal microfinance institutions (MFIs), the Capital Aid Fund for Employment of the Poor (CEP), Ho Chi Minh City is the largest and the only one with a 5-star rating on the Microfinance Information Exchange (MIX) database for information disclosure in compliance with international microfinance standards. Its accounts have also been audited annually by KPMG since 2000, with a rating by the Planet Rating of B+ and a trend Positive/Stable in 2003 and 2007.

The CEP was established in November 1991 by the Ho Chi Minh City Labor Confederation based on the Grameen Bank model to provide credit on a nonprofit basis to reduce poverty among workers and the self-employed in Ho Chi Minh City and its surrounding areas. It has been growing rapidly and consistently ever since, its borrowers reaching nearly 75,000 by the end of 2007 and its loan portfolio amounting to almost $13 million, thereby exceeding its 2008 targets of 73,000 clients and a loan portfolio of $9.5 million. Much of this remarkable growth can be attributed to the $4 million kickoff grant it received in 2001 from the Australian Agency for International Development. It currently has a staff of 236 persons, of which 143 are credit officers working in 20 branch offices in Ho Chi Minh City and nearby areas.

The CEP provides three financial product lines: loans, savings, and health micro-insurance. Of these products, loans for household income-generating businesses are the most important, composing

95% of all loans. The CEP requires compulsory savings against loans and also offers voluntary savings for its clients. It has an in-house microfinance training center providing training to its staff and to other microfinance practitioners following its model. It is now looking to expand its operations to provinces adjacent to Ho Chi Minh City, focusing on Binh Duong and Dong Nai. The CEP's funding comes mainly from required savings and its own capital, each of which account for 25% of its funds, and concessionary borrowings, which account for about 30%. The remaining funds come from various sources that include donated capital. The CEP faces the challenge of securing funding to establish new branches and to finance new lending activities and is thus developing a new strategy to access commercial loans and private equity investment. During the meeting for this study, officials said the CEP had long been ready to transform into a formal, licensed MFI, but they were unhappily anticipating a slow licensing process and were disappointed at the less-than-optimal effectiveness of the State Bank of Vietnam's microfinance regulations. One major challenge facing CEP is the role of the Ho Chi Minh City Labor Confederation in governance and ownership.

Tao Yeu May Fund

The Tao Yeu May (TYM) Fund is the second largest and one of the most successful MFIs in Viet Nam.[1] It was established in 1992 by the Vietnam Women's Union (VWU) to implement the government's poverty reduction program, using the Grameen Bank approach. Currently, it has a staff of 187, of whom 111 are credit officers located in 26 branches, mainly in the rural areas of 9 northern and central provinces. With a gross loan portfolio of more than $7 million, the TYM serves nearly 32,000 clients, almost exclusively women. Its traditional Grameen approach to lending has worked well, yielding loan recovery rates consistently over 99% and a client retention rate of 96%. Because it follows the Grameen system of small groups being combined into centers, its staff efficiency is high. Moreover, even with an interest rate of only 1.2% per month, it has been able to accumulate earnings, although these are only a small proportion of its funding compared with mandatory deposits and donor funds.

1 Most of the figures are taken from TYM Fund Brief Sheet, July 2008, which was distributed at the Asia Microfinance Forum in Ha Noi, 26–29 August 2008.

By July 2008, it had an operational self-sufficiency rate of 172%. That its average loan size is $150, with almost two-thirds of its loans below $500, suggests that it is reaching low-income borrowers. TYM leadership recognizes that obtaining an MFI license to take voluntary deposits presents a major transition and plans to enlist the assistance of GTZ to help with the challenge of deposit mobilization.[2] In addition to its minimal experience with voluntary deposits, among the other major challenges facing the TYM are defining the role of the VWU in governance and ownership and testing whether VWU involvement can be as important for voluntary deposits as it apparently has been for loan recovery.[3]

Binh Minh Community Development Consulting Company

The Binh Minh Community Development Consulting Company (CDC) was established in 2004 as a limited liability company under Viet Nam's Enterprise Law to provide community development services, focusing on microfinance.[4] Although considerably smaller than many of the other MFIs that are planning to transform themselves into licensed deposit-taking entities, with only about 4,500 clients and an outstanding loan portfolio of slightly more than $500,000 as of June 2008, the CDC is strongly motivated and has a clear understanding of the challenges of transformation, not just in taking in voluntary deposits but also in incurring the expenses involved in transformation (e.g., costs for upgrading management information system and improving internal control and governance systems along with financial and liquidity management). To cover these costs, it is seeking grants and new equity and is planning to use the Planet Rating to increase its transparency and credibility and hence its attractiveness. Although its clientele is

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[2] The TYM has a history of substantial assistance, both technical and monetary, from a significant number of international entities, including the Center for Agriculture and Rural Development (Philippines), the Grameen Trust (Bangladesh), and the Savings Bank Foundation for International Cooperation/Sparkasse Essen (Germany).

[3] The VWU also runs another large MFI, the Viet Nam–Belgium Credit Program. This program began operating in 1997 under Belgian Government funding to the Government of Viet Nam. It works much like the TYM but in different locations. It is also preparing options for transition to a formal MFI.

[4] The data on the CDC are from the Binh Minh CDC Brief Sheet, July 2008, which was distributed at the Asia Microfinance Forum in Ha Noi, 26–29 August 2008.

primarily urban, with loan sizes ranging between $20 and $250, it is clearly focused on low-income groups and women, with its customer base being 75% poor and 97% female. Using a standard small-group approach to lending with compulsory deposits and weekly repayments with no grace period, the CDC has achieved excellent loan repayment consistently—a portfolio-at-risk ratio over 30 days at 0% over time. It also has good operating efficiency, with a cost per borrower amounting to $11 and a service ratio of 381 active clients per credit officer. It has achieved these efficiencies despite lending and collecting loans without the assistance of either local governments or the VWU. By the end of 2007, the CDC had full operational self-sufficiency. Nonetheless, it had to raise interest rates recently (to 30% to 40% per annum, depending on the type of loan) to cover operating costs and to maintain profitability against the high inflation rate in 2008, as well as to build equity for its hoped-for transformation to a deposit-taking MFI.

Quang Binh Counterpart

Although Quang Binh Counterpart is one of the smallest MFIs that report figures to the Vietnam Microfinance Working Group for publication, the numbers available are especially interesting in showing its loan portfolio in great detail, not only the excellent repayment record but also data on loan size broken down between new borrowers and returning borrowers. This level of detail reflects an excellent management information system, which is important for an MFI that is planning to be licensed to take deposits, even if its overall size and amount of equity are currently well below what is required. Its loan size figures also show that it is clearly targeting a low-income clientele. Furthermore, although its loan portfolio is funded overwhelmingly from borrowings, it has nonetheless been profitable and recently raised its standard interest rate on loans from 1.2% to 1.8% per month in response to rising inflation. Staff emphasized that working with the VWU for client selection and loan recovery is virtually essential but "complicated," especially as Counterpart seeks to maintain a partnership rather than ceding control to the VWU.

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Rural and Microfinance in the Lower Mekong Region
Policies, Institutions, and Market Outcomes

This study examines progress in rural and microfinance in Cambodia, the Lao People's Democratic Republic, and Viet Nam over the past decade, in comparison with industry standards set by international best practices.

The study focuses on the policy environment, including regulatory norms and their implementation, as well as support provided to financial infrastructure, and the impact of this environment on the development and performance of institutions providing rural and microfinance services.

This examination helps guide government and international development agencies as to which types of interventions can be most supportive of efficient and sustainable institutions that provide financial products and services to the poor, especially those in rural areas.

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