

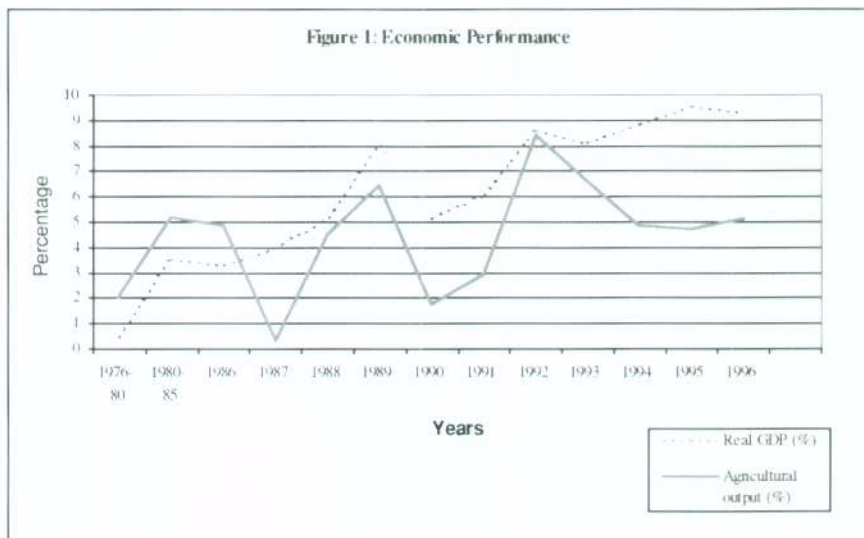
WHAT MAKES FORMAL RURAL FINANCIAL INSTITUTIONS SUCCESSFUL IN VIETNAM ?

Senanayake SMP. - University of Colombo, Sri Lanka

Ho DP. - University of Economics, HCMC, Vietnam

1. An Overview

With reunification in 1975, the Government of Vietnam was determined to introduce measures for a rapid socialist transformation, which resulted in what can be called as a "bureaucratic, centralized state subsidy system" in the whole country. Agricultural collectivization was attempted seriously in 1976-1980, so farmers were left with tiny private plots. During this period, GDP rose by just 0.4 percent annually and agricultural output rose by 2 percent per year. The industrial sector, which was meant to play the key role in the planned economy, grew at just 0.6 percent per annum, and all this growth was attributable to the small-scale non-state handicraft sector. The reforms began in 1981 with the dismantling of the centralized control of output and prices in the agricultural sector. Major reforms to the institutional framework of the economy were introduced in 1987-91, notably the passing of new laws including liberalization of foreign investment, granting the rights of using agricultural lands to farmers, amending the banking constitutions and liberalization of prices and wages policies. After two decades of reforms, the results were spectacular. Overall GDP rose by 9 percent annually, while total exports rose by 35 percent (7.100 USD billion in 1996 up from 350 USD millions in 1986). The country moved from importing cereals to exporting 3 million tons of rice and became the world's third largest exporter. As revealed in Figure 1, agricultural output has increased remarkably and has been stable since 1990. According to Haughton (1997), "a similar process occurred in Eastern Europe, with the important difference that there the industrial sector was relatively large and so its restructuring was traumatic enough to arrest economic growth in all cases. By contrast, economic reform in Vietnam and China was much less painful because the reforms led to rapid growth in the large sectors of agriculture and services"(p.48). The rapid growth in the agricultural sector stemmed from revising investment strategy during the 1980s. In spite of aiming at heavy industries, agriculture and rural development was also placed in a priority position. The contribution of the Agricultural sector to the GDP declined from 42 percent in 1989 to 23 percent in 1998. However, the absolute value of agricultural GDP increased remarkably while maintaining a stable growth rate of around 5.23 percent throughout the period. (VGSO, 1998.)



In the context of Vietnam, the following reasons led to the adoption of the strategy with heavy emphasis on agriculture. The limited amount of investment resources that was spent on heavy industries did not take comparative advantage of the country into account. These limited investments promoted capital intensive technology while labor resources were plentiful. Since capital was scarce during the 1970s, laying emphasis on agricultural development helped in achieving the following objectives: (1) increased the supply of food and non-food agricultural raw materials for domestic use; (2) increased people's income because over 80 percent of population are farmers; (3) provided growing markets for industrial output; (4) increased employment in both industrial and agricultural sectors and (5) provided savings of foreign exchange. Moreover, productivity growth in agriculture had a wider impact on other sectors of the economy. A large number of farmers were able to buy local consumer goods and demand products and services which are required in the agricultural production process. This resulted in the growth of both urban and rural non-farm output. Increasing farm output provided a reliable supply of food, increased the volume of

exports, and supported the growth in agro-processing. As a result, growth in agriculture contributed to the overall growth in the economy. The positive impacts of the agricultural reforms were increased farm incomes due to privatization in production and commerce as well as land ownership in rural areas. This opened a large-potential market for other sectors of the economy. In 1998, there were 11,974,515 households in the rural areas and engaged mainly in agriculture. Of these, 47 percent of total households needed credit and aggregate demand for credit reached VND 23,636 billion (USD 1,777 million). In other words, credit needs of farmers are very large. It can be stated without doubt that macroeconomic reforms in agriculture initially created demand for credit in Vietnam. In response to this demand, the formal financial sector has developed rapidly over the past decade. In 1990, demand of farm households for credit was mostly ignored by the Formal Financial Institutions. Only after 10 years of operation, the formal financial institutions met 68 percent of their demand. If there has been no effective reforms so far in the formal financial sector this performance could not have been achieved.

2. Assessing Performance

According to Hulme and Mosley (1996), the success of FRFI's can be measured by the default rate, profitability and Yaron's subsidy dependence index (SDI)¹. These indicators measure accurately the organization's financial efficiency.

¹ According to Jacob Yaron (1994), financial self-sustainability is achieved when the return on equity, net of any subsidy received, equal or exceeds the opportunity costs of funds. Dependence on subsidies is the inverse of self-sustainability. Because dependence on subsidies is in inverse proportion to self-sustainability, a subsidy dependence index (SDI) is suggested for tracking the progress and FRFI makes in reducing its dependence over time.

$$SDI = S / (LP \cdot i)$$

where S: Annual subsidy received = $A(m-c) + [(E \cdot m)] + K$; A: concessional borrowed funds outstanding; m: interest rate the institution would be assumed to pay for borrowed funds if access to concessional borrowed funds were eliminated; c: concessional rate of interest actually paid on concessional borrowed funds outstanding; E: average annual equity; P: annual profit; K: sum of all other subsidies received (subsidies without interest rate); LP: average annual outstanding loan portfolio of the institution; i: average on-lending interest rate paid on the loan portfolio of the institution. The SDI is calculated for the most recent years to determine whether an FRFI is actually making progress toward self-sustainability. If $SDI = 0$, it means that FRFI is fully self-sustainable; positive SDI means that some subsidy is required. $SDI = 100$, means that a doubling of the FRFI's average on-lending rate is required if subsidies are to be eliminated; negative SDI means that the FRFI has not only achieved self-sustainability but also the return on equity that exceeds the cost of imputed capital.

Table 1: Category of the Successful Institutions

Performance		Branches of type of institution						Total; % of total
		BRADs	CIBs	VBPs	PCBs	PCFs	RCCs	
Default rate (less than 5%)	Count	30	6	2	3	6	1	48 77.4%
	% within Type of institution	93.75	66.6	100	42.8	54.5	100	
Positive Profit	Count	31	9		7	11	1	59 95.2%
	% within Type of institution	96.9%	100%		100%	100%	100%	
Negative SDI	Count	30	9		3	11	1	54 87.1%
	% within Type of institution	93.8%	100%		42.9%	100%	100%	
Successful FRFIs	Count	29	6		2	6	1	44 71%
	% within Type of institution	90.6%	66.7%		28.6%	54.5%	100%	
Total	Count	32	9	2	7	11	1	62

Source: Ho DP 2001. The Mekong Delta Survey.

Note: VBARD (Vietnam Bank for Agricultural and Rural Development); CIB (Commerce Industry Bank); BP (Bank for the Poor); PCB (Private Commerce Bank); PCF (People Credit Fund); RCC (Rural Credit Cooperatives).

A low arrears rate appears to be a necessary, but not a sufficient condition of achieving profitability because a FRFI with low rate of arrears could have negative profits. For this reason, profitability should still be considered. However, if profits depend on external subsidy, they imply nothing about the efficiency of the organization, or even about its sustainability, since the elimination of subsidy can make an institution incapable of standing on its own feet. For this reason, Jaron SDI should be employed to evaluate the financial performance of FRFIs.

Assessed by these criteria and based on the conditions of Vietnam², a successful financial institution must satisfy the three criteria: *default rate under 5 percent; positive profitability; and negative SDI*. However an institution which has a positive SDI is

² In the Conference of credit activity in the VBARD system in 1996, experts concluded that an institution with default rate at greater 4 percent is considered to be not successful. Source: VBARD, 1997. The annual Report of credit activities in 1997.

considered as a successful institution if it makes sure that there has been a shift towards decreasing growth rate of SDI over 3 recent years. Based on these criteria, the successful institutions, as revealed in Table 1, comprise 71 percent of 62 institutions included in the study.

3. Why FRFIs Have Succeeded

Empirical evidence in Vietnam indicates that success of FRFI's depends on a number of factors.

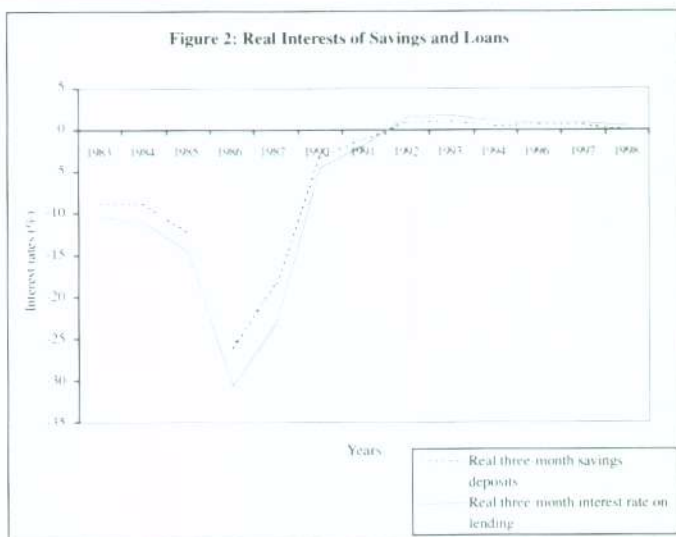
3.1 Mobilization of Savings

The structure of borrowed funds of the FRFIs has undergone a remarkable change towards a reduction in the share of concessional funds. Share of this source in total funds was 80 percent in 1980 in comparison with 12 percent in 1998. Savings deposits now form the major part of total borrowed funds, approximately 52 percent of borrowed funds came from savings deposits in 1998. The annual growth rate of savings deposits was 7.5 percent. It is interesting to find that whereas the growth rate of savers increased by 11.26 percent a year, the number of borrowers increased by 16.7 percent since 1996-98. These figures suggest that rural households have a capacity to save and have a confidence in the formal sector, and FRFIs are becoming sustainable in provision of loans to farmers because now they mostly use their own funds for this purpose.

3.2 Interest Rates and Spreads

In the past, Vietnam as a socialist country used the instrument of financial repression including negative real interest rates and an inverted interest rate structure. As revealed in Figure 2 and Table 2, the financial reforms of 1989 and latter reforms relied on interest rate and structural adjustment as one of its principal instruments. Since 1992, real interest rates of both savings and loans have been positive.

Figure 2: Real Interests of Savings and Loans



The structural adjustment of interest rates has shifted towards maintaining a positive spread of real interest rates. These figures explain how the formal sector has increased rapidly in mobilization of public savings and expansion of its lending activities. Moreover, this adjustment creates an opportunity, by which the formal institutions can maintain lending operations effectively. These had two important impacts on rural formal financial sector. First, it offered attractive returns to the general public, resulting in a massive inflow of domestic resources into the banking system. Second, it offered a positive margin to formal financial institutions. This resulted in providing loans to a larger number of borrowers by these institutions. Moreover the positive margins were sufficient to cover the formal institutions' operating costs and risks and hence ensured a viable and sustainable banking sector; this helped in encouraging growth in the financial sector as a whole.

Table 2: Interest Rates, 1983-1998

	1983	1984	1985	1986	1987	1990	1991
Inflation	11.9	13	17.5	46.4	32.5	7.7	4.8
Nominal three-month savings deposits	2	3	3	8	8	4	3.5
Real three-month savings deposits	-8.84	-8.84	-12.3	-26.2	-18.49	-3.4	-1.24
Nominal three-month interest rate on lending	0.43	0.43	0.47	1.38	1.93	2.7	3
Real three-month interest rate on lending	-10.25	-11.1	-14.49	-30.7	-23.07	-4.6	-1.7
Interest rate spread	-1.41	-2.26	-2.19	-4.5	-4.58	-1.2	-0.46

	1992	1993	1994	1996	1997	1998
Inflation	1.1	0.3	0.7	0.37	0.3	0.76
Nominal three-month savings deposits	2	1.4	1.1	0.9	0.85	0.8
Real three-month savings deposits	0.89	1.09	0.39	0.52	0.54	0.039
Nominal three-month interest rate on lending	2.7	2.1	1.8	1.25	1.2	1.15
Real three-month interest rate on lending	1.58	1.79	1.09	0.87	0.89	0.387
Interest rate spread	0.69	0.7	0.7	0.35	0.35	0.348

Source: Calculated from data in VoDai 1990; and Seibel 1992; and VBARD, 1999; and SBV, 1998; and Vietnam Women's Union, 1998.

Note: Real interest rate is determined by: $\{(1+r)/(1+p)\} - 1$, where r : nominal interest rate; p : inflation rate. The interest rate spread is the gap between the real rates of savings and loans.

3.3 Methods for Risk Reduction

The formal sector has popularized the devices which are helpful in minimizing the problems of information asymmetries in Vietnam. Table 3 shows that more than 50 percent of total institutions apply these techniques at present. They include group loan, incentive to repay and intensive loan collection.

We found that approximately 60 percent of total branches of all institutions have implemented group lending. The striking feature, as revealed in Table 2, is that branches within each type of institution have not implemented group lending uniformly. Over 55 percent of the bank branches of VBARD, CIB and VBP have implemented group lending method. Another important point is that the percentage of branches, which have adopted group lending is higher in the state sector than in the private sector. These figures suggest that there have been two alternative approaches to group lending in the formal sector. Why are there such differences? The other question is which one is more effective. Most probably these questions can be explained as follows. First, there has been an existing argument whether the group lending is really necessary while collateral is required in lending. The private sector is not likely to implement group lending method because the adoption of this technique could increase their operating costs. Moreover a head of the particular Self Help Group could

make decisions over the disbursement of loans. This has taken place in the context of Vietnam so far. In contrast to the private sector, the state sector argued that it is so difficult to screen borrowers while information asymmetries are really existing in the rural credit market. This process of screening can be done effectively through providing group loans.

Second, there is no basis to come to a conclusion which alternative has been better, so far in Vietnam. However it could be stated, no doubt, that group loan is very necessary when lending without collateral. Table 2 shows that all the branches of banks for the Poor (VBP) implemented this method.

Table 3: Methods for Risk Reduction

		Branches of various institutions						
		State sector			Private sector			
		VBARDs	CIBs	VBP	PCBs	PCFs	RCCs	
Group loan	Count	25	5	2	1	3		36
	% within type of institution	78.1%	55.6%	100%	14.3%	25%		58%
Incentive to repayment	Count	16	5	2	6	4		33
	% within type of institution	50.0%	55.6%	100%	85.7%	33.3%		53.2%
Intensive loan collection	Count	28	9		7	2		46
	% within Type of institution	87.5%	100%		100%	16.6%		74.2%
Total	Count	32	9	2	7	12	1	62

Source: Ho DP 2001. The Mekong Delta Survey.

The most important method, by which the pressure to repay can be increased is to provide "incentives to repay". Its major forms are offering progressive loans for those who have repaid previously taken loans, profit-linked bonuses for local staff and charging a very high interest rate on overdue amount of the loan. Charging a higher rate of interest on overdue loans has been a regular practice of banking institutions since 1990. Therefore, the incentive to repay is defined as either the profit-linked bonuses or the progressive lending adopted by institutions in our study. Based on these criteria, Table 2 shows that 53 percent of all branches use the method of providing incentives to repay. Our survey found that the most favorite form of incentive mechanism is a combination between progressive lending and higher rate on overdue loans. It was also found that

various combinations of these forms have been adopted by FRIFs in Vietnam.

Table 4: *Forms of Incentive to Repay*

	No. of responses	As a % of total responses
Progressive lending + Higher rate on overdue loan + the profit-linked bonuses	12	36.36
Progressive lending + Higher rate on overdue loan	20	60.60
Progressive lending + the profit-linked bonuses	1	3.04
Total branches applied incentive mechanism	33	100.00

Source: Ho DP, 2001

Another method, by which it increased pressure to repay, is intensive loan collection. As shown in Table 2, seventy-four percent of total branches have implemented this form.

Both theory and evidence in LDCs suggest that there may be more than proportionate reduction in default rate while these techniques are applied. There has not been a basis to come to such a conclusion in the context of Vietnam in the past. However it could now be stated without doubt, that intensive loan collection is gaining popularity in Vietnam.

3.4 Organizational Structure of FRIFs

The organizational structure of formal financial system has been vertical, proceeding from local to regional to national levels. For instance, Vietnam Bank for Agriculture includes transaction offices at village level, district branches, provincial branches, and regional branches. It covers the whole country widely. Each branch is a financially-independent unit under the control of VBA. Vietnam Bank for Agriculture comprised a branch network which in rural areas numbered about 500 branches and 200 transaction offices, staffed by about 28,000 employees in 1990. This network has now expanded up to 2,000 branches and transaction offices with a total staff of 20,000. In the case of People Credit Funds, the system comprises village PCFs, regional PCFs and central PCF. Up to 1996, this system included 588 village PCFs with 188,000 members. According to Mellor and Desai (1993), vertically organized FRIFs are needed because they are capable of integrating national and regional financial markets, providing human know-how to lower-level units, and decentralizing decisions on rural financial operation. With integration, internal economies of scale in

financial and transaction costs can be reaped, with consequent positive implications for viability. Moreover, it plays an important role to overcome weaknesses of segmented credit markets in rural areas. Another characteristic of FRFIs' organizational structure in Vietnam is, that almost all of the formal institutions are concerned with expanding a larger number of branches and transaction offices covering a small land area per unit. Both VBA and PCFs have transaction offices at village levels. This also includes RSHBs. A high density of FRFIs in rural areas affects rural financial market development positively. First, it improves accessibility for both rural households and formal lenders, which in turn generates understanding of specific situations, bringing about improved appraisal, monitoring, and evaluation by FRFIs. Second, it enables the scope of lending and non-lending operations to be widened and intensified in order to reap scale economies, which are crucial to the spread of the common transaction costs peculiar to FRFIs. Third, it facilitates effective competition with informal lenders, thereby enlarging coverage of farmers and other rural households. Finally, it reduces transaction costs of borrowers and depositors. Our survey finds that the number of field-level units per 1000 hectares of cultivated land is approximately 0.6 on the average of all FRFIs, especially VBARD with highest level of 0.78.

There have been large differences of banking density among different institutions. Almost all FRFIs, which had low density, have established and entered into rural financial markets in the recent years. The VBARDs and CIBs have, no doubt, more advantage in reaping of scale economies, screening clients, competing efficiency and reducing the transaction costs of borrowers and depositors.

3.5 Externality

Improvement of rural infrastructure can make agriculture less risky and then will reduce the importance of information asymmetries between borrower and lender. In the context of Vietnam, the rural electricity system is one of the important factors impacted on operations of formal financial institutions in the rural areas. This is because the presence of this power leads to expansion of other amenities in rural areas such as telephone, and television network. As a result, information gap between borrowers and lenders becomes very small. Our survey finds that the percentage of rural households using electricity is very low, 65 percent of total rural households and differ from provinces within the region. There is a significant difference of the proportion of rural households using electricity in an area where formal rural financial

institutions are operating. Unlike other institutions the CIB and PCB operate in rural areas where the level of consumption of electricity by households is higher.

3.6 Modeling Determinants of the Performance of Formal Rural Financial Institutions

We can express expansion of borrower outreach and improvement of lending efficiency as follows.

$$\text{Number of borrowers} = f(\text{use of group loan, incentive to repay, number of savers}) \quad (1)$$

$$\text{Default rate} = f(\text{density of field-level units, percentage of rural households using electricity, loan collection, incentive to repay, lending rates}) \quad (2)$$

The variables used in equation 1 and 2 need to be defined. Number of borrowers refers to rural households that have borrowed money from formal rural financial institutions (FRFIs). Number of borrowers (NB) is measured as the average number of borrowers in the period 1996-98. Group loan is a form of lending by which FRFI disburses loans to borrowers through self-help groups. Incentives to repayment are defined as either profit-linked bonuses or progressive lending as adopted by FRFI. Number of savers (AP) is defined as rural households who have deposited savings in FRFIs. Group loan (D_2) and the incentive to repayment (D_3) are dummy variables. If an institution provided group loan, $D_2 = 1$ while institutions undertaking incentive to repayment have $D_3 = 1$.

We can deal with this regression model in the following logarithmic form:

$$\ln \text{NB} = \beta_1 + \beta_2 D_2 + \beta_3 D_3 + \beta_4 \ln \text{AP} \quad (1a)$$

The default function can be expressed as:

$$\text{DR} = b_1 + b_2 D_2 + b_3 D_3 + b_4 \text{MD}_d + b_5 \text{MDe} + b_6 \text{APr} \quad (2a)$$

For the equation 2a, the dependent variable here is the average rate of default in the period 1996-98. Default rate (DR) is defined as the proportion of due loans not actually paid six months from the due date. The lending rate (APr) is the average rate of interest that FRFI charges on lending. Density of field-level units (MD_d) is the number of field-level units per 1000 hectares of cultivated land. Level of consumption of electricity by rural household (MD_e) is a proportion of rural households using electricity in an area where FRFI is operating. The incentive to repayment (D_2) and intensive loan collections (D_3) involved mechanisms by which increased pressure to repay is adopted

by FRFI. D_2 and D_3 are dummy variables. If an institution undertook incentive to repay, $D_2 = 1$, while institutions undertaking intensive loan collection have $D_3 = 1$. Both models are estimated using data from 44 successful FRFIs in the Mekong Delta survey of formal rural financial institutions. The coefficients in the models are estimated by using the Ordinary Least Square method based on a cross-sectional data set.

For Model 1, the results of regression analysis show that the number of borrowers is higher for institutions undertaking mechanisms of incentive to repay and loan group than those who do not adopt them. As expected, the coefficients of variables for incentives to repay, loan group and number of savers are positive. For Model 2, the default rate is lower for institutions undertaking mechanisms of incentive to repay and intensive loan collection than those institution which do not adopt them. As expected, the coefficients of variables for incentives to repay, intensive loan collection, density of field-level units, level of consumption of electricity by rural households, and the lending rates are negative.

Table 5: Results of Regression Analysis

Table 3: Results of Regression Analysis						
Model 1: Cross-section regression –Ordinary Least Squares analysis. Dependent variable: Average number of borrowers in logarithm (Ln NB)						
Regression coefficient on independent variables						
Sample	N. of observations	Constant	Incentive to repay (D ₂)	Loan group (D ₃)	Average number of savers in logarithm (lnAP ₄)	
Our survey	44	5.434	.124	.787	.451	
Standard Error		(.499)	(.250)	(.274)	(.084)	
Goodness of fit	R	Adjusted R ²				
	.781	.580				
t values		10.884 ^a	.496	2.876 ^a	5.340 ^a	
Model 2: Cross-section regression –Ordinary Least Squares analysis. Dependent variable: Average rate of default (DR)						
Regression coefficient on independent variables						
Sample	Constant	D ₂	MD _d	MD _e	D ₃	APr
Our survey	0.0359	-0.0174	-0.0036	-0.0024	-0.0062	-0.018
S.E	0.015	0.002	0.002	0.003	0.008	0.064
Goodness of fit	R	Adjusted R ²				
	.798	.589				
t values	2.475 ^b	-7.233 ^a	-1.857 ^c	-.753	-.741	-.292

Notes: ^a significant at 1% level; ^b significant at 5% level; ^c significant at 10% level

4. Policy Implications

The results of Model 1 shows that the variation of number of borrowers depends on loan group and number of savers, as these explanatory variables are all statistically significant in the estimated model. We find that savings mobilization has a high positive impact on expansion of borrower outreach. This factor should be emphasized in formulating policies for outreach expansion. The results of Model (6.2) show that the variation of default rates depends on incentive to repay, density of field-level unit per 1000 hectares. We find that incentive mechanism to repay has a high positive impact on decreasing default rate. Therefore, this factor should be emphasized in formulating alternative policies for improving lending efficiency and reaching various targets set for the FRFIs. If the objective is to reach a larger number of borrowers, then FRFI should emphasize on savings mobilization. Meanwhile if the objective is to improve lending efficiency, then FRFI should focus on the incentive mechanism to repay.

Hence, we have empirical evidence to confirm that the improvement of the performance of formal rural financial institutions does not depend on a single factor but on a number of factors including savings mobilization and mechanisms of enforcement and incentives for repayment.

5. Conclusion

In this study various determinants affecting the performance of FRFIs in Vietnam were identified. It became abundantly clear that to analyze their performance any single theory is insufficient and therefore is necessary to use an amalgam of theories put forward especially by the Ohio school, the structuralists and the proponents of the Imperfect information paradigm.

The empirical evidence suggests that if the objective of an FRFI is to expand borrower outreach then it should concentrate on an increase in mobilization of savings, adopt group methods in lending e.g. through Self-Help Groups and providing incentives for repayment. On the other hand if the objective is to reduce the level of default rate then it is necessary to provide incentives for repayment, and maintain a high density of Field-level units. For the success of these FRFIs the government has to provide improved infrastructure facilities in the rural areas.

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Abstract

This paper uses original data from a survey of 62 Formal Rural Financial Institutions in Vietnam in order to analyse factors contributing to the success of these institutions. The results obtained by using regression analysis confirm that there is a strong correlation between borrower outreach and mobilisation of savings and also between low default rate and use of incentive mechanisms to repay. A correlation also exists between the number of field level units of the institutions and the low default rate. The analysis leads to the conclusion that alternative policies should be implemented if the lending efficiency is to be improved.



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